

# RISK MANAGEMENT



CONSTRUCTION OF  
A DITCH RUNNING  
FROM THE BORO-  
VITSKAYA TOWER,  
1493

*Miniature from  
The Illuminated  
Chronicles,  
16th century*

**JOINTLY WITH OTHER ORGANIZATIONAL UNITS, PSB RISK MANAGEMENT PROMPTLY REACTED TO THE DETERIORATING ECONOMIC CONDITIONS IN THE COUNTRY AND DEVELOPED A NUMBER OF ANTI-CRISIS MEASURES, WHICH ALLOWED THE BANK TO MAINTAIN RISKS AT ACCEPTABLE LEVELS AND MINIMIZE POTENTIAL LOSSES.**

2008 was characterized by strong turbulence and volatility in the currency, stock, debt, commodity and other markets. High uncertainty about the future development of the global economy had a direct effect on Russia, creating challenges in many areas of the economy and logically driving enhancement of risk management in business processes.

Jointly with other organizational units, PSB Risk Management promptly reacted to the deteriorating economic conditions in the country and developed a number of anti-crisis measures allowing to maintain risks at reasonable levels and minimize potential losses.

In addition, the Bank continued to implement the risk management culture and principles based on best practice and recommendations of the Basel Committee on Banking Supervision. This effort was particularly relevant amid the global financial turmoil. As the current situation calls for review of the existing methodology related both to risk management and business

processes, in 2008, the Bank adopted a number of new regulations and improved the existing ones.

Continuing to pay great attention to the automation of risk management processes, PSB launched implementation of Kamakura Risk Manager risk management system in 2008. The system will integrate market and credit risks management, assets and liabilities management, and transfer pricing modules.

PSB identifies credit, market, liquidity and operating risks as its key risks. In addition, PSB assesses and monitors other types of risk and takes measures for their mitigation.

## CREDIT RISK MANAGEMENT

### CREDIT RISK MANAGEMENT IN CORPORATE LENDING

In corporate lending, 2008 tested the resilience of the Bank's individual and portfolio credit risk management models. 2008 diminished

risk appetite and stimulated the improvement of existing and the development of up-to-date credit risk management tools, including anti-crisis risk management tools.

The Bank accumulated data for the transition toward quantitative (statistical) credit risk assessment models. To improve identification of potential problems at the initial stages of the lending process (at the stage of borrower's creditworthiness analysis), PSB consolidated statistical data on defaults and collected information about the causes of payment arrears. PSB also paid particular attention to processes designed to ensure completeness and accuracy of data needed for a portfolio approach to risk management.

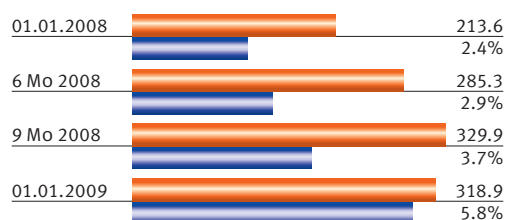
PSB finalized the development of models for the internal rating-based approach to corporate borrowers, including assessment of default probability. PSB adjusted the models based on the resulting corporate client ratings.

The collected data on overdue loans by industry allowed Risk Management Department to make recommendations on shifting the focus in lending depending on borrowers' industry and update approaches to portfolio credit risk management. In addition, PSB developed a set of criteria to assess industry risk and implemented an industry rating methodology.

As the crisis intensified, PSB launched a detailed daily monitoring of its loan portfolio, for early-stage identification of loan impairment. PSB thoroughly analyzed dynamics of client payments and loan collateral portfolios, and re-valued collateral based on its changed value.

PSB is strongly focused on managing problem assets, which is particularly relevant amid the market turmoil. PSB main objective in this area is prevention and minimization of material losses. In addition to measures already in place, in 2009, PSB intends to more actively involve local branches in managing problem

#### IMPAIRMENT ALLOWANCE TO GROSS LOANS



■ LOANS TO CUSTOMERS, RUB BILLION  
■ IMPAIRMENT ALLOWANCE, %

assets through better organizational, material, technical and methodological support of their operations in the debt collection area, as well as to use extrajudicial mechanism for collateral repossession as provided for in the amended Russian legislation.

#### CREDIT RISK MANAGEMENT IN SME LENDING

In 2008, PSB significantly improved SME credit risk assessment and implemented a set of risk mitigation measures:

- Established risk concentration limits, product limits and individual limits;
- Updated internal borrower credit rating procedures;
- Introduced risk management positions at branches and lending centers, who report to the Risk Management in the head office and are responsible for PSB units' compliance with SME lending procedures and assessment of credit risks while setting limits. In addition, PSB instituted monitoring specialist positions who report to the Credit Support unit;
- Developed operating procedures for SME credit committees in limit setting, problem loan management, and monitoring, which allowed for the optimization of the decision-making process;
- Implemented a system of regular on-site audits of lending operations quality at SME units;
- Renewed the management reporting system used to assess the loan portfolio quality.

PSB promptly reacted to market changes in Q4 2008 by adjusting its SME lending policy. PSB tightened lending criteria and requirements to borrowers, financial position of enterprises and collateral. In addition, PSB identified priority customer groups and industries least vulnerable to market turbulence; reviewed portfolio, shifting focus toward higher-margin products, shorter average maturities and un-collateralized loans.

#### CREDIT RISK MANAGEMENT IN RETAIL LENDING

In 2008, PSB improved the retail loan application review process. All applications are now collected in a single system, which automatically requests information on each borrower from a credit bureau as of February 2008. PSB significantly upgraded its scoring models for credit cards with grace period and

implemented measures for mitigating risks on interlinked credit card products through automatic repayment of overdue credit card debt, whereas funds are automatically transferred from a card with positive balance to a card with grace period.

In retail lending risk management, PSB uses «vintage» analysis and other statistical methods in addition to the regular update of its existing scoring models based on the credit history database and the Bank's own default statistics. To improve efficiency in this area, in 2008 PSB completed implementation of the SAS credit risk management solution, with an integrated retail loan portfolio risk-reporting module. The module is expected to mitigate risks through enhanced efficiency and day-to-day monitoring of risk dynamics by product and business unit (including branches and sub-branches).

To decrease the level of overdue loans and improve risk management efficiency, PSB has developed an interaction process between the head office and regional branches on risk monitoring and mitigation. The process includes data analysis on credit product risk levels at each branch, analysis of causes of default and overdue debt build-up, as well as development of common measures to improve the situation.

To mitigate credit risks and minimize potential losses due to the deepening economic crisis, PSB adopted in Q4 2008 a more conservative retail lending policy. New rules in the credit approval process take into account, among others, industry risks of a client's employer, and impose higher requirements on client creditworthiness. In addition, as of Q3 2008, PSB paid particular attention to monitoring long overdue loans, which may be related to the economic crisis, and implemented measures to prevent overdue loan growth.

In 2009, PSB plans to further enhance its retail lending process through introduction of borrower scoring in the consumer loan segment and revamp the existing scoring cards. PSB will also implement a set of measures aimed at reducing potential losses due to the economic crisis, improving overdue debt collection efficiency, including upgrade of the debt collection software based on Siebel application.

## CREDIT RISK MANAGEMENT IN OPERATIONS WITH FINANCIAL INSTITUTIONS

The key instruments to understanding credit risk level in operations with financial institutions (FI) are internal credit rating models that are based on best practice and use a broad range of quantitative and qualitative indicators. To minimize credit risks, PSB has set up and regularly reviews limits on operations with counterparty banks, related to individual instruments, bond and Eurobond issuances. Regular monitoring of counterparty credit quality and a moderately conservative limit-setting policy allowed PSB to minimize losses from operations with financial institutions, despite the challenging domestic and global market conditions.

In late 2008, PSB concluded an agreement with the Bank of Russia on partial compensation of losses from operations with banks whose licenses have been revoked. PSB drafted and agreed with the Bank of Russia a set of limits for interbank lending operations, which became a part of the agreement.

## MARKET RISK MANAGEMENT

PSB market risk management is based on a structured system of limits, including interest rate, equity and currency risk limits. The Assets and Liabilities Management Board Committee sets market risk limits, take decisions with regard to specific details of risky transactions, identifies the strategy and tactics of PSB market risk management. In 2008, PSB Risk Management further developed the market risk management system based on the methodology for market risk stress testing, adopted in April 2008.

To mitigate the impact of interest rate fluctuations on financial results, PSB continuously tests assets and liabilities for interest rate risk exposure. This allows the Bank to identify securities with the highest level of exposure to interest rate risk and set efficient stop-loss limits for open positions. The trading portfolio sensitivity to interest rate risk is assessed based on PVBP (Price Value Basis Point) indicator both for individual securities and the portfolio as a whole. To manage interest rate risk on trading positions in 2008 PSB used:

- Securities position limits;
- PVBP limits for each key debt trading portfolio;
- One-day and medium-term stop-loss limits.

PSB currency risk exposure is calculated for all open FX positions (OFP) and managed in accordance with the Bank of Russia requirements for open position limits. In addition, to manage currency risk, PSB applies VaR (Value-at-Risk) methodology both to the total OFP and to positions in all key currencies. In 2008, PSB managed currency risk exposure within the following limits:

- Total OFP and key currency OFP size limits;
- VaR limit;
- One-day and medium-term stop-loss limits.

### LIQUIDITY RISK MANAGEMENT

PSB has an efficient and responsive liquidity risk management system in place, which the Bank continued to improve in 2008. PSB has established key liquidity management procedures and requirements, set bottom limits for liquid and highly liquid assets, as well as liquidity gap limits. PSB manages its liquidity using up-to-date methods of stress testing, economic forecasting and statistical analysis.

In 2008, PSB adopted a liquidity risk limit system developed in line with the best international practice and recommendations of the Basel Committee on Banking Supervision.

The limits system is the first step toward a maximum efficient liquidity management. PSB continues to develop realistic cash-flow modeling and liquidity stress testing methodologies, based on Kamakura Risk Management application.

### OPERATING RISK MANAGEMENT

As part of PSB operating risk management, PSB collects, registers and analyzes data on operating risks. The existing operating risk assessment methodology (self-assessment of operating risk) allows PSB to monitor such risks both at the level of subdivisions and individual business processes, as well as develop efficient recommendations for risk minimization.

In 2008, PSB decided to develop and implement a fraud risk management system. To this end, PSB has built a separate database on both internal and external fraud events.

PSB approach to the identification of key risk indicators allows it to efficiently monitor the level of operating risk at key subdivisions and assess the probability of operating risk events occurring throughout the Bank. In the short term, this will allow PSB to transit toward advanced operating risk assessment approaches, in line with Basel II requirements.

### COUNTRY RISK MANAGEMENT

International operations remain one of PSB key focus, both in servicing its customers and performing its own operations. A thorough analysis of macroeconomic indicators and development trends, the assessment of regulatory base and international business practices in individual countries ensure comfortable cooperation with foreign companies. Established country limits represent reasonable restrictions allowing the Bank to minimize the default risk of the Bank's partners, arising out of economic, political or social disruption in their home countries.

HANDICRAFT AND  
TRADE QUARTER  
MINIATURE FROM  
*The Illuminated  
Chronicles,*  
16th century



# INTERNAL AUDIT AND CONTROL



GRAND PRINCE  
IVAN I FORTIFIES  
MOSCOW, 1335  
*Miniature from  
The Illuminated  
Chronicles,  
16th century*

PSB has developed an efficient internal control system to ensure legal and regulatory compliance, accuracy of financial reporting, efficiency of operations, as well as accommodation of rights and legitimate interests of Bank depositors, creditors and other counterparties.

PSB internal control system includes checks designed for timely identification of failures to comply with internal policies and procedures, a system of approval and delegation of authority, checks of compliance with the established limits and subsequent control over elimination of any identified irregularities. The internal control system efficacy is monitored by the Internal Audit and Control Department (IACD), which reports to the Board of Directors.

IACD performs internal audits of the Bank operations, issues recommendations with regard to their improvement, and assists the Bank management in ensuring its efficiency. IACD audits all organizational units in the head office and branches, as well as all transactions.

In accordance with the resolution of the Board of Directors, internal audit and control divisions were set up in 6 PSB branches in 2008, with the objective to enhance internal branch control. These divisions perform audit of respective sub-branches and other geographically close regional branches.

Such set-up of the internal audit and control system enables PSB to identify risks both in separate organizational units and the Bank as a whole.

# ANTI-MONEY LAUNDERING

PSB anti-money laundering system is set up in accordance with the provisions of the Russian Federal Law of August 7, 2001 On Combating Money Laundering and Financing of Terrorism, recommendations of the Bank of Russia and recommendations of the Financial Action Task Force (FATF).

The System aims at:

- Excluding the possibility that PSB products and services are used by criminal structures in their money-laundering schemes and operations;
- Minimizing reputational, financial and legal risks for PSB.

The Bank has developed and agreed with the Bank of Russia a set of relevant compliance rules, including:

- Client and beneficiaries identification and scrutiny;
- Ensuring that existing and potential clients are not listed among individuals involved in terrorist activities and financing of terrorism;

- Timely identification of operations subject to mandatory control, as well as operations that fall under doubtful operations, and sharing such information with the Federal Service for Financial Monitoring;
- Continuous anti-money laundering training of bank employees.

PSB has been consistently improving its Know Your Customer policy, paying particular attention to potential client identification, allowing the Bank to manage its reputational risks and counter the use of its products and services in money laundering schemes. In 2008, PSB rejected 672 client applications to open a bank account, in compliance with the existing legislation. Relations with 1,730 client were terminated based on regular monitoring results.

Short-term objectives include the expansion of the functional capacity of PSB anti-money laundering software, enhanced reliability of transaction identification systems and programs and improved procedure for data exchange between PSB head office and branches.

# MONITORING OF FINANCIAL MARKET OPERATIONS

In accordance with the Russian securities legislation, PSB introduced a system of financial market operations monitoring. The Monitoring Service is headed by the controller qualified in accordance with the applicable criteria of the Federal Service for Financial Markets (FSFM).

The key objectives of the Service include:

- Compliance monitoring of the Bank's operations in the securities market with the Russian legislation, regulations issued by FSFM and other relevant authorities, best practice of self-regulated professional participants of the securities market, as well as PSB internal financial market regulations;
- Identification, assessment and prevention of license and other risks associated with PSB operations in the securities market.

In the course of the prevention control, internal bank documents are reviewed for identification of risks and compliance with legislation requirements. Consulting and methodological support is provided to the Bank's divisions.

In 2008, the Bank's Monitoring Service conducted 25 audits and checks at PSB head office and sub-branches in Moscow. Based on the audit results, the Service developed suggestions and recommendations for elimination of irregularities.

The Bank Monitoring Service priorities include enhancement of functional capabilities of the Bank's securities transaction software; improvement of monitoring methodology; and development of measures aimed at preventing use of insider information and price manipulation in the securities markets.