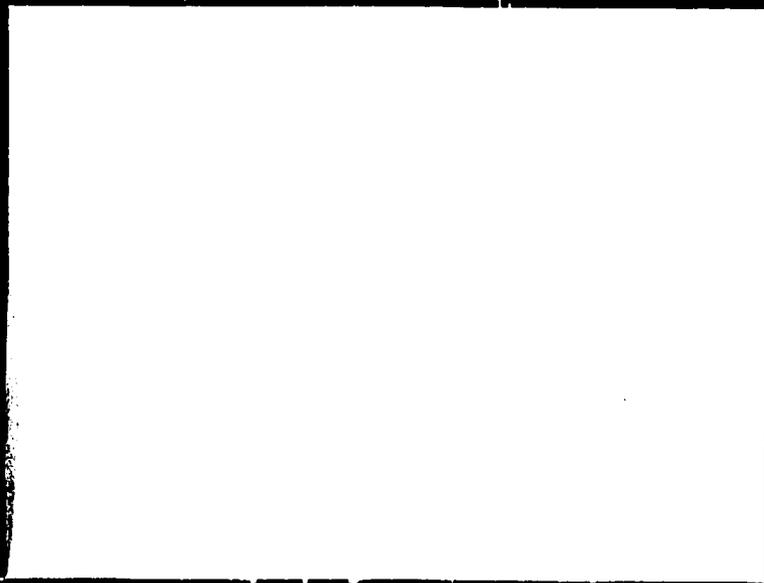


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*Price Waterhouse L.L.P.*



~~CONFIDENTIAL~~

**DEVELOPMENT OF A  
PRIVATE COMMERCIAL BANK  
IN  
NIZHNY NOVGOROD  
APRIL 1993**

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## **INTRODUCTION**

**NBD is a newly established commercial bank in Nizhny Novgorod. In the first six months of its operation, the Bank has made impressive strides in identifying and retaining competent management and personnel, and currently employs over 60 staff. After a rather tumultuous beginning in which it was forced to relocate its offices twice, the Bank has now negotiated a long-term lease for the 800 square meter premises it occupies and hopes to purchase the freehold rights in the near future.**

**NBD has been in the forefront of efforts to create a viable commercial banking industry in the Russian Republic, and to date has booked over 40 loans. It has also moved aggressively to establish its preeminence in the Nizhny Novgorod market, and was the first bank in the oblast to trade vouchers. It has similarly ambitious plans to expand its capital, services and branches in the coming year and to augment its current staff with increasingly highly trained personnel.**

**Despite the severe economic dislocations affecting the Russian economy, NBD managed to post a profit of 29 million rubles in the calendar year just ended. Stringent cost containment and stabilization policies on the part of the Bank's management should enable it to weather the continuing economic crisis, and the Bank's excellent working relations with Nizhny Novgorod's oblast government provide additional reason for optimism.**

**It remains to be seen whether NBD can survive the corrosive effects of inflation and the lack of a corps of individuals well experienced in commercial banking. Nonetheless, the NBD and its management are making every effort to learn from their mistakes and from others, and to serve the growing needs of the oblast and its citizens. With further attention to the augmenting the technical expertise of its staff, the NBD should play an increasingly important and pivotal role in Nizhny's emerging private sector.**

## Appraisal of First Year's Operation

Notwithstanding the serious economic dislocations afflicting the Russian economy, the NBD enjoyed a healthy and successful first year. Permanent office space has been identified, and plans are underway for the Bank to establish branches throughout the Nizhny region.

Boris Brevnov was appointed as the NBD's first Chief Executive Officer, and has moved to recruit well-trained personnel to staff the Bank and its principal operational areas. While its 60 staff are relatively junior by international standards, they compare favorably with other emerging Russian financial institutions and the Bank is actively seeking to develop the skill base of its personnel. Special attention has been given to appropriately organizing the Bank, and this has yielded very beneficial results.

The short-term build-out of the Bank's services is good. CEO Brevnov has been quick to respond to opportunities in the market place, and the Bank was the first to trade vouchers in the oblast. It has also developed a one-stop payroll cash disbursement system for local enterprises that is clearly superior to the 2-stop system offered by other commercial banks.

Profits after taxes were a modest 29 million rubles in the year just ended and are expected to grow tremendously in 1993. Unfortunately, this optimistic picture will be significantly affected by hyper-inflationary pressures which the Bank will be hard-pressed to counter. Adjusted for inflation, the Bank's capital is likely to erode this year.

## Current Operations - Lending

To date, NBD has made 40 loans, for the most part to finance inventory for trading companies and working capital for manufacturers. The Bank is also considering two construction financing loans.

The Bank's normal loan terms are 90 days, at an annual interest rate of 150-200 percent. The Bank follows very conservative lending practices and no loan is currently past due more than 30 days. As a matter of policy, the Bank will not roll over or extend a loan more than 30 days to avoid a default, and uniform credit review and appraisal policies are observed.

Most of the NBD's loans have been valued at 100 million rubles or less, but it has lent as much as 500 million to a single borrower. Considering NBD's capital of 600 million, even a 100 million ruble loan represents a formidable 16-17% of the Bank's capital, and every 500 million ruble loan is a direct threat to the Bank's survival in the event of a default. The consultant urges Bank management and CEO Brevnov to reduce capital risk by limiting loan size, and the Bank's willingness to do so will directly affect its viability and the evolution of prudent banking practices.

According to Evgeny Gorkov, Deputy Governor of Nizhny Novgorod oblast, the courts will enforce a pledge of collateral made to secure a loan. In the event of default, the bank files a claim with the court which is mandated to act within two weeks of the filing. If the claim is upheld, the lender may seize and sell the collateral to satisfy the debt. Despite the apparent adequacy of these legal protections, this system remains largely untried and contains an inherent weakness: no penalty attends lying to the Court. Addressing this lacunae will be central to creating a viable commercial banking sector.

### Lending in an Inflationary Environment

Lending is the basic business of banking--accepting deposits and making loans defines a bank. In Russia, however, the only depositor of consequence is the State. At current inflation rates individuals and companies save by hoarding goods and hard currency. The banking system does not mobilize real savings.

NBD's lendable funds come from the 600 million rubles of capital contributed by State enterprises which founded it, and the 487 million rubles NBD borrowed from the state-sponsored Regional Conversion Fund. The inter-bank loan market is the other funding source available to NBD; by definition, these funds are state money as well.

The economic return to NBD on loans earning a nominal 150-200% per year is negative though the *accounting* returns are positive. Few loans go bad because inflation effectively rescues borrowers. The problem with this is that the working capital of banks similarly erodes. Thus, in May, 1992, when the NBD was founded, its 600 million rubles in capital was valued at \$6 million<sup>1</sup>. At the current exchange rate of 670 rubles to the dollar, the Bank's capital is worth less than \$1 million and is deteriorating inexorably as the ruble continues its steady devaluation.

Inevitably, inflation will subside and the value of the ruble will stabilize. In the ensuing recession borrowers will fail and a growing number of loans will enter into default. This will lead to a growing number of bank failures, and is reason for unusually prudent and conservative lending practices. The need to provide venture capital remains a challenge for the entire banking sector as well as individual banks such as NBD.

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<sup>1</sup>Assumes an exchange rate of 100 rubles to US \$1.

### Voucher Dealing and Voucher Trusts

NBD began buying vouchers from individuals and traders last autumn. The Bank sells them in bulk lots to enterprises in oblast and great Nizhny Novgorod region. The bid-asked spread is wide, ranging from 300 to 1,000 rubles per voucher. The Bank also buys vouchers for its own account anticipating using them to acquire an interest in the building it occupies. The Bank's investment in vouchers for its own account is presently to the order of 30 million rubles (approximately 6,000 vouchers).

More recently, the Bank has opened 2,000 "trust" accounts for customers, e.g., as agent for the account-holders. A total of 4,500 vouchers has been invested with the Bank in this manner. As trustee, the Bank is empowered to identify and invest in firms undergoing voucher privatization.

In the last two months of 1992, voucher transactions generated 9.2 million rubles of revenue, equivalent to about 20 percent of net interest income or 22 percent of pre-tax (net) income. Either way the voucher business has been profitable to NBD and is likely to remain so. More importantly, it is a business entailing relatively small risk and little capital. The trust business clearly holds many business opportunities for the Bank.

### Cash Collection Service

The Bank has purchased three armored cars which it intends to use in connection with a commercial cash collection services. It is in the process of signing up retail stores, with the idea being to provide a competing cash collection service to that presently offered solely by the Central Bank. NBD studies indicate that it can charge up to 2% of the amount collected from enterprises and thus undercut the higher-priced services rendered by the Central Bank. Even if the Bank's cost and price estimates are only relatively accurate, cash collection services should prove quite profitable. In addition to being a low-risk, fee-based service which does not require much capital, it will also help the Bank develop important customer relationships.

### Payroll Cash Service

The Bank has installed a physically secure place to store and disburse cash, colloquially referred to as the "cage". According to Bank management, the NBD is the only private bank in the oblast to offer such a service.

Commercial customers of other banks at payroll time send someone first to their own commercial bank for a payment order, which is then transported to the Central Bank's

"cage". NBD, conversely, offers one-stop payroll services at highly competitive rates. Indications are that customers not only find this service valuable but are likely to move their accounts to NBD to enjoy the full advantages of "one stop" banking.

### Business Plan for 1993

Chief Executive Office Brevnov believes that Nizhny Novgorod needs a local bank capable of offering the full range of banking services currently only available from large Moscow banks. His ambition is to see NBD achieve this status, and this explains the tremendous importance he attaches to foreign exchange transactions, new branches and his own data processing system. While the prospects for NBD are very good, Bank Management will have to exercise care to not over extend itself or jeopardize its capital adequacy and liquidity through too rapid growth.

### Capital and Lending

As noted in more detail later in this report, CEO Brevnov is considering extending the capital of the Bank to 2.5 billion rubles. If realized, this would create a Bank which will dwarf the second largest bank in the region.

In tandem with the growth in capital, the NBD plans to significantly increase its lending operations. Exactly how much the loan portfolio will grow is currently an open question, with the Central Bank having no leverage limit at the present time. The Bank is similarly planning to reorganize its lending and credit analysis operations, hiring a new senior officer to oversee both activities. Strengthening credit and portfolio analysis remains a high priority with bank Management (see Organization and Management).

At present, the Bank does not prepare annual budgets and financial plans, and no integrated financial plan exists. The accounting staff instead prepares one-quarter forecasts of income and expenses, which are subsequently used for planning purposes.

### Securities Trading

The Nizhny Novgorod oblast is reputedly planning a 5.5 billion ruble, tax exempt bond issue this year, to be sold to individuals and enterprises. Presently structured to be exempt from state taxes, it may also be structured to be exempt from federal taxes albeit this has yet to be settled. Funds raised through the bond issue will be used to buy crude oil for processing in Nizhny Novgorod's under-utilized refineries.

NBD will not underwrite the deal but will distribute the bonds and, more importantly, will trade in the bonds in the after or secondary market. This should serve to significantly

expand the bank's business and move it unequivocally in the direction of establishing itself as a major money-center financial institution.

### Foreign Exchange Transactions

Bank senior management and Chief Executive Officer Brevnov. are convinced that NBD can make money executing foreign exchange transactions for their relationship clients. At the same time, they feel actually disadvantaged not having any professional staff capability in this area. Addressing these critical staff constraints is acknowledged to be a priority area.

For his own reasons, CEO Brevnov does not want to recruit personnel from other Russian banks. He agreed with the consultant that developing correspondent relations with well known foreign banks would be an asset, and that steps should be taken to this end. Enquiries are now being made in Moscow regarding the activities of U.S. banks, and approaches will be made to USAID to ascertain whether the agency will be able to assist in these efforts.

### Branch Expansion Plans

NBD will be opening branch banking offices in from 8 to 12 post offices in the Nizhny Novgorod oblast beginning in March, 1993. Each branch office will be simply out-fitted and will consist of a counter manned by an employee with a terminal. Present plans are for NBD to compete with the State Savings Bank for retail deposits. Branches will also be a distribution and sales point for Nizhny oblast bond issues.

NBD has also consummated a deal with an automobile service company with offices in the Baltic States and other states of the former USSR. Bank plans call for establishing between 35 and 50 branch offices throughout this enormous area. The branches will be in space provided by the automobile service company and managed by financial personnel seconded by the service company to NBD. Each branch office will have a restricted lending authority of 10 million rubles; larger loans will need to be referred to Home Office and underwritten there. Formal approval has been obtained from the Russian Central Bank for these expansion plans, and bank senior management are sanguine that they will have little difficulty obtaining banking licenses for other countries and territories in the CIS.

From a practical standpoint, the consultant urged bank senior management to proceed slowly with expansion plans, and to open a few offices in the first instance to gain operating experience. Moreover, as NBD does not appear equipped to transact multinational banking business, bank management is perhaps too optimistic at the prospects of gaining banking licenses and probably will not succeed in doing so at this time.

## Organization and Management

All Department heads report directly to Boris Brevnov, Chief Executive Officer of NBD. There is no Deputy Chief Executive Officer. Andrei Morov serves as Senior Advisor-Counsellor to Brevnov.

<u>Department</u>	<u>Officer-in-Charge</u>
Accounting	Galina Klychova
Data Processing	Dmitry Semyokhin
Securities	Andrei Mladentsev
Foreign Exchange	Natalya Metyokina
Banking Operations	Olga Yakunina
Lending Operations	Tatyana Bogatkova
Credit Analysis	Vladimir Vladimiz
Legal/New Projects	Andrei Morov
Building Maintenance and Security	Dmitry Arzhanov

Generally, bank personnel and senior management are young and energetic, with relatively little banking experience. Accounting and lending operations are administered by personnel in their forties, with CEO Brevnov being 25 years of age and his advisor, Morov, being 27. The credit analysis and securities operations--two key areas--are run by people younger than Brevnov but who come across as especially bright and capable.

Securities (voucher dealing and trust operations) were very profitable last year and should do well in 1993. As discussed elsewhere, the attractiveness of Securities trading is enhanced by its low-risk nature.

The major management weakness affecting NBD regards lending operations. The department head for this critically important area has a background in finance and credit but has never served as a loan underwriter. Given that lending carries huge risks for the Bank, it has been impressed on senior management that they must move expeditiously to secure experience in this area. Approaches have now been made to an experienced individual to head-up lending and credit analysis.

Another major source of concern is that Brevnov is spread very thin and is unable to properly execute oversight over all the areas within his purview. Appointing a Chief Operating Officer will be required in the near future, but as yet no evident candidate exists. Bank senior management have been advised to begin the search process for a COO without further delay.

The Bank also presently lacks clearly established procedures, possessing no policy manual, loan policy statement, operations manual, or systems analysis group to produce such documents. The NBD is not unique in this respect, and there is no need to produce these items at this time. As the bank grows and additional personnel and resources are added, the Senior Lending Officer should be instructed to develop a written loan policy statement.

### Capital Plans and Shareholder Relations

NBD is a closed joint stock company. Its 59 founding shareholders are all state armaments, electronics and industrial companies from the Nizhny region. Share holdings range from 400,000 rubles (one share) to 90 million rubles, equivalent to a 15% ownership position. According to bank senior management, existing shareholders are committed to retaining their shares for a two year period.

NBD was organized in part to administer the Regional Conversion Assistance Fund. It was also established by investors as a diversification and development move to aid the economic development of the region, and the bank enjoys particularly good and close relations with the regional government of Nizhny Novgorod.

NBD is currently considering increasing capital to 2.5 billion rubles, with the goal being to enlarge the bank and attract non-military investors. Present plans call for conducting a two-stage offering: one part for institutions, the other for individual investors. While bank senior management appears confident that they shall be able to secure the approval of existing shareholders for the additional share offering, management is quite vague as to how the new shares will be priced. Further efforts need to be made to convince management that new shares should sell at a higher price than the existing shareholders paid, as management currently does not comprehend the need for such a price structure.

Bank records also indicate that only two loans have been extended to founding shareholders. Indeed, the bank prides itself on not being a "pocket" bank that is organized simply to serve as a conduit for passing Central Bank credit through to its sponsors (shareholders).

### Software and Central Bank Oversight

Heretofore, all banks--at least all private ones--relied on the Central Bank's mainframe and software to process their accounts. NBD has been no different in this respect and has depended on printouts for all its information, possessing no on-line service capabilities.

NBD has bought a module designed to run on P.C.'s that will free the Bank from dependance on the Central Bank for general ledger accounting. The vendor of the module,

Mebius Joint Stock Company of Minsk, also designed the system used by the Central Bank and has sold the P.C. version to 16 other banks. NBD plans to purchase a branch-support module for placement in the branches it intends to open in the future.

According to NBD management, the Central Bank does not approve of banks cutting away from its mainframe system insofar as this deprives it of computerized information on these banks' activities. The Central Bank believes this deprives it of the ability to conduct prudential oversight, whereas the banks in question believe this not to be the case. With the expansion of independent general ledger accounting systems, the Central Bank will have to develop other mechanisms for prudent supervision.

### Regional Conversion Fund

The Regional Conversion Fund (RCF) was established by the Nizhny Novgorod Government, and funded via tax receipts. According to NBD management, approximately 1.678 billion rubles of the Fund are presently recorded on the Bank's balance sheet. In return, NBD is paid a 3% fee for managing and making disbursements from the RCF.

Oversight of the Regional Conversion Fund is vested in a State Committee, which is similarly responsible for considering applications and authorizing disbursements (NBD acts merely as a disbursing agent, playing no role in the allocation of RCF credits). As NBD acts merely as administrator and disbursing agent for the Regional Conversion Fund, the bank incurs no risk for any loan funds expended. At the same time, carrying these funds on the Bank's balance sheet overstates the leverage and understates NBD's relative capital strength. NBD's designation as exclusive agent speaks to Brevnov's excellent relationship with the region's political leadership. This is further evidenced by the fact that the Bank has been permitted to borrow 487 million rubles from the Conversion Fund at 90% interest, well below prevailing market rates, which it has subsequently re-lent for its own account.

## Summary of Highlights of Strategic Plan for NBD\*

The formulation of a strategic plan to guide NBD's future growth is in the early stages of development. Obviously, the principal constraints on future growth is the availability of new capital to fuel that growth, the erosion of capital by the general environment and limited opportunities for investing and lending profitably. Listed below are the main lines of action which will bring the NBD through the early stages of its growth, along with the strategic threats which imperil its future viability.

### **Current Operations**

#### **Profitable lines of business**

1. Voucher business, offers a short term opportunity to build profitability.
2. The trust business has potential to offer services to investors in the newly privatized companies.
3. Cage and cash operations provide a long term profitable business potential to NBD.
4. Software purchase will provide modern tools to NBD to manage and control their operation.

#### **Potential Threats**

Loan policy - A Rs 500 million loan is too large for the current capital of the Bank. Rs 100 million is a better limit. When capital increases, the maximum loan size can too.

Loan operations - It is desirable for the lending officer to have as much experience as possible.

### **Future opportunities**

Distributing and trading Nizhny bonds should be a very good business.

Correspondent relations with a foreign bank will be important. Seek out a strong, well known bank preferably one with a Moscow office. Specific contacts have been established by the consultant for NBD follow-up.

Initially, branch office expansion should be confined to the city of Nizhny Novgorod. In this connection, the arrangement to open branches in 7 or 8 post office locations in the city is a good idea, and seems within NBD's current operational control capacity. To expand lending operations into more remote locations with untrained staff will expose the bank to an

excessive level of underwriting risk as well as operations and control problems. The consultant would recommend that such plans be deferred, if at all possible, until the Bank has a stronger human and financial resource position.

### **General Strategy**

Selling services for a fee is much safer and ultimately more profitable than making loans in the current hyper-inflationary environment. The Bank's success will be defined in the future not by Bank size, but by its growing capital strength. As matters stand now, each loan made contributes to the erosion of capital. During a period of high inflation, the accounting profits recorded will be more than offset by the rate of inflation; and when the inevitable stabilization program takes effect, many businesses will fail, and thus many of these loans will default.

A Russian translation of this letter was faxed  
to Brevnov by Price Waterhouse's Moscow office

March 4, 1993

Boris Brevnov  
NBD Bank  
Nizhny Novgorod

Dear Boris:

When you are next in Moscow make an appointment with one of the two people listed below from Chase Manhattan Bank.

Chase is looking for correspondent relationships throughout Russia. They have none in Nizhny Novgorod, and they would be pleased to meet with you.

Steve Fullenkamp and Mary Ginsberg are the Representative and the Deputy Representative of the Bank respectively. The address and telephone numbers of Chase are as follows:

Chase Manhattan Bank N.A.  
Krasnopresnenskay Embankment 12  
1709 Moscow - 123610  
Telephone: 7095 253 2865  
Fax: 7095 230 2174

When you call or write Chase say that you are doing so at my suggestion.

You may also want to talk to Moscow International Bank which is a joint venture of five foreign and three Russian banks and does a substantial foreign business.

Good luck.

John Morgan

### Central Bank Regulatory Policy and Practice

I met with Jean Meyer, an official from the French Central Bank who under IMF auspices is serving as an adviser to the Russian Central Bank with emphasis on regulatory policy. He has been in-country since August, 1992. The following information was provided by Meyer.

- The Central Bank's minimum capital requirement has recently been raised to 100 million rubles to charter a bank.
- There is no maximum leverage ratio.
- A 15% capital limit on loans to one borrower is in place but ineffective because what constitutes one borrower is so poorly defined.
- The Central Bank employs a limited on-site compliance-oriented examination. Safety and soundness issues of loan quality and capital adequacy are outside the examiner's purview.
- The Central Bank has no policy limitations nor prior approval requirement for new branches for Russian banks in or out of the country.
- Russian accounting concepts differ from those used in Europe or the U.S.. There is nothing akin to GAAP or internationally accepted accounting standards in use. In Meyer's view accounting reform is essential to eventual financial reform.

### Upgrading Russian Bank Management Skills

AID might consider supporting a Russian analog to the Stonier School of Banking at Rutgers, the State University of New Jersey.

Stonier Runs both full-time and short-course programs over the whole range of banking operations - credit analysis, branch operations, treasury and cash management and on and on.

Banks nominate their own people to attend a specific course or program. The sponsoring bank pays the tuition.

Faculty is drawn from Rutgers and, especially in the summer courses, from other schools as well. A graduation certificate from Stonier is not a Harvard M.B.A. but it is valued in the market place.

If there were a joint program between Stonier and some Russian counterpart organization it would be an opportunity to train a Russian faculty who could over time learn how to train Russian bankers.

If you asked them, I know the Graduate School of Management at the University of Minnesota which already does a fair amount of work in Eastern Europe would be pleased to talk to you about leading such a program. They would be right at home in Moscow in February.

**NBD**

Balance Sheet - 12/31/92  
(in millions of rubles)

<u>Assets</u>		<u>Liabilities</u>	
Cash	158.5	Accounts Payable	7.6
Deposits in other banks	588.8	Interbank borrowing	50.0
Interbank loans	100.0	Deposits	
C&I Loans	100.0	Commercial	178.5
RCF Loans		State Enterprises	18.4
one year or less	930.0	Individuals	3.4
over one year	263.4	RCF Account	1193.4
Miscellaneous	180.9	RCF borrowing	487.8
Bldgs. & Equipment	<u>73.9</u>	Miscellaneous	50.8
	2691.4	Balancing item	<u>68.3</u>
		Total Liabilities	2058.2
		Net worth	<u>633.2</u>
			2691.4

RCF: Regional Conversion Fund  
Source: NBD Bank and my inferences

NBD

Income Statement

year ending 12/31/92

(in millions of rubles)

Interest Income	
Short Term Loans	30.3
Long Term Loans	9.1
Inter-Bank Loans	<u>16.1</u>
Total	55.5
Interest Expense	
Corporate Deposits	8.4
Individuals	0.1
Inter-Bank Loans	<u>0.7</u>
Total	9.2
Net Interest Income	46.3
Voucher Trading and Trust	<u>2.2</u>
Total income	55.5
Operating expenses	
Payroll	3.4
Supplies and Services	9.3
Fax, Telex	<u>0.9</u>
Total	13.6
Net Income Pre-Tax	41.9
Taxes at 30%	<u>12.6</u>
Net After Tax	29.3

Source: NBD Bank

Prevailing Interest Rates

<u>Short term</u>	<u>Annual Rate</u>	<u>Term</u>
State Savings Bank-passbook	40%	
Central Bank Advances	140%	
Interbank Loans	120%	normal 2 months maximum 6 months
Commercial bank loans	150-200%	3 months
 <u>Long Term</u>		
Regional Conversion Fund industrial borrowers	37%	3 yr. maximum
NBD bank	90%	
State Savings Bank any depositor	45%	one year
child's numbered account	80%	3 years

Source: NBD Bank