



Moody's Investors Service

Credit Opinion: **Bank of Khanty-Mansiysk, JSC**

Global Credit Research - 27 Jan 2010

Khanty-Mansiysk, Russia

Ratings

Category	Moody's Rating
Outlook	Stable
Bank Deposits	Ba3/NP
NSR Bank Deposits -Dom Curr	Aa3.ru/--
Bank Financial Strength	E+

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Key Indicators

Bank of Khanty-Mansiysk, JSC

	[1]2008	2007	2006	2005	Avg.
Total assets (US\$ million)	3961.28	3438.18	2638.82	1899.75	2984.51
Shareholders' Equity (US\$ million)	348.58	336.67	301.35	155.56	285.54
Return on average assets	-0.78	0.51	1.20	1.04	0.50
Recurring earnings power [2]	0.96	0.98	1.96	3.20	1.77
Net interest margin	5.81	4.32	4.35	5.86	5.09
Cost/income ratio (%) [3]	81.97	80.71	67.35	52.44	70.62
Problem loans % gross loans	7.60	--	--	--	7.60
Tier 1 Ratio (%)	--	--	16.85	12.20	14.53

[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 Bank of Khanty-Mansiysk

(BKHM), which translates into a B2 Baseline Credit Assessment (BCA). The rating reflects the bank's strong position franchise in the home region of Khanty-Mansiysk as well as sound regional expertise and established connections with number of large corporates. However, it is constrained by the large customer concentrations on both sides of the bank's balance sheet, increased volume of related-party exposures that undermine economic capital as well as its weak financial performance - although expected to recover somewhat in 2009 - and the risks inherent in the deteriorating operating environment in Russia.

The bank's Ba3 local and foreign currency deposit ratings benefit from a two-notch uplift from the bank's BCA of B2, incorporating a moderate probability of regional support given the bank's social and economic importance in its home region - Khanty-Mansiysk Autonomous District (KMAO; issuer rating of Baa3), which owns a 44.2% stake in the bank.

Credit Strengths

- Moderate probability of parental support from KMAO in case of distress
- Visible regional franchise especially in retail deposit taking and servicing budget and infrastructure settlements
- Strong business ties with a number of large corporates and a longstanding relationship with KMAO authorities support the franchise
- Effective infrastructure solutions (such as IT) support the bank's role of settlement agent for KMAO
- Balanced liquidity profile

Credit Challenges

- Volatile operating environment in Russia puts pressure on the bank's financial fundamentals and is expected to continue over the medium term
- Volatile operating conditions and weak financial performance pressured by growing loan loss reserves
- Customer concentrations remain high in the loan book
- Increased volume of related-party transactions over recent years undermines economic capital

Rating Outlook

BKHM's ratings carry a stable outlook.

What Could Change the Rating - Up

For BKHM's BFSR to enjoy upward pressure, which we do not expect in the near term, the bank would need to display materially lower levels of concentration on both sides of its balance sheet (including related parties), and maintain good core profitability, asset quality and - more importantly - adequate level of capital in relation to the risks taken.

What Could Change the Rating - Down

The BFSR (and thus the deposit ratings) could face downward pressure in the event of deterioration in asset quality, a material decline in profitability and weakening capitalisation. Any evidence of the region intending to materially reduce its stake in the bank could result in Moody's adjusting downwards its assessment of the probability of

regional support for BKhM. This, in turn, could have negative implications for the bank's deposit ratings.

Recent Results and Company Events

As at 31 December 2008 BKhM reported total consolidated IFRS assets of RUB116 billion (US\$4 billion) and consolidated net loss of RUB779 million (US\$26.5 million).

In 2009, KMAO decreased its stake in the bank from 66% to 44.2% following a new capital issue of RUB3.5 (US\$110 million) billion that was acquired by the bank's corporate shareholder.

In the nine months to 1 October 2009, the bank reported unaudited total assets of RUB127 billion in accordance with Russian Accounting Standards, and net income of RUB414 million

DETAILED RATING CONSIDERATIONS

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

Bank Financial Strength Rating

Moody's assigns a bank financial strength rating (BFSR) of E+ to BKhM, which translates into a B2 BCA. The rating reflects the bank's strong franchise position in the home region of Khanty-Mansiysk as well as sound regional expertise and established connections with number of large corporates. However, the rating is constrained by the large customer concentrations on both sides of the bank's balance sheet, increased volume of related-party exposures that undermine economic capital, as well as its weak financial performance and the risks inherent in the deteriorating operating environment in Russia.

As a point of reference, the assigned BFSR is one notch lower than the D- outcome of Moody's BFSR scorecard. Moody's believes the E+ rating is an appropriate measure of the bank's financial strength given the significant single-borrower concentrations in its loan books and increased level of related-party transactions that exceed those of D- rated banks in Russia. The BFSR also reflects concerns with regard to the bank's ability to generate sound profitability from stable sources and expected asset quality deterioration.

Qualitative Rating Factors (70% weighting)

Factor 1: Franchise Value

Trend: Neutral

BKhM is a mid-sized player that ranked 30th in terms of total assets; 30th in terms of equity; and 22nd in terms of retail deposits among Russian banks as at 30 September 2009 (source: Interfax). BKhM was established as an institution for servicing budget settlements of local authorities and government-related entities; it therefore holds a unique niche in the region, accumulating 45% share of retail deposits, almost 100% of budget and government-related social programmes, and almost 100% of utility and tax settlements.

BKhM is predominantly a corporate bank with over 65% of total loans attributable to corporates; however, given its status as a government agent for social programmes, the bank has accumulated significant mortgage portfolio - 20% of total loan book as at 31 December 2008. The loans were originated under a regional programme, with an interest and price compensation package for borrowers. Together with other retail products such as auto and consumer loans, this segment contributed over 25% to the bank's pre-provision segment income in 2008.

BKhM manages its business through a regionally oriented branch network covering all major industrial centres in the home market and number of large cities outside of KMAO. The bank's visibility in the region is supported by (i) its well-developed IT and payment solutions such as tax and public utilities payments, and (ii) its key role of servicing both budget and infrastructure settlements in the region .

These considerations support a D score for Franchise Value and Neutral trend.

Factor 2: Risk Positioning

Trend: Neutral

BKhM was established by the government of KMAO and is currently owned by the regional government (44.2% of voting shares) and number of private investors such as I?T Group (approximately 40%). Although the regional government diluted its share from 66% to 44% in 2009 as a result of new capital injection (RUB3.5 billion), it confirmed its initial intention to hold at least a blocking stake in the bank to secure its social importance in the region. The gradual dilution of KMAO's stake is in line with BKhM's privatisation plan that had been initiated in 2006.

The bank's supervisory board consists of 11 members including four formally independent members; however, we are of opinion that the level of independent oversight over the bank's business and risk-taking culture still has room for improvement as we have observed an increasing volume of related-party lending following the introduction of private shareholders in late 2008 (78% of Tier 1 capital as at YE2008 and 52% in 2007).

BKhM's risk management infrastructure and practices are appropriate for its size and market standing. However, we also consider that the level of risk management is at a development stage, with some management practices - such as full independence of the Chief Risk Officer and the risk function - not being implemented, due to the bank's focus on growth and maintaining current market shares over recent years; however, this is common for almost all Russian banks.

Credit risk concentration is very high. As of 31 December 2008, BKhM's aggregate exposure to the top 20 borrowers exceeded 300% of Tier 1 capital, reflecting the poor granularity of the bank's loan portfolio and its high susceptibility to the performance of a few customers. The top 20 exposures represented more than 600% of the bank's annualised pre-provision income (defined as net interest, net commission and other operating income) in 2008. At the same time, the bank's related-party exposures climbed to 78% of Tier 1 capital as at YE2008 from 52% a year earlier - reflecting the bank's risk approach. Moody's notes that the changes in the bank's risk-taking approach followed the dilution of regional ownership to 66% and the introduction of a new private shareholder - an industrial major in Russia - in late 2008. We do not expect concentrations to decrease materially going forward, given the bank's focus on business growth.

At the same time, the level of market risks (tradable instruments compared to capital) taken by the bank is somewhat high, rendering the bank's profitability vulnerable to performance of certain instruments. In 2008, BKhM recorded losses on operations with securities of almost 30% of operating income, due to negative revaluation of a number of default credit-linked notes and embedded put options. Although growth in global markets in 2009 brought some recovery to the bank's profits, its performance remains volatile to potential negative repercussions on the market.

Based on the above-mentioned considerations, we assigned an E score and neutral trend for Risk positioning.

Factor 3: Regulatory Environment

Refer to Moody's Banking System Profile on Russia, published in November 2009, for information on this factor.

Factor 4: Operating Environment

Trend: Weakening

This factor is common to all Russian banks. Moody's assigns an E+ score for the overall operating environment. Refer to Moody's Banking System Profile on Russia, published in November 2009, for information on this factor.

Factor 5: Profitability

Trend: Weakening

BKHM reported a net IFRS loss of RUB779 million (US\$26.5 million) in 2008 (2007: net income of RUB395 million (US\$16.1 million)) which translates into negative recurring ratios. The performance was driven by negative revaluation of default credit-linked notes and embedded put options.

The credit-linked notes that were first to default were US dollar denominated floating coupon notes issued by the major international financial institutions, the repayment of which is dependent on certain corporate bonds being repaid by their issuers in full. We observe that the notes are linked to the performance of blue chip Russian government and private corporates and thus have substantial potential to recover, as evidenced by strengthening market prices for those instruments in early 2009.

At the same time, we note that the bank's loan portfolio had demonstrated some deterioration in 2008, and we expect this to have continued in 2009, with the bank's earnings stressed by increasing provision expenses. BKHM's loan portfolio is heavily concentrated, which increases the bank's dependence on single-name performance. Thus, we assign a weakening trend to the D+ score for profitability.

Factor 6: Liquidity

Trend: Neutral

BKHM's dependence on market funds is limited. The core of the bank's funding base is customer deposits (net loans-to-customer deposits ratio was 124.7% at YE2008 and 81% at YE2007). We note that the local authorities decreased the volume of funding that was historically placed in the bank; the decline occurred in late 2008. Although the bank was able to replace deposits by liquidity from Central Bank of Russia, we view this relief as somewhat temporary and will continue to closely monitor the bank's liquidity profile and its ability to diversify its funding away from regional and politically driven customer perceptions. We adjusted downwardly the C+ score generated by the scorecard to capture liquidity concerns, and assign neutral trend.

Factor 7: Capital Adequacy

Trend: Weakening

The bank reported Tier 1 capital adequacy ratio of 8.2% as at YE2008. In late 2009, the bank's capitalisation was supported by additional capital increase of RUB3.5 billion. However, economic capitalisation is undermined by high single-name concentration in the loan book and increased volume of related-party lending.

The score of A for capital adequacy was downwardly adjusted to E+ to capture Moody's concerns over single-name concentrations, while the weakening trend reflects expected

pressure on profitability and asset quality which, in turn, could damage capital adequacy.

Factor 8: Efficiency

Trend: Neutral

Given its status as an agent for social and infrastructure programmes in the region, BKHM has historically maintained a high level of operating expenses with the cost-to-income ratio reported at 82% in 2008 and 81% in 2007. We do not expect the bank's efficiency to recover in the medium term and thus maintain neutral trend for the D score.

Factor 9: Asset Quality

Trend: Weakening

According to the bank, its level of problem loans in the portfolio is about 7.6% as at YE2008, and 60% covered by loan loss provision. Problem loans should be considered together with restructured loans, which amounted to ca. 20% of gross loans at end-Q3 2009. Although loan restructuring allowed the bank to strengthen its portfolio performance, Moody's notes that this only partially mitigates the risk of further erosion in quality due to the continuous economic slowdown in Russia.

Moody's main area of concern is the high level of single-name concentrations in the loan book; therefore, the default of any large borrower could result in a material deterioration in the bank's asset quality.

In Moody's view, the weakening trend and the downwardly adjusted C+ score is an adequate measure of the bank's asset quality.

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns a global local currency (GLC) deposit rating of Ba3 to BKHM. The rating benefits from a two-notch uplift from the bank's BCA of B2 and incorporate a moderate probability of regional support given the bank's social and economic importance in its home region - Khanty-Mansiysk Autonomous District (issuer rating of Baa3), which owns a 44.2% stake in the bank.

National Scale Rating

BKHM is rated Aa3.ru by Moody's Interfax on Russia's National Scale Rating (NSR). 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

Moody's assigns a Ba3 foreign currency deposit rating to BKHM. The rating is assigned at the same level as the bank's GLC deposit rating and is not constrained by the country foreign currency deposit ceiling for Russia.

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

Bank of Khanty-Mansiysk, JSC

Rating Factors [1]	A	B	C	D	E	Total Score	Trend
Qualitative Factors (70%)						E+	
Factor: Franchise Value						D	Neutral
Market Share and Sustainability				x			
Geographical Diversification				x			
Earnings Stability				x			
Earnings Diversification [2]							
Factor: Risk Positioning						E	Neutral
Corporate Governance [2]					x		
- Ownership and Organizational Complexity				x			
- Key Man Risk				x			
- Insider and Related-Party Risks					x		
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						E+	Neutral
Economic Stability					x		
Integrity and Corruption					x		
Legal System				x			

Financial Factors (30%)						C	
Factor: Profitability						D+	Weakening
PPP % Avg RWA - Basel I			1.57%				
Net Income % Avg RWA - Basel I				0.43%			
Factor: Liquidity						C+	Neutral
(Mkt funds-Liquid Assets) % Total Assets	-						
Liquidity Management	10.59%			x			
Factor: Capital Adequacy						A	Weakening
Tier 1 ratio (%) - Basel I	11.37%						
Tangible Common Equity / RWA - Basel I	11.37%						
Factor: Efficiency						D	Neutral
Cost/income ratio				76.68%			
Factor: Asset Quality						C+	Weakening
Problem Loans % Gross Loans			2.53%				
Problem Loans % (Equity + LLR)		13.16%					
Lowest Combined Score (9%)						D+	
Economic Insolvency Override						Neutral	
Aggregate Score						D-	
Assigned BFSR						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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