Credit Opinion: Vostochny Express Bank

Vostochny Express Bank

Khabarovsk, Russia

Ratings

Category	Moody's Rating
Outlook	Positive(m)
Bank Deposits	B3/NP
Bank Financial Strength	E+
Senior Unsecured -Dom Curr	B3

Contacts

Analyst	Phone
Semyon Isakov/Moscow	7.495.641.1881
Lev Dorf/Moscow	
Reynold R. Leegerstee/London	44.20.7772.5454

Key Indicators

Vostochny Express Bank

	[1]2006	2005	2004	Avg.
Total assets (US$ million)	362.63	85.37	13.50	153.84
Shareholders' Equity (US$ million)	57.66	21.11	1.53	26.77
Return on average assets	15.17	22.76	0.56	12.83
Recurring earnings power [2]	5.75	0.96	0.18	2.30
Net interest margin	16.43	3.58	8.61	9.54
Cost/income ratio (%) [3]	78.62	94.68	98.26	90.52
Problem loans % gross loans	12.78	3.19	0.18	5.38
Equity % Assets	15.90	24.73	11.30	17.31

[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 Vostochny Express Bank (VE), which translates into a Baseline Credit Assessment (BCA) of B3. The ratings reflect VE's relatively short track record under its present business model as well as the high level of operational and credit risks stemming from its aggressive growth strategy in the riskiest segment of unsecured consumer lending. However, the ratings are supported by VE's established and continuously strengthening regional franchise in its home region as well as its expanding geographical coverage. The bank's healthy financials also support the ratings.

VE's B3 global local currency (GLC) deposit ratings do not impute any support considerations and therefore are at the same level as the BCA.

Credit Strengths

- Growing franchise in Russia's North West and Moscow regions along with a well-established regional retail franchise where the bank enjoys the second-largest distribution network and good brand recognition

- Clear-cut strategy focused on rapid expansion in retail implemented by a capable and experienced management team with support from sister entity URSA Bank

- Good profitability to date, although a significant portion of non-interest income has been non-recurring in nature

- Ongoing diversification of funding, with growing focus on domestic retail deposits

Credit Challenges

- Relatively short track record and risks inherent to retail lending in a country with untested consumer behaviour in stress scenarios

- Reliance on non-recurring profitability, related to the sale of loans to URSA Bank, undermine earnings stability.

- Reduced access to wholesale funding could adversely affect VE's loan expansion and erode the bank's franchise value

- Weakening asset quality will test strength of VE's loan underwriting and collection functions, while provisioning coverage is not sufficient

Rating Outlook

The bank's B3 GLC and foreign currency deposit ratings carry a positive outlook which reflects ongoing strengthening of the bank's franchise and our expectation of the bank maintaining solid financial fundamentals and improving core profitability.

The E+ BFSR carries a stable outlook.

What Could Change the Rating - Up

The bank is currently well positioned within the E+ BFSR category and we see limited upside potential for the BFSR in the medium term.

In Moody's opinion, the B3 GLC and foreign currency deposit ratings could be upgraded in the near-to-medium term if (i) the bank improves its recurring profitability and (ii) strengthens its deposit franchise, enabling it to fund future growth in lending

What Could Change the Rating - Down

The bank is currently well positioned within the E+ BFSR, and its B3 deposit ratings carry a positive outlook so their downgrade is unlikely. However, a material deterioration in asset quality, leading to losses and reduction in liquidity and economic capitalisation, putting the bank in danger of insolvency, could exert pressure on the ratings.

Recent Results and Developments

VE's total assets, as reported under IFRS at 30 June 2007, increased to RUB15.7 billion (US$ 609 million) compared to RUB9.5 billion (US$ 363 million) at year-end 2006. During 2H2007 the bank loan book demonstrated 80% growth (1H2007: 90%) which was mainly funded by RUB5.4 billion Eurobond issuance and retail deposits.

Retail deposit base grew by almost RUB3.6 billion in 2H2007 representing a 50% increase from 30 June 2007 and accounted for 50% of total liabilities as at 31 December 2007.

In 2007 Renaissance Finance Capital Fund exercised an option to increase its equity stake to 15%, and took one of the six seats on the board of directors.

The new capital injection of RUB2.2 billion (US$90 million) from VE's shareholders (took place at the end of February 2008) substantially increased the bank's capitalisation levels and will support future growth of the bank.

DETAILED RATING CONSIDERATIONS

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

Bank Financial Strength Rating

Moody's assigns a BFSR of E+ to VE, reflecting its short track record under its present business model as well as the high level of operational and credit risks stemming from its aggressive growth strategy in the riskiest segment of the retail loan market - unsecured consumer lending. However, the ratings are supported by VE's established and continuously strengthening regional franchise in its home region as well as its growing geographical coverage.

The bank's consistently strong profitability and adequate capitalisation also support the ratings.

As a point of reference, the bank's assigned BSFR of E+ is two notches lower than the scorecard outcome of D.

Qualitative Factors (70%)

Factor 1

Franchise Value

Trend: Improving

Headquartered in the City of Khabarovsk in Russia's Far East region, VE is a full-service retail bank, formerly known as Dalvneshtorgbank. The bank was established in 1991 to develop and promote international business activities for regional clients with business and commercial interests mainly in China.

In 2003, a majority stake in the bank was acquired by Igor Kim and his partners (who are also major shareholders in URSA Bank - a successor of Sibacadembank and Uralvneshtorgbank, and the second-largest bank in the SME and retail business segments of Western Siberia and the Urals - rated Ba3/Not Prime/D-). In 2005 a new management team was put in place to implement a new strategy of developing retail business (at the initial stage it mainly focused on scoring-based unsecured consumer loans). In June 2006, the bank's name was changed to Vostochny Express Bank.

VE's lending expansion under its new strategy was significantly supported by its sister URSA Bank, which has acquired large portions of VE's retail loan book since 2005. According to the loan sale agreements between two banks, URSA had an option to purchase portfolios of loans from VE while VE continued servicing the loans and retained servicing fees paid by the borrowers (1.5% per month).

Over the past three years, VE has, through organic growth, established a credible retail lending business and created a good regional franchise where it operates the second-largest retail distribution network and has the second-largest retail loan portfolio in the regions of its presence, with market shares currently ranging from 3% to 20%.

With approximately US$1 billion in total assets at the end of 2007, VE was ranked 89th by Interfax (ranked 148th in 2006) among all Russian banks. VE's branch network currently comprises 10 regional branches and over 800 points of sale. In 2007, VE began expanding its branch network and operations outside of its home region by opening outlets in Moscow and Russia's North West regions.

Retail banking currently accounts for the majority of VE's net interest income, loans and deposits. As of 30 September 2007, over 98% of the bank's loan portfolio consisted of retail loans and over 88% of its customer deposits were held by individuals.

We adjust VE's score for franchise value downward, but maintain an improving trend which reflects improving core earnings as well as geographical diversification. However,

in our opinion, reliance on non-recurring profitability, related to the sale of loans to URSA Bank, undermine earnings stability;

Factor 2

Risk Positioning

Trend: Neutral

VE is effectively owned by seven major shareholders whose equity stakes each exceeds 5%. In fact, over 80% of the bank's capital is controlled by two groups of shareholders - Mr. Kim together with his partners in banking business and Mr. Sergey Vlasov (VE's CEO). Renaissance Finance Capital Fund increased its equity stake to 15% in 2007 and took one of the six seats on the board of directors.

Credit and industry risk concentration is very low as the bank mainly services individual clients, and 92% of all loans do not exceed US$4,000. Nonetheless, we are of the opinion that VE has a high appetite for credit risk, reflected by the bank's aggressive growth strategy both in its home region and outside of its boundaries, and by emphasis on the riskiest segment of the retail loan market - unsecured consumer lending.

A relatively advanced scoring model, based on large customer database, aids manageability of the high level of credit risks stemming from VE's aggressive growth strategy in the retail loan market

The bank's market risk appetite, as measured by the potential loss of trading and non-trading books due to major market movements, is low. VE engages in securities operations for liquidity management purposes only.

Although the bank has historically displayed fairly good liquidity management, liquidity risk, in our view, should become a greater significant component of VE's risk analysis, especially given the reduced access to the wholesale funding and reduction of loans sold to Ursa. Starting from 3Q2007 the bank has been actively developing its retail deposit franchise, which significantly improved over the past six months.

In our view, the bank needs to demonstrate a longer track record of its ability to finance growth by attracting deposits in order to prove its resilience to a period of non-access to wholesale funding without experiencing any reduction in business activity that could impair franchise value. However, given the relatively short-term nature of the bank's loan portfolio and remote exposure to refinancing risk, VE is not likely to face serious liquidity problems in the near-to-medium term.

VE's score of E for risk positioning is mainly driven by its high level of operational and credit risks stemming from its aggressive growth strategy in the riskiest segment of unsecured consumer lending.

Factor 3

Regulatory Environment

Refer to Moody's Banking System Outlook for Russia, published in September 2007, to obtain a detailed discussion on this factor

Factor 4

Operating Environment

Trend: Neutral

This factor is common to all Russian banks. Moody's assigns an E+ score for the overall operating environment in Russia. Refer to Moody's Banking System Outlook for Russia, published in September 2007, for information on the country's operating environment.

Quantitative Factors (30%)

Factor 5

Profitability

Trend: Weakening

VE posted net income of RUB283 million (US$10.96 million), for the first six months of 2007, which translated into a strong RoAA of 4.48% and RoAE of 34%. We note that VE's results have been historically mainly driven by the non-recurring income related to the sale of loans to URSA Bank.

VE's results on sale of loans accounted for 32% of total operating income at mid-2007, down from 54% as of year-end 2006 and 72% as of year-end 2005; The result on the sale of loans reflects the present value of service fees to be retained by VE on the loans sold to URSA Bank. We also recognise that VE's core earnings such as Net Interest income have been significantly improving, demonstrating considerable annualised growth of 150% in the first six months of 2007 and accounting for 60% of operating income (28% of operating income in 2006). We view this trend positively as it could be a sign of improving earnings stability.

Going forward, we expect the bank to strengthen its recurring earnings, given its ongoing rapid expansion and reduction of loans sold to URSA, which would be viewed as positive for the bank's ratings.

Meanwhile we consider VE's profitability to be unstable, also taking into account potential increase in loan impairment provisions. For analytical purposes we use a lower score than generated by the bank financial strength scorecard

Factor 6

Liquidity

Trend: Weakening

VE has been reliant on wholesale funding to support its rapid growth. Since 2005 the bank has refinanced large portions of its consumer finance loan portfolio by selling them to URSA Bank.

In 2007 the total amount of loans sold to URSA increased to RUR 7.9 billion (RUR 7.16 billion in 2006; RUB2.4 billion in 2005), representing a substantial portion of VE's loan book. We note that the uncertainty on the international credit markets is reducing the bank's access to wholesale funds which, along with reduced liquidity provided by URSA (in our view URSA is not likely to continue acquiring loans in 2008), could adversely affect VE's liquidity profile and its franchise development. During this period we will be closely monitoring the bank's ability to access alternative financing to meet ongoing liquidity needs and to fund its growth.

Taking into account that VE has been successful in attracting retail deposits over the past six months (thanks to VE's innovative and aggressive approach, good brand name recognition and wide distribution network which ensures good customer reach), we still believe that the bank's resilience to periods of market turbulence not yet been tested.

However, we do not anticipate significant deterioration of the bank's liquidity in the near-to-medium term, given the bank's short-term loan book and its rapidly growing retail deposit base which already accounts for more than 50% of the banks total liabilities. The bank's ability to mitigate refinancing risks will be largely tested in 2009 when more sizeable repayments of Eurobonds issued in 2007 have to be made.

In light of the developments mentioned above, the D+ scorecard outcome for liquidity has been adjusted downwards to D

Factor 7

Capital Adequacy

Trend: Weakening

VE's shareholder equity was around RUB1.8 billion at 1H 2007 and funded 11.6% of the bank's total assets (2005: 24.7%). Despite the relatively strong internal capital generation capacity (albeit mostly driven by non-recurring earnings), the decrease in capitalisation levels had been expected as the bank has been growing its loan portfolio at a very rapid pace. The new capital injection of RUB2.2 billion (US$90 million) from VE's shareholders (took place at the end of February 2008) substantially increased the bank's capitalisation levels and will support future growth of the bank.

We believe that in the near-to-medium term VE's capitalisation is likely to be sufficient given (i) our expectation that loan growth will slow down, (ii) the shareholders' proven ability to inject additional capital to support growth and (iii) a degree of comfort provided by VE's internal capacity to generate capital.

In our view, future capital increases will be mainly dependent on continuing shareholder support due to the expected decrease of VE's internal revenue generation.

We lowered the score to B to reflect the bank's dependence on external capital injections and its currently low level of loan impairment provisions, which if increased will also negatively impact VE's capital.

Factor 8

Efficiency

Trend: Neutral

Due to substantial start-up costs and ongoing rapid expansion, VE has displayed comparatively low efficiency to date, albeit improving since 2005, with the cost-to-income and costs-to-average assets ratios reported at 77% and 17%, respectively, as at 1H2007, (1H2006: 79% and 21%, respectively). We do not expect VE's efficiency ratios to improve substantially in the medium term as its regional expansion policy is still under way.

The adjusted score for efficiency is D

Factor 9

Asset Quality

Trend: Weakening

VE's retail loans demonstrated very rapid growth in 2006-2007 and their quality indicators have worsened relative to the previous year - overdue loans jumped to 10.8% of the gross loan portfolio as at 1H2007, up from 3.3% reported in 1H2006. (YE2006:12.7%). However, the level of loans overdue for more than 90 days - which we consider as problem loans - was significantly lower and stood at 5.7% as at 30 September 2007. We, however, note that assets quality ratios have been diluted by a rapid loan-book growth. The upward trend in the overdue loans absolute balance coupled with the fast-growing loan portfolio could result in higher delinquencies in a maturing loan portfolio. Provisioning coverage (of loans overdue by more than 90 days) was maintained at 85% as at 1H2007 - remained slightly lower than we would expect for a bank operating in the riskiest segment of unsecured consumer lending.

That said, despite the currently adequate asset quality for consumer finance business, the bank's score for asset quality has been downwardly adjusted to D

Global Local Currency Deposit Rating (Joint Default Analysis)

Moody's assigns global local currency (GLC) deposit ratings of B3/Not Prime to VE, in line with its Baseline Credit Assessment. Moody's has not assessed any probability of systemic support as VE's position on the Russian market is not sufficiently significant to warrant any systemic support in the case of need. Although Moody's believes VE could potentially benefit from shareholder support in the case of need, the ability and willingness of the shareholders to support the bank is very difficult to estimate, and is thus excluded from our considerations.

Foreign Currency Deposit Rating

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

Foreign Currency Debt Rating

The bank's foreign currency debt rating of B3 is at the same level as its GLC deposit rating.

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 honour 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

Vostochny Express Bank

Rating Factors [1]	**A**	**B**	**C**	**D**	**E**	**Total Score**	**Trend**
Qualitative Factors (70%)						**E+**	
Factor: Franchise Value						**C+**	**Improving**
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							
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						**B+**	**Weakening**
PPP % Avg RWA		3.00%					
Net Income % Avg RWA	2.50%						
Factor: Liquidity						**D+**	**Weakening**
(Mkt funds-Liquid Assets) % Total Assets			5.17%				
Liquidity Management				x			
Factor: Capital Adequacy						**A**	**Weakening**
Tier 1 ratio (%)	19.91%						
Tangible Common Equity % RWA	19.91%						
Factor: Efficiency						**E**	**Neutral**
Cost/income ratio					90.52%		
Factor: Asset Quality						**C**	**Weakening**
Problem Loans % Gross Loans				6.00%			
Problem Loans % (Equity + LLR)		16.19%					
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