

RISK MANAGEMENT



THE ROLE OF RISK MANAGEMENT IN PSB BUSINESS PROCESSES INCREASED SIGNIFICANTLY IN 2009. IN CORPORATE BUSINESS, PSB ADOPTED THE NEW CREDIT POLICY, IMPLEMENTED NEW CREDIT ANALYSIS, LAUNCHED OPTIMIZATION OF LENDING PROCEDURES AND ESTABLISHED A PLATFORM FOR SYSTEMIC CREDIT RISK MANAGEMENT. IN SME BUSINESS, WE INTRODUCED A RISK MANAGEMENT SYSTEM INDEPENDENT OF THE CLIENT BUSINESS AND LAUNCHED REGULAR LOAN PORTFOLIO QUALITY MONITORING.

The role of risk management in PSB business processes increased greatly in 2009. Uncertainty as to when the global economic crisis would definitively end, and as to its exact consequences, made it indispensable to clearly understand and assess risks, with the view of their subsequent minimization at all stages of business decision-making.

A relative stabilization as of mid-2009 enabled us to transit from drastic anti-crisis measures, which effectively depressed business activity, towards a comprehensive potential stress projection system. Implementation of a set of measures aimed at prevention of significant stress-induced losses allowed us to resume operations across various business segments, while maintaining risks at acceptable levels.

In 2009, we pursued implementation of risk management culture and principles based on the best international practice and recommendations of the Basel Committee on Banking Supervision.

Our key risks are credit risk, market risk, liquidity risk and operational risk, including fraud risk. In addition, PSB assesses a number of other risks and implements measures to minimize them.

CREDIT RISK MANAGEMENT

CORPORATE BUSINESS

In 2009 one of the key measures aimed at increase of the efficiency of credit risk management amid the continuing financial and economic crisis, has been a project of large-scale reengineering of the credit process in respect of corporate clients. The reengineering covered all its basic stages - from the analysis of clients and the decision-making on lending to subsequent monitoring and handling of problem loans.

The framework for improvement of the system of credit analysis made by credit subdivisions has been the shift of focus from assessment of the creditworthiness of direct participants of a credit transaction (the borrower, the guarantor, etc.) to the complex and comprehensive analysis of stability and solvency of the business of the whole group of companies including prospective participants in a transaction. Included in this project has been the revision of the internal methodology of credit analysis, including the development and approval of a new form of credit opinion in which a structured approach to the documentation of analysis of results is imple-

mented, including the assessment of qualitative characteristics and financial indices of the client.

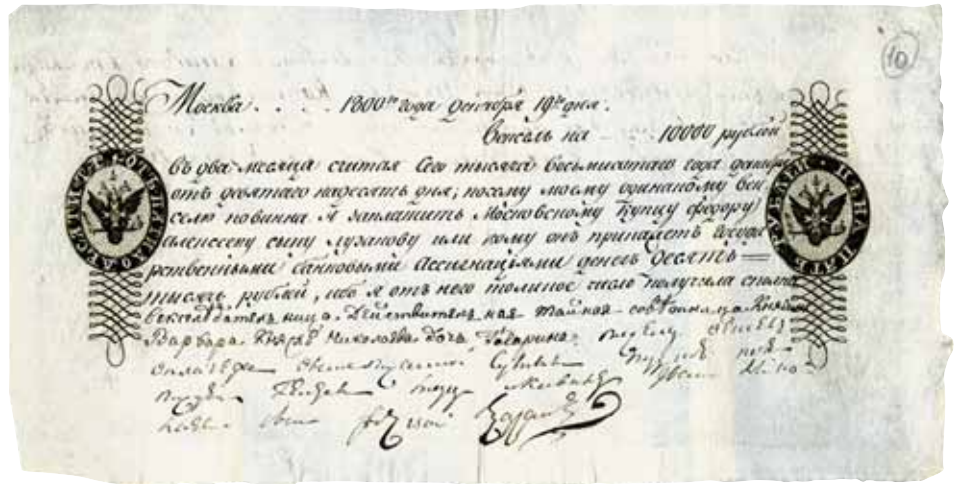
Instead of the previous practice of approval of each credit transaction by an authorized body, a principle of establishment of a single lending limit has been introduced that restricts all risks of the client and reflects the conditions on which the Group is ready to bear these risks. Thus the lending limit determines the list of credit products that are authorized to be granted to the client, the conditions for their granting and further support, and also the parameters, frequency and criteria of subsequent monitoring of the established limit. Introduction of limits has allowed the optimization of the process of granting of credit products due to the fact that each transaction with the client does not require an authorized body's decision, and only a check is required that the lending limit established for the client has not been breached.

To improve the quality of credit risk assessment and management, PSB set up a new credit risk management unit, Credit Risk Analysis Department, which ensures independent analysis of applications for corporate clients' limit setting.

In 2009 there were changes made to the system of authority to make decisions on corporate clients lending: in order to increase the efficiency of decision-making, a part of the authority of the Credit Committee has been delegated to the Operational Credit Committee. In addition, the Group applies the "four eyes" principle where a decision is made only in case the client's authorized manager and the risk manager have reached an agreement.

The system of monitoring of lending limits established for corporate clients is being transformed with the introduction of a new system aimed at consolidation of all limit information in a specialized subdivision of risk management – Credit Risks Monitoring Department. In addition, we have been pursuing automation of lending limit, decision-making process, identification of lending limit breaches by clients and remedy measure control.

To limit concentration of credit risk, PSB put in place a portfolio limit system setting limits for largest borrowers, related parties and industry limits. Portfolio limit monitoring is based on the early warning principle: the Bank management receives a warning when limit utilization reaches 90%, which ensures promptness of management decisions with regard to overall credit risk limitation.



In 2009, PSB significantly revamped its operating management accounting system used for assessment of its loan portfolio quality. We developed a methodology for projection of likely levels of overdue and impaired debt.

PSB pays particular attention to processing corporate clients' problem assets, with the view of preventing and minimizing losses for the Bank. Pre- court work with clients with overdue debt is now a separate operating segment. In addition, we implemented problem loan security portfolio monitoring and set up a single problem loan security database.

In 2010, PSB intends to automate its problem loan security database, implement the process of security disposal through various auctions, and broadly apply out-of-court security foreclosure procedures in line with the relevant new legislation amendments.

SME BUSINESS

In line with the best risk management practice, SME credit risk management was in 2009 consolidated within a separate business unit, which increased its independence of its judgment and reflected a further step towards implementation of a systemic approach to PSB credit risk management.

In order to increase the efficiency of decision-making and minimize losses, PSB introduced risk reporting, regularly presented to management, in respect of the condition of credit portfolio of small and medium business. This includes reporting that reflects the results of analysis of the reasons for defaults and increase in overdue indebtedness. A system vintage analysis of overdue indebtedness has also been developed, i.e. analysis of overdue loans dynamics in SME loan portfolio granted during the same period of time. The system allows assessing the impact of changes in credit process, client and client business requirements, product metrics and other external factors, on overdue loan levels.

As part of the credit product pricing process improvement, PSB in 2009 implemented a risk premium calculation methodology based on retrospective loan portfolio quality analysis combined with

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projection of default levels for SME loans.

PSB reacted in time to the change in market conditions, having adjusted the credit policy for small and medium business. PSB tightened the conditions for issue of credit products, the required financial position

of enterprises, the nature and amount of collateral being accepted. Furthermore, PSB determined priority groups of clients and industries most susceptible to the effect of current market conditions. The policy moved to the granting of more profitable products, reduction of weighted average lending periods and reduction of unsecured products.

To prevent growth in overdue and problem loans, we closely monitored our SME loan portfolio throughout 2009. Monitoring of financial position and solvency of clients with debt in excess of RUB 9 million allowed for prompt decision-making with regard to further cooperation with each individual client. In addition, restructuring and refinancing standards developed in 2009, supported prompt decision-making in respect of clients experiencing temporary financial difficulties.

As part of measures aiming to improve quality of risk assessment by our credit units, in 2009 we tightened control over compliance with the adopted lending technologies and client credit quality assessment, including through on-site and remote audits of our network credit operations by head-office experts.

PSB pursued automation of collection, systematization and storage of SME lending limit and overdue debt collection data.

RETAIL BUSINESS

With the view of decreasing credit risks and potential losses amid the economic crisis, the Bank in 2009 pursued a conservative retail credit policy. In keeping with the policy, credit decision-making rules reflect the risks associated with the sector



of activity of the borrower's employer and set high borrower credit quality requirements. The existing credit card scoring model was updated in Q1 and Q4. Consumer loan scoring model was implemented at the beginning of Q3 and updated in Q4. In addition, retail client verification and credit decision-making processes were centralized in 2009. The centralized process now employs credit experts (underwriters) ensuring additional review of loan applications. In Q3, PSB Financial and Retail Risks Department together with SME and Retail Lending Department developed an underwriting methodology, including loan application review rules and measures for underwriting process quality improvement.

Retail Risk Committee was set up for the purposes of retail risk control and efficient management, as well as minimization of PSB losses. The Committee is a permanent collegial body, which meets on a regular basis.

For the purposes of retail credit risk management, PSB employs, on the one hand, special maturing debt analysis methodology (vintage analysis) and other statistical methods, while, on the other hand, regularly calibrating the existing scoring models based on the Credit History Bureau data and PSB own default statistics.

With a view of credit risk minimization, PSB Financial and Retail Risk Department together with Product and Technology Department developed a retail loan restructuring methodology. Loan and credit card restructuring processes were launched in Q2 and Q3 2009, respectively.

Middle Office, the new Documentum-based consumer loan system, was implemented in Q3. As of Q1 2010, the system is expected to include credit card as well.

In addition, in 2009 we finalized statistical analysis methods applied to retail loan portfolios, as well as analysis of collection efficiency. We launched implementation of a specialized automated analytical system in Collection (based on a SAS solution). To increase collection efficiency, in Q4 PSB pursued development of the automated overdue debt processing system Collection Siebel. The project objective is to fully automate all stages of overdue debt operations, including pre- and post-court foreclosures.

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MARKET RISK MANAGEMENT

The backbone of PSB market risk management system is a structured system of limits, including limitation of impact of interest rate, securities and foreign exchange risks. PSB Assets and Liabilities Committee (ALCO) sets market risk limits, makes decisions related to approval of risk-bearing transaction metrics,

and develops market risk management strategy and tactics. In 2009, PSB Financial and Retail Risks Department initiated development of a market risk management system based on risk assessment and management methods applied amid strong market volatility. Specifically, to assess risks associated with PSB Eurobond and Shares+Futures portfolios, CVaR (Shortfall) calculation methodology was developed with respective limit setting amid abnormal price/forex rate/interest rate volatility.

To reduce the risk of interest rate volatility impact on financial results, PSB has been testing traded assets for interest rate risk exposure on the ongoing basis. The approach allows identifying securities with the highest interest rate risk exposure and setting efficient open position stop-loss limits. Trading portfolio sensitivity to interest rate risk is assessed based on PVBP (price per 1 basis point) both for individual securities and portfolio as a whole.

PSB foreign exchange risk is assessed across all open FX positions and managed in line with the Bank of Russia requirements for open position limits. In addition, FX risk is managed based on VaR (Value-at-Risk) methodology both across all open FX positions and key individual currencies.

PSB share portfolio is composed of highly liquid blue-chip instruments included in Russia's stock exchange indices. In 2009, the stock exchange market was prone to increased risk levels. For hedging purposes, PSB launched trading in share futures and indices. As a result, the Share Portfolio was transformed into Shares+Futures Portfolio. "Shares+Futures"



Portfolio risk assessment is based on Monte-Carlo modeling.

The following limits were applied in 2009 for market risk control purposes:

- ◆ Position limits;
- ◆ PVBP limits for each portfolio of key traded debt and term liabilities;
- ◆ Portfolio volatility limits:
 - CVaR limits for Shares+Futures and Eurobond portfolios;
 - VaR limit for traded FX portfolio.
- ◆ Overnight stop-loss limits;
- ◆ Mid-term stop-loss limits.

In 2009, PSB twice produced a report on market risk stress testing, outlining potential losses across trading portfolios under various multi-factor stress scenarios.

LIQUIDITY RISK MANAGEMENT

The liquidity risk limit system adopted in 2009, supported successful PSB operations throughout the crisis. Further to a series of stress events, which occurred in 2008-2009, the system was updated and significantly improved.

In 2009, we updated our liquidity ratio system, which enabled us to project with a high degree of precision liquidity fluctuations capable of critically affecting our financial position. Based on historic data analysis and modeling of various crisis development scenarios, we set limits for the liquidity reserve, as well as for current and structural liquidity. Daily monitoring of such indicators ensures timely and full settlements with all our clients and counterparties in any situations, irrespective of external environment.

In addition to the liquidity ratio system, PSB implemented a dynamic model for liquid asset distribution efficiency assessment, which ensures greater return on assets without a significant increase in risk level.

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of current interest rates for various terms and in various currencies. A system of indicative limits was developed for interest rate risk management purposes:

- ◆ PVBP limits for the term interest rate structure of PSB balance sheet across three key currencies: RUB, USD and EUR.
- ◆ CVaR limit for the economic value of future cash flows; the limit is intended to cap volatility of the interest rate structure combining balance sheet and off-balance sheet positions, and reflects combined fluctuations of various-term interest rates across various currencies.

Pursuant to an ALCO decision, PVBP and CVaR compliance with the set limits is monitored on a monthly basis.

INTEREST RATE RISK MANAGEMENT

In 2009, PSB adopted a new interest rate risk assessment methodology for non-trading banking operations, reflecting market fluctuations

OPERATIONAL RISK AND FRAUD RISK MANAGEMENT

In 2009, PSB set up Fraud Risk Management Division as a separate unit within its operational risk management system. Fraud risk management is ensured across several areas:

- ◆ As part of risk management improvement effort, PSB developed fraud risk management regulations, which outline key fraud countering principles, employee authority and responsibility distribution, fraud characteristics and key crite-

ria allowing for fraud identification. In addition, fraud events were categorized by type;

- ◆ PSB implemented an anti-fraud training program for new employees, as part of adaptation seminars, and developed a similar program for its branches;
- ◆ We set up a separate credit and non-credit fraud database.

To improve operational risk and fraud risk assessment quality, we apply a process-based approach including analysis of likelihood of risk realization at individual stages of our business process. Based on results of the analysis, we develop recommendations for identified risk minimization. Measures aimed at reduction of critical operational risks are monitored on a regular basis.

For the first time, operational risk drivers are now included in stress scenarios used in our stress testing.

PSB organizes regular operational risk and fraud risk management training programs for its employees. The programs provide detailed overview of various operational risk events and their drivers, as well as key principles of operational risk management, and numerous case studies.

The adopted approach to key risk indicator identification allows to monitor operational risk levels across key business units, as well as project the likelihood of operational risk events at the Bank level.

Key principles of operational risk and fraud risk management are adopted at all PSB Group banks,

which apply a single operational risk classification system and harmonized approaches to risk level assessment. PSB Group banks have carried out operational risk self-assessment and submit regular operational risk reports.

FINANCIAL INSTITUTION RISK MANAGEMENT

Despite a considerable contraction of transaction volumes at the end of 2008 – beginning of 2009, PSB in the reporting period maintained its leading positions in the interbank market. PSB counterparties continued to meet their payment obligations in full and on time. Given the relatively big number of maintained limits, this is a reflection of sound PSB approaches to assessment of counterparty bank credit quality. The financial stability assessment model adopted at PSB is based on analysis of a wide variety of qualitative and quantitative indicators. Appropriateness of such indicators, as well as fairness of derived conclusions in respect of counterparty reliability are reflected in the fact that no PSB counterparty bank has until now defaulted on its liabilities.

A balanced limit-setting policy and regular monitoring enable PSB to maintain its presence across the full range of interbank transactions amid a challenging environment in both domestic and international markets.

INTERNAL CONTROL SYSTEM



Due to growing risks amid economic downturn, PSB continued to improve its internal control system throughout 2009, focusing on development of the system's ability not only to prevent abusive practices but also to facilitate efficiency of banking operations through internal controls integration into all business processes, as well as to support timely risk assessment.

PSB internal control system is designed to ensure:

- ◆ Strong operating efficiency and performance, efficiency of asset and liability management (including asset preservation) and bank risk management;
- ◆ Accuracy, completeness, objectivity and timeliness of financial, accounting and other reporting to external and internal users;
- ◆ Data security;
- ◆ Compliance with legislation, incorporation documents and internal regulations.

PSB internal control system is composed of the Bank governing bodies, revision commission, chief accountant and her deputies, branch managers and their deputies, branch chief accountants and their deputies and, finally, Bank business units and employees responsible for internal control in line with their competences as set forth in the Bank incorporation documents and internal regulations.

The Bank Internal Audit and Control Department (IACD) ensures monitoring, control and objective assessment of all components of the internal control system. IACD carries out financial, operating and compliance audits, as well as corporate governance quality audits to identify facts of non-compliance with the existing legislation and regulations, PSB internal policies and procedures, misuse of power in decision-making and improper risk assessment in banking operations. The department assesses the internal control system, submits recommendations for its improvement and controls completeness and efficiency of remedy measures. All PSB business units, including branches, as well as all operations are subject to control. Internal audit and control services set up at 6 branches of the Bank ensure control of the respective branches.

IACD regularly informs PSB governing bodies about identified significant risks, facts of non-compliance with legislation, regulations and internal policies and procedures subject to internal control, as well as relevant remedy measures and results of implementation thereof.

An integral part of the internal control system is control of PSB professional financial market operations, ensured by the Financial Market Operation Compliance Service (FMOCS).

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The service key responsibilities include:

- ◆ Securities market legislation compliance control;
- ◆ Protection of investor and client rights and legal interests;
- ◆ Prevention of malpractice in PSB financial market operations (price manipulation, conflict of interest, insider trading, etc.).

FMOCS acts across two areas:

- ◆ Ongoing control, i.e. real-time monitoring of the Bank operations and its

clients, aimed at prevention of risks associated with professional operations in the securities market, as well as advising the Bank business units on issues related to financial market licensed operations;

- ◆ Follow-up control, i.e. scheduled and ad-hoc audits, including control of remedies for previously identified violations. The department controls securities markets operations (broker, dealer, custody and asset management transactions), as well as operations of specific business units involved in financial market operations.

Another integral part of the Bank internal control system is its Financial Monitoring Service ensuring development and implementation of internal control rules and programs to counter legalization (laundering) of proceeds from crime, and terrorism financing. In addition, the Financial Monitoring Service is in charge for filings with the Federal Service for Financial Monitoring, the relevant supervising authority. The Financial Monitoring Service key responsibility is to prevent the following risks:

- ◆ Use of bank accounts for illegal money laundering;
- ◆ Use of bank accounts for terrorism financing;
- ◆ Bank employee involvement in legalization of proceeds;
- ◆ Use of Bank products and services in money laundering schemes and transactions;
- ◆ Undue financial losses;
- ◆ Goodwill loss.

PSB continues to improve its Know-Your-Client policy, with a particular focus on verification of potential clients, with the view of preventing the use of PSB products and services in doubtful financial schemes, and managing potential reputational risks.