



Moody's Investors Service

## Credit Opinion: Natsionalny Kosmichesky Bank OAO (NK Bank)

Global Credit Research - 17 Jul 2009

Moscow, Russia

### Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	B3/NP
NSR Bank Deposits -Dom Curr	Baa3.ru/--
Bank Financial Strength	E+

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### Key Indicators

#### Natsionalny Kosmichesky Bank OAO

	[1]2008	2007	2006	2005	2004	Avg.
Total Assets (US\$ million)	278.94	318.96	285.54	288.16	169.37	268.19
Shareholders' Equity (US\$ million)	47.92	50.37	49.19	35.52	30.69	42.74
Return on Average Assets	5.67	1.19	3.77	2.78	0.92	2.87
Recurring Earnings Power [2]	9.42	4.46	5.23	4.82	2.17	5.22
Net Interest Margin	7.79	7.16	4.45	3.80	2.64	5.17
Cost/Income ratio (%) [3]	27.91	44.82	29.69	26.77	56.01	37.04
Problem Loans % Gross Loans	20.30	6.17	8.17	0.30	0.07	7.00
Equity % Assets	17.18	15.79	17.23	12.33	18.12	16.13

[1] As of December 31. [2] Preprovision income % average assets. [3] Non-Interest Expense % Operating Income.

### Opinion

#### SUMMARY RATING RATIONALE

Moody's assigns a Bank Financial Strength Rating (BFSR) of E+ to Natsionalny Kosmichesky Bank (NKBank), which translates into a Baseline Credit Assessment (BCA) of B3. The rating is constrained by NKBank's low franchise value (which is based, to a large extent, on the personal contacts of the bank's owners and senior management), modest scale of operations, highly concentrated loan portfolio, vulnerable liquidity stemming from concentrated funding and weak asset quality as well as underdeveloped corporate governance practices. However, the BFSR is supported by NKBank's good capitalisation and willingness of the shareholders to provide financing and capitalise the bank in case of need.

NKBank's Global Local Currency (GLC) deposit ratings of B3/Not Prime are at the same level as the bank's BCA and do not incorporate any element of systemic support. Parental support in case of need cannot be ruled out, although Moody's remains uncertain with regard to the timeliness and scope of such support and, therefore, we do not impute it into NKBank's ratings.

#### Credit Strengths

- Owners' expertise and personal contacts, which ensures good relationships with a number of relatively large corporate and individual customers
- Willingness of the shareholders to capitalise the bank and provide funding and/or attract third-party funding into the bank
- Good capitalisation

#### Credit Challenges

- Narrow franchise - dependent on shareholders and senior managers, and a lack of clear competitive advantages

- Vulnerable liquidity - compromised by asset quality and high concentration of funding base
- Limited sources of funding
- Underdeveloped corporate governance and risk management practices
- Highly concentrated loan portfolio

### Rating Outlook

All of the bank's ratings carry a stable outlook.

### What Could Change the Rating - Up

NKB's ratings do not have upward potential in the short-to-medium term. An upgrade of the bank's ratings would require a notable strengthening and widening of its franchise and better diversification of both assets and the funding base, which would also need to be accompanied by good asset quality, solid liquidity and good financial performance. Implementation of more advanced corporate governance and risk management practices would also be essential conditions for a ratings upgrade.

### What Could Change the Rating - Down

Negative pressure on NKB's ratings could result from a material deterioration in asset quality and/or liquidity problems. Further shrinkage of NKB's franchise could also result in a downgrade of the ratings.

### Recent Results and Developments

As of 31 December 2008, NKB reported total assets under IFRS of RUB8.2 billion (US\$283 million), a 5% increase compared with year-end 2007 (RUB7.8 billion). NKB's gross loans grew by 10% in 2008, largely due to revaluation of FX exposure in the loan book in Q4 2008. In January-May 2009 the bank experienced a 13% outflow from customer accounts due to shrinkage of resources of its customers. At the same time, the loan book grew 6%, financed by funding from the Central Bank of Russia (CBR). In the period December 2008-January 2009, the bank received a new capital injection of RUB55 million and attracted RUB150 million of subordinated debt.

### DETAILED RATING CONSIDERATIONS

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

#### Bank Financial Strength Rating

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As a point of reference, the assigned BFSR is two notches lower than the D outcome of Moody's bank financial strength scorecard which had placed too much emphasis on the bank's reasonable financial fundamentals.

#### Qualitative Factors (70%)

##### Factor 1: Franchise Value

Trend: Neutral

As of 1 July 2009, NKB was ranked 208 among Russian banks in terms of assets and is a boutique bank which provides a range of banking services with a clear focus on corporate banking to a limited number of large customers, which is supported by the personal links of the shareholders and/or senior managers. This results in bank's franchise being quite limited, with a few names dominating the loan book (top 20: 71% of the total loan portfolio) and the funding base (top 20 customers: 66% of customer funding). NKB does not target wide-scale retail banking; individual customers, although accounting for about one-third of the loan book and over 40% of customer accounts, represented by a small group of high-net-worth individuals.

NKB is currently engaged in acquiring additional sources of funding and has already achieved some success. However, the bank's reliance on a relatively short-term and highly concentrated funding base exposes it to the risk of inability to finance its operations at sufficient levels in the event of significant funding volatility. In our opinion, the bank's E score for franchise value is an appropriate score.

##### Factor 2: Risk Positioning

Trend: Neutral

NKB is controlled by one individual, with other two largest groups enjoying minority stakes. These stakeholders also have business interests in other sectors, including aerospace and construction. The decision-making process is at times highly centralised, and Moody's also notes a weak risk management function, which is lacking in independence and authority. As is the case for the majority of its peers, NKB's loan portfolio is characterised by high borrower concentration in relation to equity (top 20: 340% of year-end 2008 equity) and top two borrowers accounting for almost half of equity.

The bank's equity is exposed to substantial risk due to significant concentration in the real estate and development sector (e.g. 90% of year-end-2008 equity),

and, in particular, due to the fact that the majority of the borrowers from these sectors is concentrated in the top 20 borrowers. The bank's market risk is relatively low as it has reduced its securities book, and foreign exchange risk is low since it is naturally hedged by the appropriate matching of the currency structure of assets and liabilities. Liquidity is subject to performance of the loan portfolio and funding base which is subject to the risk of large withdrawals, especially given the current adverse economic conditions.

Mbody's assigns an E score with a neutral trend for risk positioning.

#### Factor 3: Regulatory Environment

For a discussion of the regulatory environment, refer to Mbody's Banking System Profile on Russia, published in September 2008.

#### Factor 4: Operating Environment

Trend: Weakening

This factor is common to all Russian banks. Mbody's assigns an E+ score for the overall operating environment. For a discussion of the operating environment, refer to Mbody's Banking System Profile on Russia, published in September 2008.

#### Quantitative Factors (30%)

#### Factor 5: Profitability

Trend: Weakening

The bank has recorded satisfactory profitability from core operations in recent years. In 2008 the large loss on the securities portfolio was more than offset by one private equity jumbo deal. NIM remained strong at 7% in 2008. At the same time, we note that the bank's earnings performance is becoming adversely affected by an increase in loan loss provision expenses as a result of asset quality deterioration caused by the mounting problems in the Russian economy. In light of this constraint, Mbody's adjusts the A score for profitability downward to D.

#### Factor 6: Liquidity

Trend: Weakening

The bank's liquidity is matched if loan restructuring and problem loans (currently 25% of the loan book) are not taken into account, and if the bank significantly reduces the level of lending. However, Mbody's estimates that the bank is likely to have to rely on CBR liquidity funding and/or significantly reduce (or cease) lending operations in the event of a significant unexpected outflow of customer funds, if (i) the bank continues lending at the current volumes; (ii) new funding is attracted (already agreed), (iii) there is a restructuring in the loan book (at levels below the current level).

The bank's liquidity suffers significant concentrations both in the funding base and loan book, rendering cashflows potentially unstable but the bank also benefits from the well established relationships with the major customers, thereby reducing the probability of large withdrawals.

#### Factor 7: Capital Adequacy

Trend: Weakening

Although NKB's Tier 1 and total capital ratios have been relatively high in recent years (19% and 21%, respectively, at year-end 2008), the single-name concentrations in the loan portfolio undermines economic capital. At the same time, Mbody's notes that the shareholders have been supportive in terms of capital replenishment, and a new RUB300 million capital injection is planned by year-end 2009, although the ability to capitalise the bank at higher levels is untested. In light of the issues of high concentration, we have adjusted the bank's score for capital adequacy to C from A, with a neutral trend.

#### Factor 8: Efficiency

Trend: Weakening

NKB has historically been cost-efficient as result of its wholesale business model and good profitability. Going forward, NKB's efficiency levels may come under pressure due to shrinkage of its business, which could be mitigated by possible some cost optimisation measures. Therefore, the unadjusted A score for efficiency is adjusted to C with a weakening trend.

#### Factor 9: Asset Quality

Trend: Weakening

Although the NFLs (90+ days overdue) are currently low at 3%, there is a significant (22%) restructured loan portfolio. and, in addition, loans which are not likely to be repaid before maturity. Mbody's estimated that over 30% of the loan book is likely to be restructured by year-end 2009. The bank's asset quality is negatively affected by significant exposure to the real estate and construction sectors, and by high concentration in the loan book. Mbody's notes that further market disruption could give rise to additional asset quality problems. In this context, the bank's score of asset quality is E+ with a weakening trend.

#### Global Local Currency Deposit Rating (Joint Default Analysis)

NKB's GLC deposit ratings of B3/Not Prime are based on the bank's BCA and do not incorporate any element of systemic support given the bank's very limited franchise value and its low importance for the Russian banking system as a whole. Parental support cannot be ruled out, although Mbody's remains uncertain about the timeliness and scope of such support; therefore, we do not impute it into NKB's ratings.

## National Scale Rating

Mbody's assigns a Baa3.ru national scale rating to NKB. National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks.

## Foreign Currency Deposit Rating

NKB's foreign currency deposit ratings of B3/Not Prime are at the same level as its GLC deposit ratings.

## ABOUT MOODY'S BANK RATINGS

### Bank Financial Strength Rating

Mbody's Bank Financial Strength Ratings (BFSRs) represent Mbody'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 Mbody'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 Mbody's opinion of any external support. Specifically, Mbody'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. Mbody'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 Mbody'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, Mbody'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 Mbody's globally applicable ratings; rather they address relative credit risk within a given country. A Aaa rating on Mbody'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

Mbody'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 ratings

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 Mbody's Bank Financial Strength Scorecard

Mbody'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 Mbody'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

### Natsionalny Kosmichesky Bank OAO (NK Bank)

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						E	

<b>Factor: Franchise Value</b>						E	Neutral
Market Share and Sustainability					x		
Geographical Diversification					x		
Earnings Stability					x		
Earnings Diversification [2]					x		
<b>Factor: Risk Positioning</b>						E	Neutral
<b>Corporate Governance [2]</b>					x		
- Ownership and Organizational Complexity				x			
- Key Man Risk					x		
- Insider and Related-Party Risks					x		
<b>Controls and Risk Management</b>				x			
- Risk Management					x		
- Controls			x				
<b>Financial Reporting Transparency</b>			x				
- Global Comparability	x						
- Frequency and Timeliness					x		
- Quality of Financial Information				x			
<b>Credit Risk Concentration</b>					x		
- Borrower Concentration					x		
- Industry Concentration		x					
<b>Liquidity Management</b>					x		
<b>Market Risk Appetite</b>				x			
<b>Factor: Operating Environment</b>						E+	Weakening
<b>Economic Stability</b>					x		
<b>Integrity and Corruption</b>					x		
<b>Legal System</b>				x			
<b>Financial Factors (30%)</b>						C	
<b>Factor: Profitability</b>						A	Weakening
PPP %Avg RWA - Basel I	7.15%						
Net Income %Avg RWA - Basel I	4.10%						
<b>Factor: Liquidity</b>						C-	Weakening
(Mkt funds-Liquid Assets) % Total Assets	-11.63%						
<b>Liquidity Management</b>					x		
<b>Factor: Capital Adequacy</b>						A	Weakening
Tier 1 ratio (%) - Basel I	18.48%						
Tangible Common Equity / RWA - Basel I	18.48%						
<b>Factor: Efficiency</b>						A	Weakening
Cost/income ratio	34.14%						
<b>Factor: Asset Quality</b>						E+	Weakening
Problem Loans % Gross Loans					13.94%		
Problem Loans % (Equity + LLR)				44.37%			
<b>Lowest Combined Score (9%)</b>						E+	
<b>Economic Insolvency Override</b>						Neutral	
<b>Aggregate Score</b>						D-	
<b>Assigned BFSR</b>						E+	

[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



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