Use of Derivatives in Financing in Russia

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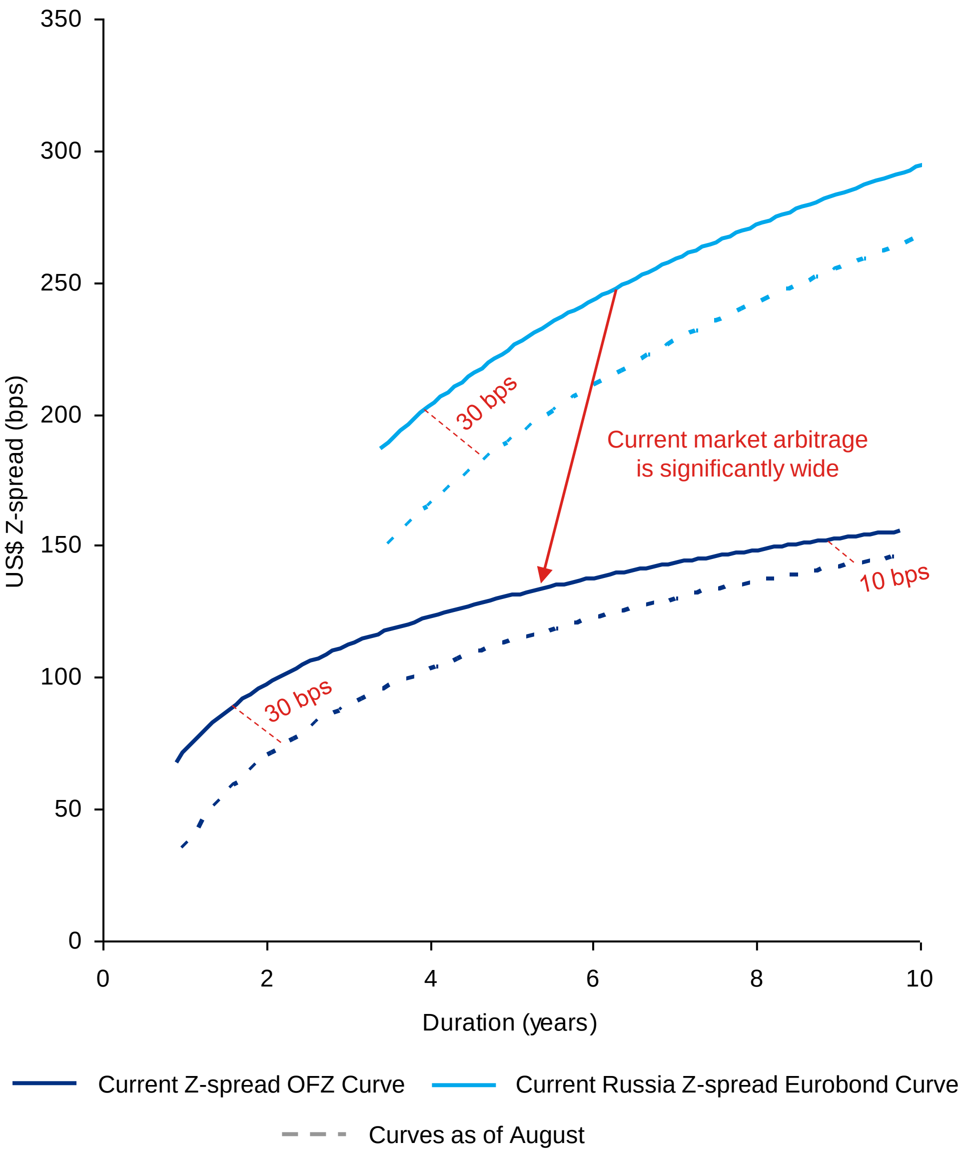
Russian Government Bonds swapped to USD LIBOR

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

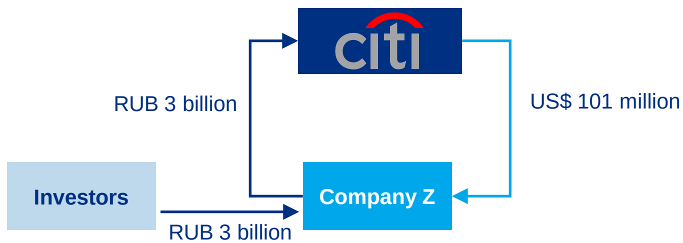
** Current Z-spread curve doesn't include CVA*

USDRUB Cross Currency Swap Example

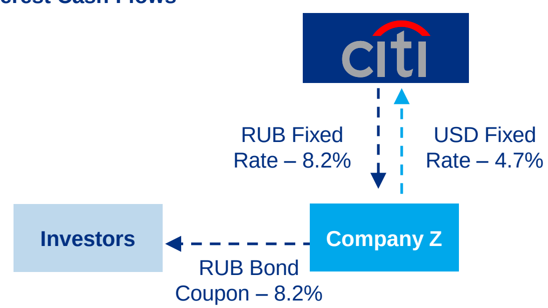
The Cross Currency Swap would allow Company "Z" to fully convert its RUB bond issue into US$

Transaction Cashflows

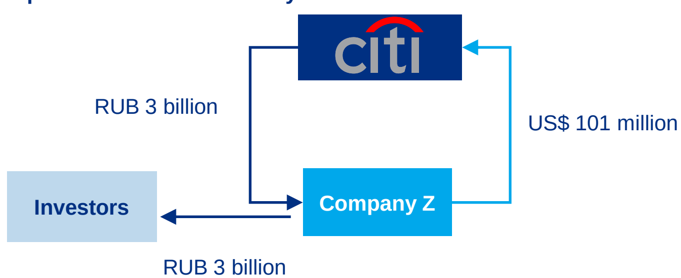
Step 1 – Principal Cash Flows at Inception



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 investments grade companies

Ba2/BB/BB+
5y: +330 bps

Ba1/BB-/BB+
3y: +300 bps

Ba3/BB/--
3y: +290 bps
5y: +330 bps

Severstal
Ba2/BB/BB-
3y: +300 bps

EVRAZ
B1/B/B+
3y: +280 bps
5y: +310 bps

Baa3/BB+/--
3y: +260 bps
5y: +290 bps

Baa1/--/BBB
3y: +200 bps
5y: +210 bps

GAZPROM
Baa1/BBB/BBB
3y: +200 bps
5y: +210 bps

Baa2/BBB-/BBB-
3y: +140 bps
5y: +160 bps

Baa1/BBB/BBB
3y: +120 bps
5y: +170 bps

Baa1/BBB/BBB
3y: +55 bps
5y: +85 bps

HIGH Arbitrage

LOW Arbitrage

- 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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Citi works with its clients in greenhouse gas intensive industries to evaluate emerging risks from climate change and, where appropriate, to mitigate those risks.