



In what has undoubtedly proven to be one of the most difficult years in Russia's financial history, 1998 has also turned out to be an unprecedented test of Alfa Bank's management strategies and balance sheet strength. Thanks to its early assessment of the growing economic risks and timely actions to protect itself, the Bank emerged from the crisis as one of a handful of Russian banks with equity.

In June 1998, after nearly 9 months of internal restructuring, Alfa Bank completed its operational merger with its sister investment company, Alfa Capital. By integrating the two businesses, the Alfa Group Consortium created a truly universal financial institution able to offer clients a full range of retail, wholesale and investment banking products and services. At the same time, the merger considerably streamlined cost centers such as accounting, risk management and back office, while at the same time eliminating potential areas of competition in capital markets and corporate finance operations.

The key strategic aims of the new Alfa Bank are centered around building a mid-market corporate banking business and VIP retail franchise, coordinating strategy and control across the branch and subsidiary network and ensuring the development of a sales-driven brokerage business in both equity and fixed income products.

For the purposes of financial reporting in 1998, the merged Alfa Bank has issued a combined Alfa Financial Group balance sheet presented herein. Since it is difficult to compare the current statements (see note 3 of the Financial Statements) with the historical-cost-based accounts of previous periods, we will refer to the key parameters in the pro forma accounts in order to examine the effects of last year's financial crisis on the Bank's performance and clarify the strategic aims of the Group going forward into the next millennium.

The Group balance sheet in 1998 was significantly affected by the August financial crisis and as such witnessed a considerable contraction in almost all of the main indicators. The Bank's total assets recorded a substantial decrease of 33.4% to USD 951.2 million from USD 1,427 million at 1997 year-end. This downsizing was the result of the sharp devaluation of the rouble and the collapse of the Russian capital markets. It is worth noting that precautionary steps that were taken by the Management in the lending and trading businesses early in the year considerably reduced the impact of the crisis on the balance sheet of the Bank. These measures which included re-organization of these operations in late spring of 1998, focused on a strategy to enable the Bank to withstand a possible "worst case scenario" in the deterioration of the country's economy. Nevertheless, the events that followed August 17th had a dramatic effect on the year-end results of these core operations. Alfa Bank's corporate loan book was reduced by 56% over 1998 from USD 370 million to USD 163 million while the securities portfolio fell by over 93% from USD 487 million at the end of 1997 to USD 30 million at year end 1998.

The capital of the Bank – as well as being hit by the emerging market crisis in late 1997 (as exemplified by retained deficit of USD 261 million) and the continued volatility in 1998 (net operational loss of USD 204.7 million) – was further eroded as a result of the accounting methodology used to measure Bank's performance. The adjustments made in accordance with IAS 29 (Financial Reporting in Hyperinflationary Economies) have resulted in a translation loss (due to inflation) of more than USD 213 million, representing over 30% of the total year-end charge against equity. Nevertheless, with the support of the Bank's investments, particularly the revaluation gain from the independent appraisal of Alfa Group Consortium's holding in the Tyumen Oil Company (TNK), which the Bank financed in 1997, allowed equity to remain positive at USD 51 million. This facilitated the Bank's risk weighted capital adequacy at year-end to equal 5.8%.

At December 31, 1998 the Bank's total loan portfolio equaled USD 169 million, representing a decrease of USD 258.7 million, or 60% from USD 427.7 million at December 31, 1998. The year-end loan balance consisted of USD 163.0 million of commercial loans and USD 6.0 million of loans and advances to banks. The sizeable downturn in the Bank's credit activity has made a major impact on the role that lending plays in the asset structure of the Bank. Although lending activities witnessed a marginal expansion in early 1999, these operations will be influenced throughout 1999 by increased credit risk, with the financial position of corporate and inter-bank counter-parties continuing to be affected and interest rate and currency risks remaining prevalent.

The customer loan book decreased by USD 207 million or by 60% on 1997 year-end results (USD 163 million against USD 370 million in 1997). Commercial loans represented 96.4% of the total loan book and 17% of total assets. The end of the year loan book is over 80% denominated in dollars – a trend common to the portfolio throughout the year. Some 24% of the aggregate commercial loan portfolio consists of loans distributed under the federal agricultural program, which also accounts for a significant part of the overdue loans at the year end. According to the Agreement signed by the Ministry of Finance, Ministry of Agriculture and Alfa Bank on 5 December 1997, Alfa Bank acts as a commission agent for the federal ministries with responsibility for administering the credit facilities and ensuring their timely repayment to the Special Fund once they have been paid back to the Bank by the federally nominated borrower. From this Agreement it is understood that the Bank does not bear credit risk in regard to the recipient of the agricultural loans.

Loans and advances to banks amounted to USD 6.0 million at the end of the year, representing 0.63% of total assets versus 4% at year-end 1997. The book is dominated by hard currency loans to a very select number of mostly Government-owned banks, a clear indication of the market wide breakdown in trust among interbank counterparties.

Traded securities amounted to USD 30 million versus USD 487 million at the end of 1997. While Alfa began the year with a securities portfolio which was diversified among rouble and foreign currency State debt instruments and Russian corporate shares, the management of the Bank – in light of continued volatility and diminishing liquidity in these markets – adopted a conservative strategy early in the summer by gradually reducing the size of its GKO/OFZ portfolio to the minimum required to maintain its primary dealer status.

At December 31, 1998, the Bank's investment portfolio amounted to USD 610 million, an increase of USD 431.1 or 240.8% from USD 179.0 million at December 31, 1997. The investment book is principally made up of investments in

associated companies and in particular the Bank's financing of Alfa Group's purchase of a major stake in Tyumen Oil Company (TNK), which by itself represents more than 88% of the total investment portfolio. The underlying value of this investment has witnessed a considerable appreciation as a result of the much-improved performance of the company and the devaluation effects of the August crisis, all of which have been taken into account by independent appraisers. Consequently, the Bank benefited from a substantial increase in the value of its original investment and recorded a net gain to the Bank's equity of USD 222 million. Reiterating its policy with respect to this transaction, Alfa Bank confirms that its investment into TNK was always intended to be a short-term undertaking, and as such, it will be completely removed from the Bank's balance sheet over the next 3-5 years.

At end of the year Alfa Bank's total liabilities amounted to USD 899 million recording a decline of 23% from USD 1,182 million in 1997. The fall on the liabilities side is primarily attributed to a 34% decline in total deposits from USD 588 million at December 31, 1997 to USD 385 million at December 31, 1998 and a 41% drop in other borrowings (from USD 417 million to USD 247 million over the year). Of total deposits, 64% were in hard currency, 33% in roubles with other currencies making up the balance.

Customer deposits and related bills of exchange ended the year at USD 291 million and USD 42.7 million respectively, representing moderate reductions of 32.8% and 31% respectively in customer account balances and veksel compared with the previous year. Overall sectoral breakdown of customer deposits continues to be well diversified among different economic sectors with areas such as commerce/trade and finance/investment accounting for a greater proportional decline, in line with the effects of the crisis on operations in these sectors. Deposits from Banks amounted to USD 50 million versus USD 92 million at the end of 1997. As a percentage of total liabilities, deposits from banks fell from 7.7% at the end of 1997 to 5.5% at the end of 1998, reflecting continued volatility in the interbank market.

As a result of a partial retirement and repayment of the Bank's large international borrowing, "other borrowed funds" were reduced by 41% to USD 247 million. The restructured USCP, Medium Term Notes (Eurobonds) and a repo loan received in 1998 represent Alfa Bank's longer-term liabilities, which are partially responsible for its ability to maintain sufficient liquidity at the peak of the financial crisis in the 3rd and 4th quarters of 1998. Since the issue of the USD 175 million Eurobond in July 1997, the Bank has retired USD 24.8 million of MTN debt by purchasing the Notes at discount to face value leaving just over USD 150 million worth of Notes outstanding to maturity on July 2000.

Subsequent to the initial payment of USD 9.9 million on the USD 77 million USCP at the end of 1998, the Bank has successfully restructured the balance of the facility on July 16, 1999 by making an additional payment of USD 20.2 million and rescheduling the outstanding amount over a period of three and a half years. As a result of this restructuring Alfa Bank is not in technical default on any of its foreign obligations.

OPERATING RESULTS

Net interest income rose by more than 15% to USD 23.9 million from USD 20.7 million at year-end 1997 on the back of strong performance of the loan portfolio and prudent management of the Bank's coupon-paying fixed income securities prior to the August market crash.

Non-interest income declined by 160% on the year-end 1997 figure of USD 109 million. The significant losses borne by the Bank from securities trading and translation losses from the steep devaluation of the rouble were partially held back by advances made in foreign exchange trading and fee and commission income late in the year.

Fees and commissions income increased by 52% from USD 33 million in 1997 to USD 50 million for 1998 – a clear sign of the Bank's expanding corporate services and products. The inflow of new clients from "problem banks" in the 3rd and 4th quarters provided for a more than two-fold expansion of trade finance, documentary and cash management services. At the same time, active arbitrage operations on the Electronic Lot Trading System (SELT) morning and afternoon sessions resulted in foreign exchange trading gains of USD 41.6 million, an increase of 231% from USD 12.6 million in 1997.

Alfa Bank's total operating loss of USD 40.8 million in 1998 can to a great extent be explained by the overall economic adversity dominating the operating environment. Salary costs in 1998 increased by 203%, to USD 48.2 million from USD 15.8 million over 1997. The significant increase in this area reflects the Bank's dynamic personnel expansion at the regional branch level, in corporate client services, information technology and banking card departments. Keeping in mind the fact that salaries were reduced by 40% for all employees following the drastic downturn in economic conditions after the August crisis, the Bank actually ended the year with 60% more staff than it employed in January 1998. Consequently, the Bank ended the year with a loss before taxation of USD 207.7 million, compared to a profit before income tax of USD 52.4 million in 1997.

Bank wide provisions increased by USD 101.3 million or 544% from USD 18.6 million in 1997 to USD 119.9 million 1998. The lion's share of provisions were allocated towards possible credit losses (34% of total provisions) and diminution in value of investments (48% of total provisions).

As mentioned in the auditors' report, the management has not provided fully for the Bank's potential exposure to the domestic non-deliverable (index) foreign exchange forward market (NDF). When entering into NDF contracts, the parties agree to deliver only the difference in price of foreign exchange between the date of trade and maturity which implies the absence of the transfer of funds for the full amount of the contract at the date of settlement. These transactions were concluded when the development of the Russian banking sector was stable and the relatively calm financial markets facilitated transactions based on mutual trust between banks. Arbitrage courts have referred to the Russian Civil Code, which classifies these transactions as "gambling/betting" and as a result refused to offer legal support for the participating counterparties by not giving them a hearing.

As their execution is not compulsory under current legislation it is the view of the management that unrealized losses do not require provisions or unrealized gains recognition in the Bank's financial statements. Subsequently, a USD 2 million provision is allocated towards potential legal expenses which might arise from unilateral legal action from some of the Alfa Bank's forward counterparties.

The Bank's very conservative assessment of the continued financial and economic uncertainty, as reflected in provision allocation, have produced a post tax loss of USD 204.7 million.