

Use of Derivatives in Financing in Russia

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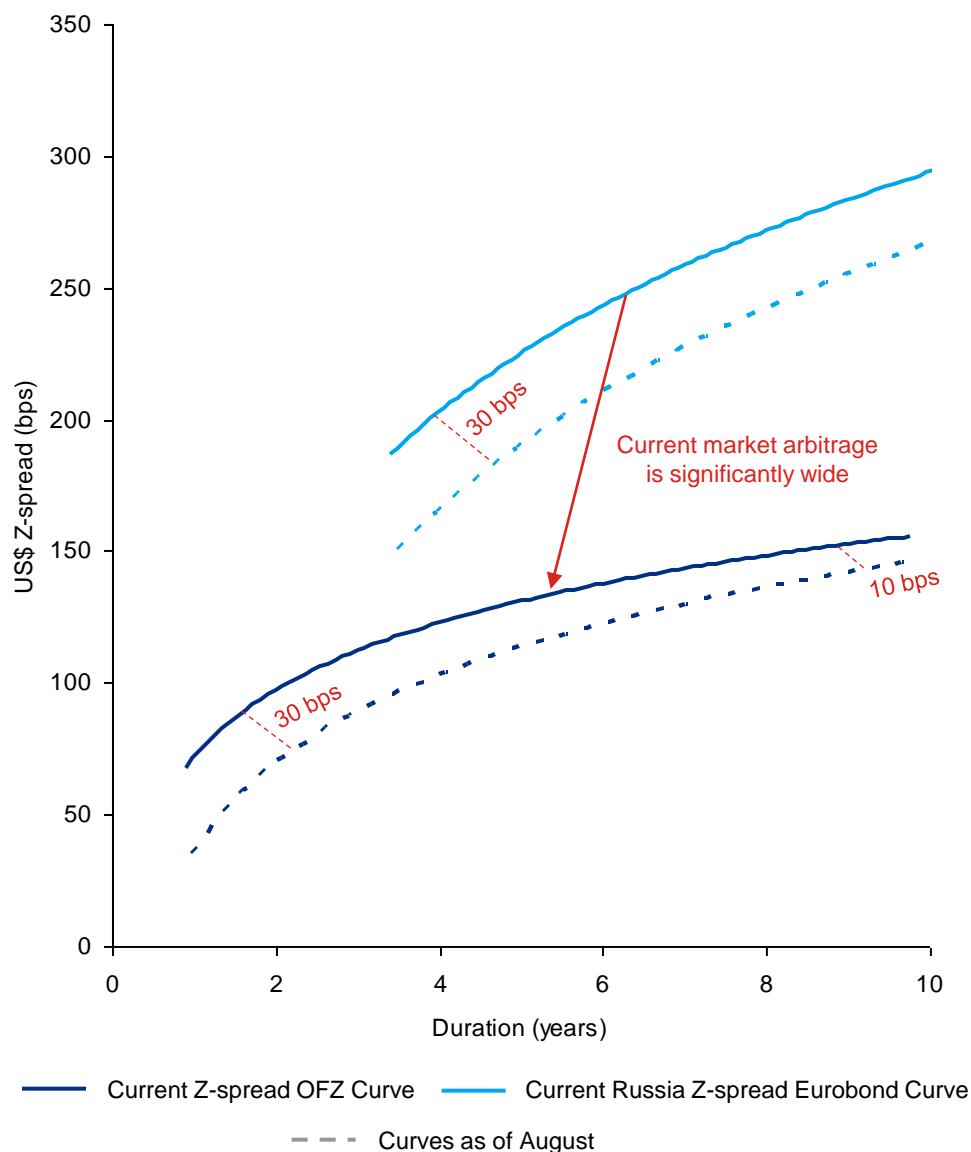
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Russian Government Bonds swapped to USD LIBOR

US\$ Funding* in the local market is cheaper...



...But it depends on the credit quality of the Issuer

- US\$ Z spread curve in the local market is calculated on the basis of RUB local bond curves and market cross currency swap curve (from Libor 3m to RUB fixed rate)
- The US\$ Z spreads for the Eurobonds are significantly higher than for the domestic deals and we observe the arbitrage between the curves to persist for the last 2 years
- The theoretical market arbitrage between US\$ Z-spreads in the local and international markets is reduced due to credit value adjustment (CVA). CVA is the charge used by banks to reflect potential credit exposure related to Derivatives.
- Since August we saw widening in the Z-spread curves both for Local and Eurobond curves
 - Russian Eurobond curve widened by 30 bps
 - Russian local curve (OFZ) widened by 30 bps at the short end of the curve and by 10 bps at the long end respectively

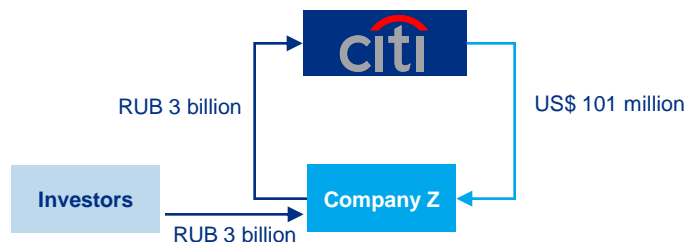
* Current Z-spread curve doesn't include CVA

USDRUB Cross Currency Swap Example

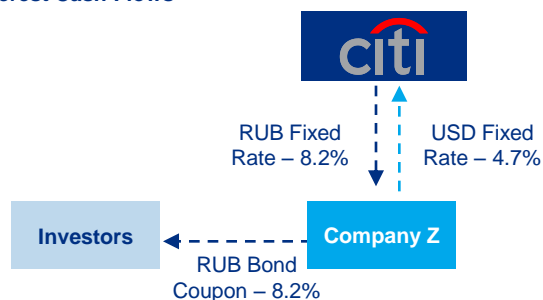
The Cross Currency Swap would allow Company “Z” to fully convert its RUB bond issue into US\$

Transaction Cashflows

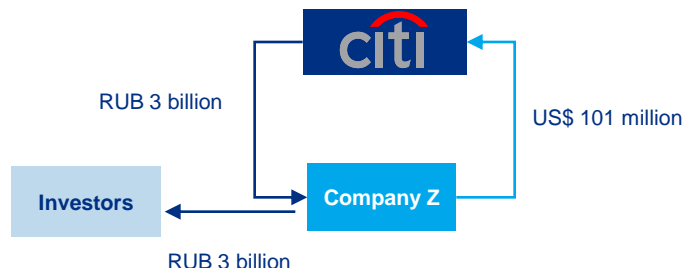
Step 1 – Principal Cash Flows at Inception



Step 2 – Interest Cash Flows



Step 3 – Principal Cash Flows at Maturity

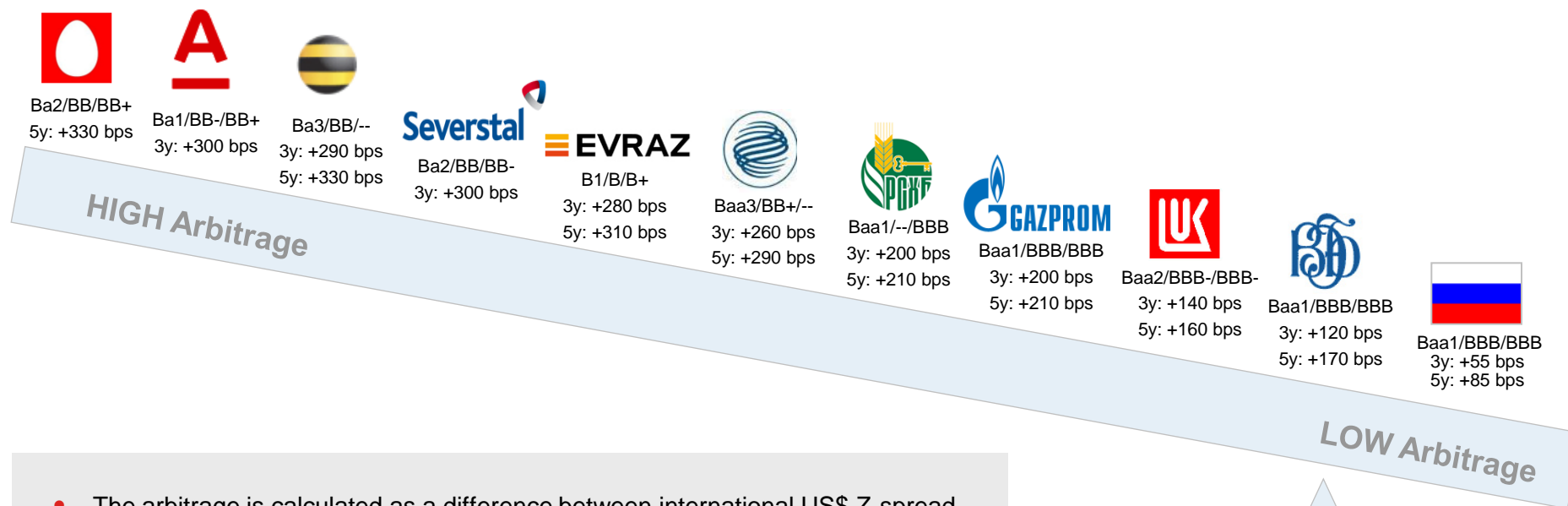


Swap Indicative Terms

- Issuer: Company Z
- Issuer's Rating: BB-
- Swap Providers: Citi
- RUB Principal Amount: RUB 3 billion, based on Initial Exchange Rate
- USD Principal Amount: US\$ 101 mm
- Initial Exchange Rate: 29.65, Spot USD/RUB FX Rate on Trade Date
- Effective Date: Linked to the RUB bond settlement date
- Maturity Date: 3 years from Effective Date
- Principal Exchange: Initial and Final
- USD Day Count Fraction: Actual / 360
- RUB Day Count Action: Actual / Actual
- Company “Z” receives:
 - RUB Principal Amount on Effective Date
 - RUB 8.2% on RUB Principal Amount
 - RUB Principal Repayment on Maturity Date
- Company “Z” pays:
 - US\$ Principal Amount on Effective Date
 - US\$ 4.7% on USD Principal Amount
 - US\$ Principal Repayment on Maturity Date
- Events of Default: According to ISDA documentation
- Margin Provisions: Not required
- Documentation: ISDA and signed confirmation
- Governing Law: English Law

Significant Arbitrage Between US\$ Z-spreads

Theoretical arbitrage between local and international Z-spread curves increases as the issuer rating is decreasing: the lowest arbitrage is between sovereign curves, medium arbitrage is in case of quasi-sovereigns and investment grade companies and large arbitrage is in case of non investment grade companies



- The arbitrage is calculated as a difference between international US\$ Z-spread curve and local US\$ Z-spread curve
- The Local Z-spread curve doesn't include Credit Value Adjustment (CVA should be calculated separately for each Issuer). The lower the credit standing of the issuer the higher the CVA, thus reducing the actual arbitrage available.
- US\$ Z-spread curve in the local market is calculated on the basis of RUB local bond curves and market cross currency swap curve (from Libor 3m to RUB fixed rate)

Local Bond vs Eurobond

Local RUB Bond with Cross Currency Swap in US\$

US\$ Denominated Eurobond

Pros

- Tighter pricing possible in the current market
- Flexibility to place the bonds in the domestic market
- Lower transaction expenses

- Longer tenors and larger volumes are achievable
- Flexibility on the final decision on tenors, size and tranching structure
- Access to the international institutional investors base
- No usage of banks' lines

Cons

- Limited tenor and deal size
- Non enforceable margining (about to change?)
- Potential negative accounting impact (hedge accounting possible, but need to be very careful)
- Relatively low liquidity in the Russian swap market
- The banks' appetite for CCY swaps tends to reduce for longer tenors

- Stricter disclosure requirements
- Higher transaction expenses
- Higher Z-spreads

Implications of CVA and new Basel III

- CVA – Credit Value Adjustment = charge required by banks to compensate them for credit risk of Derivatives
- Basel III – capital requirements for unmargined derivatives have been increased dramatically by the regulators
- Example: BBB Issuer, Basel III requirement without margining 93bp, Basel III requirement with daily margining and a threshold of zero 4bp
- What is needed in Russia:
 - Hedge accounting concepts established already
 - Bankruptcy netting legislation passed already
 - Regulatory framework is yet to be established (FSFM, NAUFOR, rules)
 - Netting and margining should become standard techniques for managing the Derivative exposures and thus reducing the costs for borrowers

Conclusions

- ▲ Use of Derivatives can lower the costs of borrowing for Russian borrowers
- ▲ Enabling laws passed, but regulatory framework is yet to be defined
- ▲ Use of margining for Derivatives transactions should become widespread

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