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 credit assessment of Ba2. The rating reflects the 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 come under pressure.

The bank has gradually expanded its small- and medium-sized enterprise (SME) business, which increased to over 22% of its total exposures in 2007 from around 12% in 2005 and 2006. This transition could generate some degree of uncertainty in its 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 and strong management team

- Social mission of helping the poor, while achieving profitability

Credit Challenges

- Small size weighs on efficiency and limits business scope

- Growing SME exposures may lead to strategy and operational changes

- Increased competition in a crowded banking market

- High funding reliance on institutional borrowing relative to the peers

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

Rating Outlook

The outlook for all ratings is stable. Moreover, continued rapid growth will necessitate capital replenishment soon, while the presence of growth risk requires the establishment of more prudent risk governance standards.

To comply with the target CAR at 14%, the Bank has obtained board approval to raise new capital by the first half of 2008.

What Could Change the Rating - Up

- Significant increase in market share and considerable strengthening of franchise

- Successful diversification of business without exposure to undue risks

What Could Change the Rating - Down

- Rapid growth, resulting in significant deterioration in asset quality

- Weakening of its capital position

- Increased competition, leading to significant deterioration in margins and profitability

Recent Results and Developments

XacBank reported unaudited net profit of MNT 2.89 billion for 2007, versus MNT 1.77 billion for 2006. The strong performance was attributable to 21.7% YoY growth in net-interest income.

Non-interest income rose 39.3% YoY on the back of growth in net fees and commissions income. However, its contribution to total operating income was moderate at near 16% for 2007.

Cost-to-income ratio rose to 69.6% for 2007, similar to that in the previous year, while asset quality was good and its non-performing loan (NPL or 90-day overdue loans) ratio was 0.6% at end-2007. Reported risk weighted capital ratio was 11% at end-2007, versus 15.8% at end-2006.

In December 2007, XacBank signed a strategic equity investment with the European Bank for Reconstruction and Development (EBRD) and International Finance Corporation (IFC) following the sale of shares by some of its shareholders including Newcom, MicroVest and Shorecap.

EBRD and IFC have acquired existing shares and each hold 10% in XAC-GE LLC, the holding company of XacBank. XacBank's total capital remains unchanged.

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, 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 adjustments in NPLs and risk-weighting for the bank's security holdings, and which resulted in weaker profitability, capital adequacy and asset quality indicators; and 2) volatility inherent in the operating environment in Mongolia, and uncertainty about the impact of changes in business strategy and operation due to its expanding SME businesses.

Qualitative Rating Factors (70%)

Factor 1: Franchise Value

Trend: Improving

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

However, the bank's overall franchise is still small, albeit its market share gains in system loans to near 5% at end-2007 from slightly over 3% in 2004. The franchise value score is further weighted down by uncertainty about earnings stability and its lack of geographical diversification. 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 diversifying into the SME segment, which could have different business models and risk-return characteristics.

Management has made efforts in enhancing its risk infrastructure before expanding on SME business, including recruiting foreign advisor in respect of staff training, risk management and operating a specialized SME center. Sustainability of its growth strategy in SME in terms of risk-adjusted return throughout the cycle will be a credit positive if it's a proven successful niche franchise.

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 60.2%-owned by a number of foreign investors, including Mercy Corp, a US-based non-profit organization, Micro Vest, ShoreCap International and Triodos. The addition of two new investors, EBRD and IFC, will further strengthen its corporate governance practices.

Moody's believes the bank's international shareholders are very supportive, 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 credit concentration risk. In addition, liquidity and market risk management are at a developing stage, given system and technology constraints and the underdevelopment of the domestic capital market.

Meanwhile, the bank has endeavored to enhance its risk governance structure. Consolidated Risk Management Division is established to oversee credit risk, market and operational risks on a daily basis. For instance, sector limit is imposed and VAR (Value-At-Risk) is adopted to address FX volatilities.

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 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

All Mongolian banks are subject to the same 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 improvements since the banking crisis in the 1990s. The regulator -- Bank of Mongolia - has since issued regulations in areas, such as bank licensing, restructuring, internal controls, prudential ratios, on-site examinations as well as more recently corporate governance. All 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 weak by global standards and vulnerable to changes in Mongolia's volatile economic and complicated operating environment. More regulation and supervision efforts are needed, in particular, to help strengthen 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.

Quantitative Rating Factors (30%)

Factor 5: Profitability

Trend: Weakening

XacBank has excellent profitability ratios. The 3-year average pre-provision profits (PPP) to average risk-weighted assets (RWA) was 4.98%, while net income to average RWA was 3.48% between 2005 and 1H2007. However, the profitability performance, among various measures, is on a downward trend as a result of growing competition. Net interest margins, for instance, were 12.8% in 2006, dropping from over 14.1% in 2005, a prevailing trend witnessed in the banking sector. Accordingly, scorecard profitability ratios showed similar down trends in 2007.

Moreover, the bank's earnings are highly reliant on loan-interest income. By contrast, its non-interest income accounted for less than 16% of operating income in 2007. Given the small scale of the bank, operating efficiency has been low.

Overall, 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 requirements for assets rated B1, which is Moody's current rating for the 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. Its 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. Generally, XAC Bank relies more on wholesale (non-deposit) funding than its major rivals. At end-2007, loans to deposits measured 160.0%, higher than other major Mongolian banks. Short-term assets to total assets were 21%, relatively lower than the peer average.

On liquidity management front, the bank endeavored to resolve its system and technology constraints. On the other hand, insufficient development of the domestic capital market and money market as well as lack of hedging instruments constrain the bank's liquidity management. XacBank scores C- for liquidity.

Factor 7: Capital Adequacy

Trend: Weakening

XacBank has a solid capital position, but has steadily decline due to the rapid growth in its loan book. Its total capital ratio was 11% at end-2007, versus 15.8% at end-2006 and 21.1% at end-2005. Given Mongolia's volatile operating environment, XacBank needs to exceed 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 may therefore require a further capital supplement soon.

To strengthen its capital position, XacBank will raise new capital and issue subordinated debt in the near future. The latter, in Moody's view, is credit neutral due to the fixed charges that it incurs and its limited loss absorption capacity.

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 would need to be written-off from 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, operating efficiency has been low. Its 3-year average cost-to-income ratio was 70.45% between 2005 and 2007, high compared to that of similarly-rated peers. The bank scores D in efficiency.

Factor 9: Asset Quality

Trend: Improving

Asset quality has always been very strong and lending fully secured. Its NPL ratio was good at 0.56% at end-2007, versus 0.86% at end-2006, 0.47% at end-2005, and 0.4% at end-2004.

Loan concentration is low, but has seen a gradual increase with average loan sizes of MNT 1,266,000 (USD 1,088) at end-June 2007 versus the prior year's MNT 877,000 (USD 748), reflecting its emphasis of a higher-end of the market or SMEs and mortgages. From the long term perspective, increasing concentration risk may affect the bank's credit quality.

In line with the regulator's change in provisioning policy, XacBank reported declining NPL coverage ratio (reserves over NPL), from 334% at end-2004 to 94% at end-2006 and then to 123.9% at end-2007. NPL plus its past due loan coverage ratio (reserves over the sum of NPL and past due loans) accordingly fell from 128% at end-2004 to 61% at end-2006 and then rose to 74.7% at end-2007.

The bank managed to raise NPL coverage during the past year. On the other hand, its substantially high growth of the last few years has diluted its NPL ratios. It has become essential to contain NPL influxes well after consideration of the rapid growth in its loan book and the inherent credit charges of the economic cycle.

Overall, XacBank's asset quality is good. The adjustment of a portion of the SMLs in its NPLs exerted slight downward pressure on its strong asset quality score of A.

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 credit assessment of Ba2, Moody's assessment of "moderate" systemic support, and 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 over 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. Important considerations underlying Mongolia's foreign currency deposit rating are the high degree of dollarization of the 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 Credit 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: Franchise Value						**E+**	**Improving**
Market Share and Sustainability				**x**			
Geographical Diversification					**x**		
Earnings Stability					**x**		
Earnings Diversification [2]							
Factor: Risk Positioning						**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		**x**					
- Borrower Concentration		x					
- Industry Concentration		x					
Liquidity Management			**x**				
Market Risk Appetite					**x**		
Factor: Operating Environment						**D-**	**Neutral**
Economic Stability					**x**		
Integrity and Corruption					**x**		
Legal System			**x**				
Financial Factors (30%) [3]						**B-**	
Factor: Profitability						**A**	**Weakening**
PPP % Avg RWA	4.98%						
Net Income % Avg RWA	3.48%						
Factor: Liquidity						**C-**	**Neutral**
(Mkt funds-Liquid Assets) % Total Assets				13.28%			
Liquidity Management			x				
Factor: Capital Adequacy						**A**	**Weakening**
Tier 1 ratio (%)	16.56%						
Tangible Common Equity % RWA	16.17%						
Factor: Efficiency						**D**	**Neutral**
Cost/income ratio				70.45%			
Factor: Asset Quality						**A**	**Improving**
Problem Loans % Gross Loans	0.70%						
Problem Loans % (Equity + LLR)	3.72%						
Lowest Combined Score (9%)						**C-**	
Economic Insolvency Override						**Neutral**	
Aggregate Score						**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 (2005-1H2007)