

# 2008 RESULTS AND 2009 STRATEGY

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PSB ADAPTED ITS STRATEGY TO THE CHANGING MARKET ENVIRONMENT ALREADY IN MID-2008. MEASURES IMPLEMENTED BY PSB, AS WELL AS SAFETY MARGIN GAINED OVER YEARS ALLOWED THE BANK TO REPORT OVERALL GOOD RESULTS FOR 2008.

## 2008 KEY RESULTS

### ECONOMIC AND INDUSTRY ANALYSIS.

#### KEY 2008 ISSUES AND RISKS

2008 was the most challenging year for the Russian banking sector and the entire Russian economy in the past decade.

The deepening financial crisis with concurrent economic and political challenges in H2 2008 intensified the inherent structural problems of the Russian economy. As a result, Russian banks faced a severe recession.

Key negative factors, which affected Russia's banking sector on the back of the global financial crisis include:

- Shutdown of capital markets resulted in the significant growth of funding costs for private banks;
- Capital outflow and the stock market meltdown resulted in losses from securities transactions, falling market capitalization of major banks and the decreased value

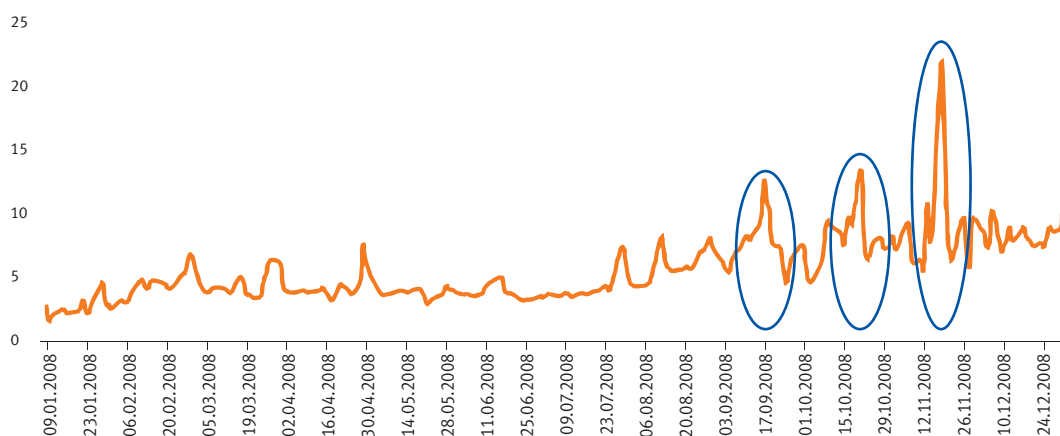
of securities used by corporates as loan collateral. This resulted in the confidence crisis in the financial markets;

- Rising inflation and consequent tightening of the monetary policy resulted in the higher refinancing rate and a limited liquidity in H1 2008;
- Significant RUB devaluation in Q4 2008 made it difficult for borrowers to service foreign currency-denominated loans;
- Growing unemployment, shrinking real household disposable incomes and decreased bank lending resulted in a major slump in domestic demand;
- Slumping demand, primarily for industrial products, and practically unavailable market funding for companies, which had relied on debt refinancing, resulted in defaults on corporate bonds and loans, as well as increased leverage and worsened creditworthiness.

The credit crunch and unpredictable situation in capital markets in 2008 were the biggest challenges for the Russian banking sector, including PSB. This resulted in a higher dependency of banks on government funding and an increased competition with state-owned banks.

Credit crunch hit the market in September – November 2008, accompanied by extremely high volatility of interbank loan rates.

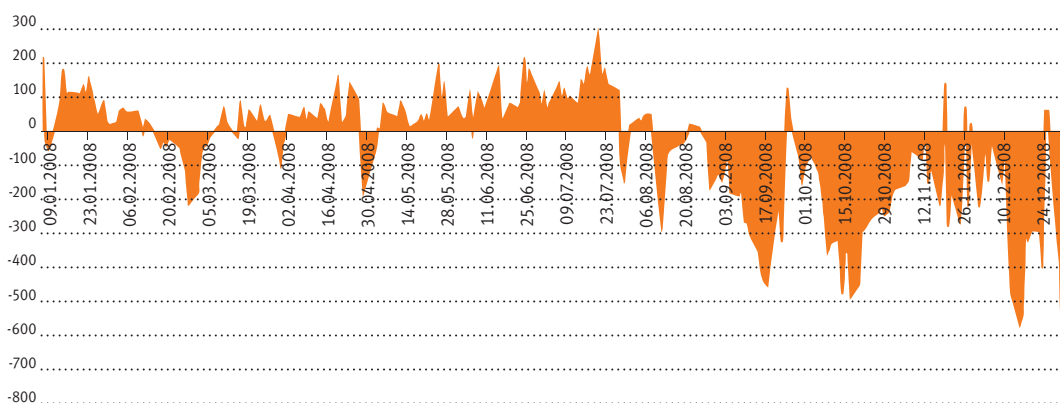
INTERBANK LOAN RATES (MIACR) FROM JANUARY 01, 2008 TO JANUARY 01, 2009, ANNUAL RATES FOR RUB LOANS, %



Net balance of liquidity provision / absorption operations by the Russian Central Bank (CBR) had a downward trend in 2008, as CBR

was forced to fill liquidity gaps in the banking sector throughout the second half of the year.

NET BALANCE OF LIQUIDITY PROVISION / ABSORPTION BY CBR FROM JANUARY 01, 2008 TO JANUARY 01, 2009, RUB BILLION



Liquidity situation improved in November – December 2008 on the back of the massive state support. Despite a certain lack of consistency in the government anti-crisis measures, they certainly helped to stabilize the situation and prevented the banking system from collapse. The announced government support measures included:

- Lowered mandatory reserve requirements;
- Raised limit on deposit insurance to RUB 700 thousand;
- Provision of more than RUB 950 billion subordinated loans to the banking sector;
- CBR is enabled to purchase corporate bonds and shares from banks in open market operations;
- Deposit Insurance Agency assumes responsibility for financial rehabilitation of economically significant banks and receives RUB 200 million for the purpose;
- Provision of uncollateralized loans to banks at CBR auctions;
- Extension of the CBR Lombard List to include shares and commercial paper by Russian issuers;

- Placement of temporarily available funds of the federal budget and state-owned corporations in bank deposits;
- Support to the Russian securities market via provision of RUB 175 billion funds to state-owned VEB (Vneshekonombank) to purchase Russian securities and corporate bonds;
- Government decision to buy troubled mortgages from Russian banks through the Agency for Housing Mortgage Lending and to boost the Agency's capital.

However, despite the measures taken by the Government the financial crisis developed into an economic crisis. This means that the key challenges for the Russian banks in 2009 will include asset quality and losses due to additional loan provisioning. Whether or not the banks are able to survive the crisis will depend on their ability to cope with these challenges.

#### ANTI-CRISIS MEASURES

PSB adapted its strategy to the changing market environment already in mid-2008. Equity investments had been reduced in advance, which allowed the Bank to minimize securities portfolio losses.

In the fall of 2008, PSB implemented additional anti-crisis measures and established clear priorities for the business segments:

- Accumulation of additional liquidity cushion;
- Reduction of lending volumes, abandonment of the most risky operations;
- Tightened loan underwriting standards, revised credit limits;
- Changed corporate and retail product mix;
- Review of the branch network efficiency and current staffing numbers;
- Focus on providing services to key corporate clients;
- Increased loan and deposit interest rates;
- Revised fees and commissions;
- Increased provision coverage of loans.

#### 2008 RESULTS

Measures implemented by PSB, as well as safety margin gained over years allowed the Bank to report overall good results for 2008. In 2008, PSB moved up in Russian banks rankings - from 12th to 11th place by assets and from 14th to 12th place by capital (under RAS).

In 2008, PSB loan portfolio (under IFRS) increased by 49% to RUB 319 billion, with the growth rate of 12% in H2 2008 overall, despite a 3% decrease in Q4 2008 following the implementation of anti-crisis measures.

Overall, corporate lending demonstrated strong growth in 2008. In particular, PSB solidified its positions in factoring and international financing. In 2008 PSB became a number one player on the Russian factoring market with 23.5% market share; was among top 3 banks in international financing with a 11% market share; and among top 10 banks by volume of corporate lending and funding.

In 2008, SME loan portfolio and credit card lending demonstrated a strong growth.

Despite the growth of overdue loans due to negative developments in the Russian economy, PSB does not consider the current level of overdue loans as alarming. To control further growth of overdue loans, PSB has implemented a range of measures, including a stronger monitoring of loan repayment schedules and case by case review of each borrower, which may lead to a request for an increased collateral or an agreement on a new repayment schedule acceptable to both parties, etc.

In 2008, PSB was the leader in inter-dealer bond REPO transactions; one of top 10 bond market operators on the Moscow Interbank Currency Exchange (MICEX). The Bank also strengthened its position among top 5 operators in the secondary market for RUB-denominated bonds, and a No. 1 operator in the federal loan bond (OFZ) market.

PSB managed to stabilize its liquidity position and finish the year with positive results. As at 1 January 2009, PSB had ample liquid assets. The quick liquidity ratio N2 was 75% (with the required minimum of 15%), while highly liquid assets stood at RUB 81 billion. The Bank received support from its shareholders, including Commerzbank, through their participation in additional share issues.

Measures implemented by PSB ensured a significant inflow of both corporate and retail deposits. The number of PSB corporate clients reached 70 thousand and retail clients - 950 thousand. Current accounts and deposits of corporate clients (non-financial organizations) increased by 53% year-on-year, and those of retail clients by 51%. PSB received two syndicated loans of US\$ 175 million and US\$ 280 million, and was the only bank in Eastern Europe to have successfully accomplished two Eurobond issues totaling US\$ 250 million.

PSB continued to expand and optimize its branch network. The Bank opened five branches in Stavropol, Penza, Syktyvkar, Tver and Lipetsk, and a first retail sub-branch in Cyprus. At the same time, it closed some inefficient points of sale (e.g. in shopping centres and car dealerships).

PSB continued to work toward its goal to become one of the most technologically advanced banks in Russia. In 2008, all PSB branches connected to online-banking PSB-Retail, and the number of users increased two-fold to 61 thousand people. The number of corporate clients using e-banking PSB On-Line was up 1.5 times to 33 thousand companies in 2008.

In 2008, PSB completed brand restyling. In line with the new corporate style, PSB updated its promotion materials, replaced signage and revamped both interior and exterior design at its offices and branches.

## OPPORTUNITIES IN TIMES OF CRISIS

### PSB STRATEGY FOR 2009

PSB key objectives in 2009 are to ensure the highest possible stability and efficiency of its operations, preserve shareholder value and serve the interests of creditors and depositors. The main focus will be on profitability, liquidity and capitalization adequate to the difficult market conditions. However, PSB long-term strategy — to become Russia's No. 1 privately owned bank in 2012-2015 — remains unchanged.

Key focus for all PSB business segments will be on asset quality and acceptable levels of overdue loans. PSB does not plan to significantly grow its business in 2009.

The Bank will continue to develop as a universal financial institution. Further development of business areas with proven strong performance,

i.e. factoring, trade finance and SME lending, is fundamental to achieving its objectives.

Given the lack of long-term resources in 2009, the main focus will be on promotion of short-term lending products for each client segment.

In 2009, the emphasis will be on enhancing risk management, ensuring adequate funding and maintaining a balanced portfolio of assets and liabilities.

A thorough monitoring of overdue loans implies their timely identification and early efforts to improve client payment discipline and debt collection efficiency.

PSB will pursue a balanced cost optimization policy to ensure its business profitability, while preserving the basis for further growth.

The Bank considers the current situation as an opportunity to optimize business processes, improve client service, foster talents and maintain the team's positive spirit.

PSB will pay particular attention to developing and promoting its brand driven by value propositions for each target client group.

The focus of Corporate Banking will be on funding and short-term high-margin lending products, such as factoring. PSB will strive to maintain leading positions in factoring and international finance. It will give a stronger emphasis to control and minimization of overdue loans, as well as to commission-based products, including settlement services. Comprehensive approach to client service and cross sales with Investment and Retail Banking will be key success factors.

SME lending is one of PSB priorities for 2009. High margins and efficient risk management are the main growth drivers in the segment. PSB will continue to offer a broad product range to its clients, primarily medium-sized companies, including deposit products and settlement services. PSB intends to increase commission income through offering clients bundled services.

Consumer loans and credit card loans under payroll schemes and loyalty programs will be PSB priorities in Retail lending in 2009, in addition to commission-based settlement services. Stricter control procedures, including an improved scoring system, and tighter loan underwriting standards will help to efficiently

control overdue loans increase. In addition, PSB will continue to thoroughly monitor loan repayments and will restructure loans in case borrowers have been laid-off or had their salary reduced.

In order to improve efficiency and quality of client service, PSB will continue to promote on-line banking PSB-Retail, and develop new products and partnership programs (banking insurance, co-branding, affinity cards issued in cooperation with charity and non-profit organizations). The focus will be on attracting retail funding through offering a broad range of deposit products, high service quality, as well as development of efficient services to VIP clients through Private Banking.

Investment Banking, including securities market operations and cooperation with financial institutions, is another key component of PSB long-term development strategy. In 2009, the main emphasis of securities market operations

will be on optimizing profitability and risks. Securities portfolio will be enhanced with liquid instruments and will serve an additional source of liquidity. Investment Banking will be looking for new sources of fee and commission income, participate in loan restructuring deals and optimize settlement services. Other priorities will include increasing funding from federal and local authorities and state-owned corporations, and refinancing or substituting international borrowings with domestic funding.

#### SALES CHANNELS

In 2009, PSB will continue to optimize its branch network. New outlets will be opened in cities and regions with the biggest business potential, while inefficient outlets will be closed. The key focus will be on reducing costs of sales and costs of service through optimization of business processes, centralization of back-office functions and development of on-line banking services and partner sales channels.



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# MANAGEMENT DISCUSSION AND ANALYSIS



THE COUNCIL OF  
PRINCES DMITRY  
IOANNOVICH AND  
VLADIMIR  
ANDREYEVICH  
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Chronicles,  
16th century*

AMID DETERIORATING CONDITIONS IN THE RUSSIAN ECONOMY AS A WHOLE AND ITS FINANCIAL SECTOR IN PARTICULAR, IN H2 2008 PSB CONTINUED TO GROW FASTER THAN ITS COMPETITORS, WHICH ALLOWED THE BANK TO MOVE UP IN THE RUSSIAN BANKS RANKING TO 11<sup>TH</sup> PLACE BY ASSETS.

## 2008 KEY FINANCIAL HIGHLIGHTS:

- Total assets grew by 57% to RUB 462 billion;
- Total shareholders' equity rose by 44% to RUB 40 billion;
- Operating income increased by 81% to RUB 28.2 billion;
- Cost-to-income ratio dropped to 43.8%, an improvement from 51.3% in 2007;
- Net provision charge for impairment losses totaled RUB 13.7 billion or 48.6% of operating income, up from 16.6% in 2007;
- Profit for the year amounted to RUB 1.6 billion, a decline of 58% against 2007;
- Total capital adequacy ratio as at 31 December 2008 was 13.14%, slightly down from 13.51% posted at YE 2007;
- Tier 1 capital ratio was 9.70%, up from 9.41% at YE 2007.

Weaker bottom line reflected a significant deterioration of the Russian economy and the financial sector in H2 2008, which caused worsening loan quality and a corresponding increase in provisioning for impairment – the key negative P&L driver for PSB in 2008. In addition, given a de-facto shutdown of both global and domestic capital markets, lack of liquidity in the banking sector and credit crunch in the economy, as well as a free fall of main stock market indices, PSB's primary focus was on maintaining low-margin liquid assets at significantly higher levels than prior to the crisis, which unavoidably affected the financial result.

At the same time, the strong growth of operating income, rooted in PSB's expanding customer base, represented the key positive P&L driver, which brought about a material improvement of the cost-to-income ratio. Another positive driver included enhanced overheads controls and modernized accounting systems; combined with measures aimed at increasing productivity, these resulted in revenues significantly outpacing expenses (81% and 55% annual growth, respectively).

Based on H1 2008 results, the management reviewed PSB asset growth plans, which brought the assets growth rate in H2 2008 down to 21% from 30% in H1 2008. However, in 2008 PSB grew faster than its competitors, which allowed it to improve the ranking position and become No. 11 bank by assets in Russia. Shareholders' equity was boosted by two share issues in the total amount of RUB 8.3 billion, placed among the existing shareholders. Amid the exacerbating global financial crisis in H2 2008, the possibilities of expanding the shareholder base and raising capital in the international capital market weakened. Coupled with the continued policy of full profit retention, the two share issues at PSB led to a slightly improved tier 1 capital ratio.

#### OTHER FINANCIAL HIGHLIGHTS:

- Net interest income rose by 81% to RUB 22.0 billion;
- Net fee and commission income doubled to RUB 4.7 billion, with its share in operating income increasing to 16.7%, up from 15.2% in 2007;
- Loans to customers, net of allowance for impairment losses increased by 44% to RUB 300.4 billion, which made up 65% of total assets (down from 71% at YE 2007);
- Customer deposits and current accounts rose by 63% to RUB 230 billion and accounted for 54% of total liabilities (up one percentage point from YE 2007).

The share of net interest income in operating income remained at a high 78% as PSB focused on its core business – customer lending – and reduced both the volume and the duration of its fixed income portfolio in times of increased financial market volatility. As PSB priorities in H2 2008 were on attracting customer funding and increasing the liquidity cushion, this resulted in a reduced share of loans and an increased share of customer deposits on the Bank's balance sheet. Deposits of state and local authorities were the fastest-growing funding component (five-fold growth in 2008). PSB also demonstrated its ability to compensate for the reduced access to international funding by the inflow of corporate term deposits, which doubled in 2008. Similarly, the growth in retail deposits at PSB (by 51% to RUB 53 billion) significantly outpaced the 15% Russian market average (as calculated from CBR data).

#### KEY FINANCIAL METRICS:

- Return on average equity of 4.6% (2007: 17.4%);
- Return on average assets of 0.4% (2007: 1.6%);
- Net interest margin of 6.7%, up from 6.2% in 2007;
- Liquid assets made up 28% of PSB balance sheet at YE 2008, up from 23% at YE 2007;
- Net loans to customer deposits ratio declined to 131%, from 148% at YE 2007;
- Non-performing loans (NPL) totaled RUB 8.9 billion, or 2.8% of gross loans before impairment charge, up from 0.7% at YE 2007;
- Coverage of gross loans by allowance for impairment increased to 5.8% from 2.4% in 2007, reflecting higher credit risks amid the economic downturn;
- NPL coverage by total impairment allowance declined to 208% from 365% at YE 2007;
- The aggregate amount of large loans (i.e. those exceeding 10% of shareholders' equity) accounted for 15.2% of gross loans, up from 11.4% at YE 2007;
- The aggregate amount of ten largest customer deposits and current accounts accounted for 38.3% of total customer deposits and current accounts, up from 21.6% at YE 2007.

## OVERVIEW OF 2008 FINANCIAL RESULTS

### NET INTEREST INCOME

Net interest income increase by 81% year-on-year was mainly driven by the strong growth of interest income from loans to customers (92% of total interest income in 2008 against 89% in 2007). Interest income from financial assets at fair value through profit or loss was the second biggest source of interest income, with a share in the total interest income at just 3%.

Interest expense grew at a slower pace than interest income, which resulted in a net interest margin increase to 6.7% from 6.2%. The biggest share of interest expense (47%) was attributable to current accounts and deposits from customers (40% in 2007) followed by

deposits and balances from financial institutions (25%), including resources provided to PSB for financing its clients' trade and project finance deals; own securities issued (19%) and other borrowed funds (8%). The sharp decline of the latter (to 8% from 14%), mostly comprised of syndicated loans with floating rates, was due to lower LIBOR rate in 2008 compared with 2007.

#### NET NON-INTEREST INCOME

The sources of fee and commission income, which in line with PSB strategy represent the bulk of non-interest income, remained well diversified and included documentary operations (23% of the total fee and commission income), money transfer fees (19%), servicing of plastic cards (16%), foreign currency operations (12%), operations with cash (11%), and banknote operations (6%).

PSB posted a RUB 1.8 billion net loss on trading securities (2007: net loss of RUB 124 million), attributable to the financial markets meltdown in 2008 as the Bank reduced its trading book and realized losses. However, interest income on securities and reverse repos in the amount of RUB 2.4 billion overcompensated for the trading loss. In addition, thanks to increased exchange rate volatility in 2008, PSB posted net foreign exchange (FX) gain of RUB 2.1 billion, combining net FX trading gain and net FX translation gain.

#### LOAN IMPAIRMENT ALLOWANCE

The loan impairment allowance increased more than threefold and as at 31 December 2008 amounted to RUB 18.5 billion. This increase was due to additional provisioning of RUB 13.2 billion net of a RUB 529 million write-offs.

#### OPERATING EXPENSES

General and administrative expenses increased by 55% to RUB 12.4 billion, driven by growth in employee compensation (in 2008, PSB headcount increased to 9.7 thousand employees from 7 thousand as at YE 2007), advertising and marketing expenses, costs of communications and information, and business development-related expenses.

Concurrently, PSB management implemented cost control measures, including a phase-by-phase implementation of the SAP-based management system and optimization of the branch network and staffing numbers. Operating expenses increased at a slower pace than revenues (55% and 81%, respectively), leading to an improved cost-to-income ratio at 43.6%, down from 51.3% in 2007. Other indicators indicating the improved operating efficiency include

a higher assets-per-employee ratio, as well as a low (2.7%) cost-to-assets ratio, unchanged from previous year.

#### LOANS TO CUSTOMERS

Gross loans to customers continued to grow rapidly in 2008 (up 49%). Loans to corporate clients (up 42% in 2008) accounted for the bulk of the loan book, yet the share shrank from 83% to 78% of gross loans, following even faster growth of loans to retail and SME customers. Keeping loan quality under control in times of an economic downturn and borrowers' inability to refinance maturing obligations became the main issue in lending in 2008. The proportion of loans overdue 90 days and more increased as follows: in corporate loans – from 0.15% to 1.37%, in SME loans – from zero to 1.89%, and in retail loans – from 3.94% to 10.54%. Furthermore, the level of restructured loans also increased, namely to 2.4% in corporate loans and 1.3% in SME loans.

#### TRADING SECURITIES PORTFOLIO

PSB trading securities were down from 9% to merely 3% of total assets, as the Bank continued to reduce dependency on the financial markets amid high volatility and reclassified trading securities in the amount of RUB 6.8 billion as investments held to maturity, aiming to decrease the impact of negative foreign exchange revaluation on the financial result. As at 31 December 2008, listed Russian corporate bonds comprised the bulk of the trading securities portfolio (44% of the total, up from 19% in 2007). PSB did not hold any material equity investments.

#### CUSTOMER FUNDING

In 2008, current accounts and deposits from customers rose sharply by 63% to RUB 230 billion, or 54% of total liabilities. Funding from corporate clients (68% of the total) was up 53% year-on-year. Particularly noteworthy was PSB's ability to compensate for the reduced access to international funding by increasing term deposits inflow from corporate customers (up 98% in 2008). Deposits from state and local authorities were the fastest-growing funding component, having grown five-fold from the previous year level. The growth in retail deposits at PSB (by 51% to RUB 53 billion) significantly outpaced the 15% Russian market average (as calculated from CBR data).

#### MARKET FUNDING

Funding from foreign financial institutions and market borrowings includes Eurobonds, RUB-denominated bonds, syndicated loans and

other borrowings. The total volume of such funding rose in 2008 by 37% to RUB 60 billion, or 14% of the total PSB liabilities (4 percentage points lower than in 2007). Unsubordinated and subordinated loan participation notes (Eurobonds) accounted for the bulk of market funding at RUB 26.8 billion, followed by syndicated loans (RUB 22 billion). The syndicated loans mature in 2009-2012, and as at the end of Q1 2009, PSB successfully repaid two syndicated loans in the total amount of US\$ 375 million, with no recourse to refinancing. Unsubordinated Eurobonds mostly have longer maturities, falling due in October 2010 and 2011, as well as in July 2013. The nearest subordinated loan maturity is in December 2011.

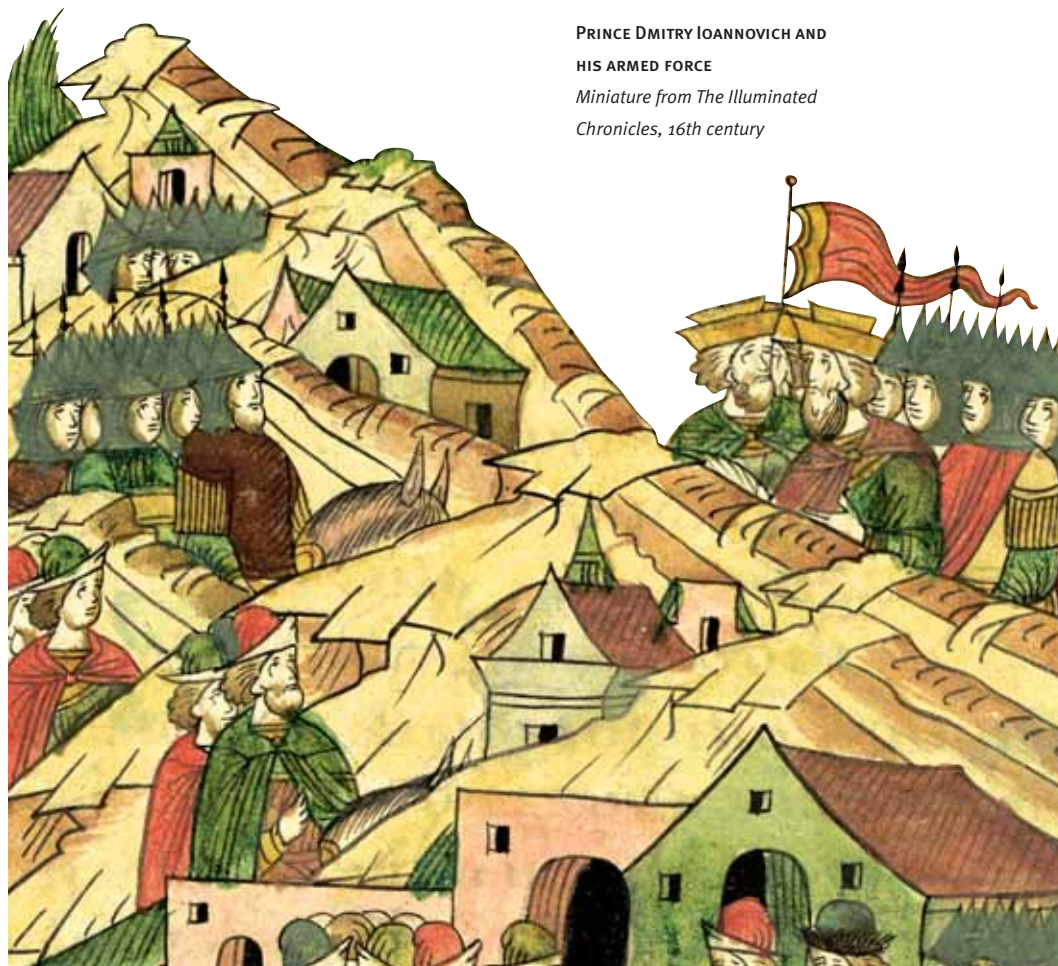
#### SHAREHOLDERS' EQUITY

In 2008, shareholders' equity increased by 47%, or by RUB 12.3 billion. The increase was mainly driven by: (a) two additional share issues totaling RUB 8.3 billion; (b) shareholders' commitment to full profit retention (RUB 2.7 billion); and (c) fixed assets revaluation net of deferred tax (RUB 768 million).

#### SUBSEQUENT EVENTS

In January-February 2009, PSB reduced deposits received from the Bank of Russia from RUB 57.5 billion to RUB 27.2 billion.

On 9 March 2009, PSB repaid in advance a US\$ 175 million syndicated loan. As per the terms of the loan agreement, the loan was due on 24 April 2009.



PRINCE DMITRY IOANNOVICH AND  
HIS ARMED FORCE

*Miniature from The Illuminated  
Chronicles, 16th century*