



PRIMARY DEALERSHIP UKRAINE



Introduction

- After a series of preliminary discussions with the local Banking community, the National bank of Ukraine, local SEC and international bodies (IMF among others), the Government has launched the process on Primary Dealership development in Ukraine via issuing it's Resolution dd April 14, 2009 along with the Procedure dd June 10, 2009 from Ministry of Finance On Primary Dealer's status, selection and 'modus operandi'.
- This process was first initiated in 1998 but was postponed due to inefficient set-up initially proposed by MoF which was deemed to be weak due to the volatile market conditions that prevailed at such time and justifiable criticism of the local regulatory environment.

General set-up and regulatory pre-conditions

Dealers: banks registered in Ukraine (including subsidiaries)

Maximum number of primary dealers - 16

Minimum number of primary dealers – 6

Application criteria:

- the license on securities trading from local Regulator (SEC and Central bank)
- min paid capital EUR 10 Mio
- Market experience proved with UAH 1 Bn historical trading turnover

A Primary Dealer's duties:

- the participation at primary placements for 3% min during each 6-month period on average;
- to keep 3% share of secondary market turnover for the same period;
- daily two-side quoting on the bonds in the dealer's portfolio;
- consulting support for MoF on market situation etc.

A Primary dealer's rights:

- the exclusive access to primary placements along with other PDs
- the liquidity support by Central bank via Repo.

The club development in 2009

The selection process procedure:

- Should MoF not have managed to received applications from 6 dealers at the first time of asking (it was the case on August 20) the opportunity to apply is kept open every month until 6 names are secured.

Next session took place on September 10th.

- As 6 dealers are selected MoF signs the agreements with them and keeps further sessions on quarterly basis until 12 names are on the list;

- As 12 names are selected MoF organizes next sessions on semi-annual basis until 16 names are achieved.

Results:

August 2009	ING, RZB, Ukrsib, Ukgazbank	-4 names have been accepted
September 2009	OTP, Unicredit, Erste, Rodovid	- have joined – thus making 8 names
December 2009	Bank Kyiv, Bank Kyivska Rus'	- have joined – 10 names

Should the agreement with a particular dealer be cancelled - MoF will organize a new selection session within 1 month to find a replacement.

The general comment of SCO (Jacques Mounier) in support of this activity :

- This request is driven to generate increased commercial flows.
- The necessity we believe that is behind our request is a necessity for being as usual among the pioneers (up to 16 nevertheless...), but also to make sure that we will have those customer flows from the banks, insurance companies and maybe other investors that will trade T-bills/bonds, on top of serving our own group related needs in Kiev, Index (CASA unit in Ukraine) and ourselves, as well as abroad, even if in the latter case requests could come from other banks and investors than CALYON.
- In servicing our client base, we do propose to customers all type of services and products that exist in our tool kit. Primary Dealership would be a significant new feature. It should be clear also that in Ukraine our image is the result of the quality of the service we have provided, in a reliable and professional manner, which has established very good credibility.
- Not offering such possibility cripples our presence and development possibilities.
- On the country envelope limit allocation, we are speaking about UAH bonds, the UAH being **not** a country risked currency... And if this view is not shared by DRPP who insist on keeping it as a 'risk weighted' currency, we would endeavour to arbitrage within the existing allocated envelope.

The rationale for CALYON to become a PD

- Maintenance of Calyon's excellent local standing in keeping apace with our direct International Bank competition, by meeting the demands of the local 'investor' client base.
- Direct access to a primary placement saves the intermediation spread which is practically unlimited and quite high in this market place (200-500 bp);
- PD status suggests the ability to "dictate" real yield level and acceptable structure for next placements in liaison with other PDs;
- It provides high flexibility in managing temporary skews in B/S i.e. CBU regular extra liquidity and refinancing reserves with CB whereas needed;
- Yield curve pattern with its stable (and economically not justified) carry opportunities because of absent hedging tools and very short-term cash market liquidity provides stable (minimum 400 bp in average) gain against historical cost of CBU liabilities thanks to the growing share of stable liabilities in the part of technical balances on customers current accounts (UAH 500 Mio i.e. EUR 40 Mio) on top of commercial deposits and liquidity reserves,
- Cross-selling opportunities in developing business with FIs (insurance companies and investment funds): cash-management with FX and custodian services,
- Direct access for the Group global product lines and their customers for either direct investments or repackaging structures (CLN, CDO ...)
- Direct local revenues from the activity are expected at EUR 1.5 Mio per year.

The rationale for CALYON to become PD (Customers)

The Investor client base and ‘cross-selling’ opportunities.

1) Local customers (insurance companies, investment boutiques, funds) keeping with us their accounts as with custodian and normally asking trader’s services. As well as custody/trading facilities they do provide UAH flows in cash deposits plus FX as the side business (thanks to local regulatory environment, your custodian is normally your trader to be approached first and current accounts to facilitate the settlements, FX is easier with the bank when you keep current account also).

Should we fail to provide existing investors with direct access to full primary yield there is not much reasons for them to keep the whole set-up with us. Splitting business is justifiable only with significant price arbitrage against core banker offer etc.

2) Non-residents. Currently occasional customers and mostly M&A related ones. We are lagging behind ING in servicing non-residents who act as portfolio investors in domestic debts. These are to be developed either directly or to be approached via London-based Funds coverage set-up.

The specific risks and strategy

As stated on Page 3 one of the undertakings as a PD is the obligation to bid on an average over a given 6 month period of 3% of CBU market issuance.

- Anything not re-sold will have to remain in the form of a carry-trade.
- The exposure is to be limited to EUR 50 Mio 'notional' for exactly such cases.

How therefore to manage such risk :

- Purchase of short-dated Bill issuance would be the main priority (80% of the placements next year are to be 3-9 m T-bills) should we have significant effective primary placements volumes and lacking customers' applications.
 - We avoid medium-term and long-term issues if not backed with customers' orders.
 - We do resell to local CB or refinance with it where there is 0-loss opportunity.
 - We would quickly exit the role of Primary Dealer if we reach full limit utilization and there is no liquidity neither on the secondary market nor acceptable effective Bids from other PD's (PD's are supposed to quotes a two-way price.)
- There is no penalty leveraged when a PD decides to give up it's position apart from that of local 'reputational risk'.

Practical view:

- The T-bills/bonds primary placements volumes effectively sold to market (i.e. except specific placements with CB) in 2009 and forecast for 2010 is accurately assessed to be UAH 12 Bn (approx EUR 1 Bn).
- Divided between 16 (number of required PD's) this would imply EUR 62.5 Mio to be bought by each during the full year.

- Theoretically, if all 16 have decided not to invest during 6 months there is no 3% share at all – that's one of regulatory gaps to be clarified at the later stage by local CB modus-operandi detailing the Government Decree and MoF Resolution on the Primary Dealership.

Market risk set-up changes required

Existing market risk authorization:

product	Domestic government debts (T-bills/bonds);
max notional amount	EUR 20 Mio
max maturity	3 years;
VaR	EUR 0.2 Mio

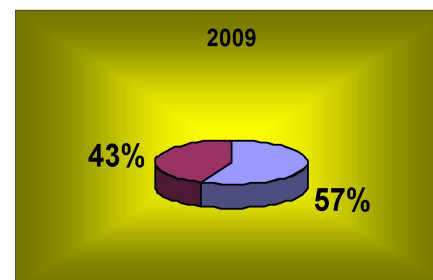
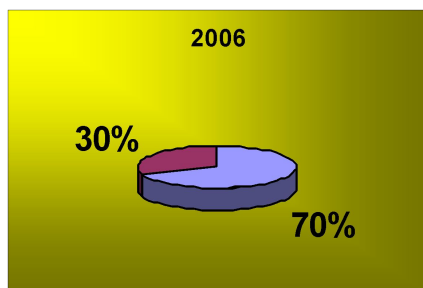
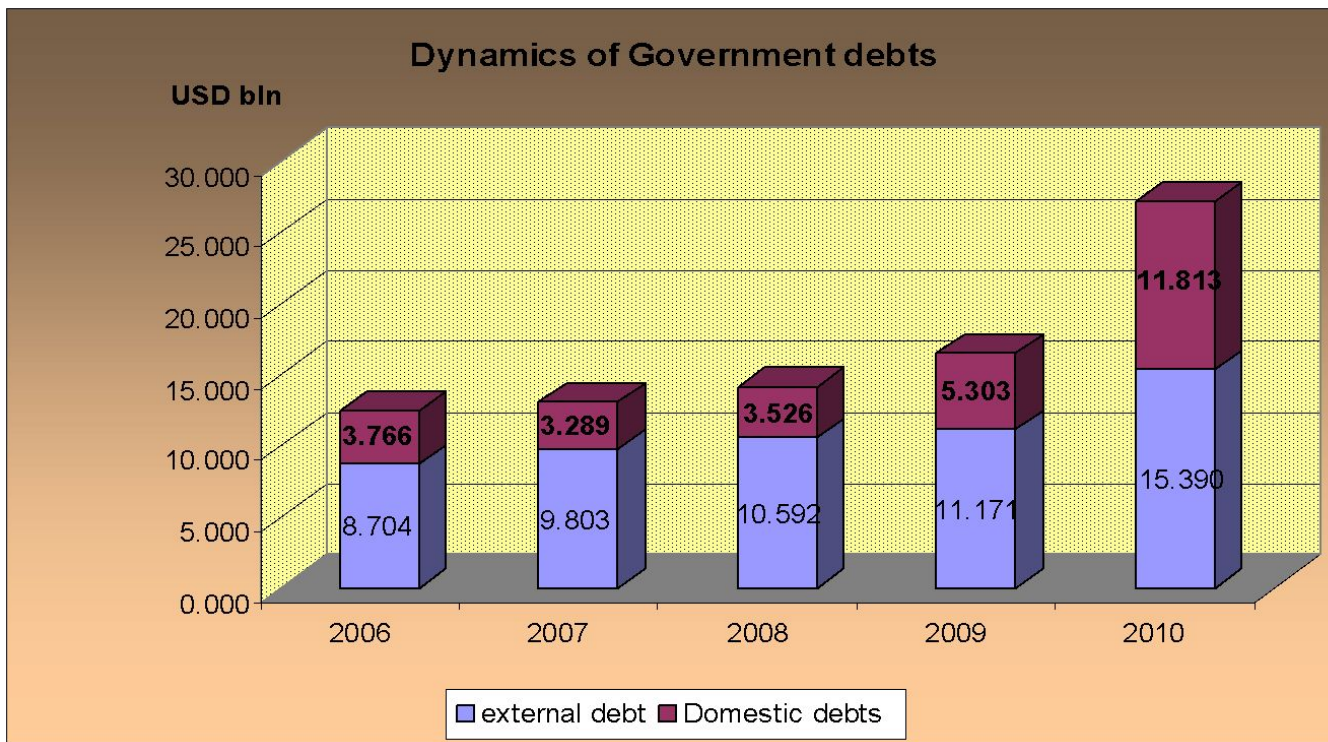
Required changes:

max notional amount	EUR 30 Mio (10 Mio plus)
max maturity	no changes
VaR	to be defined

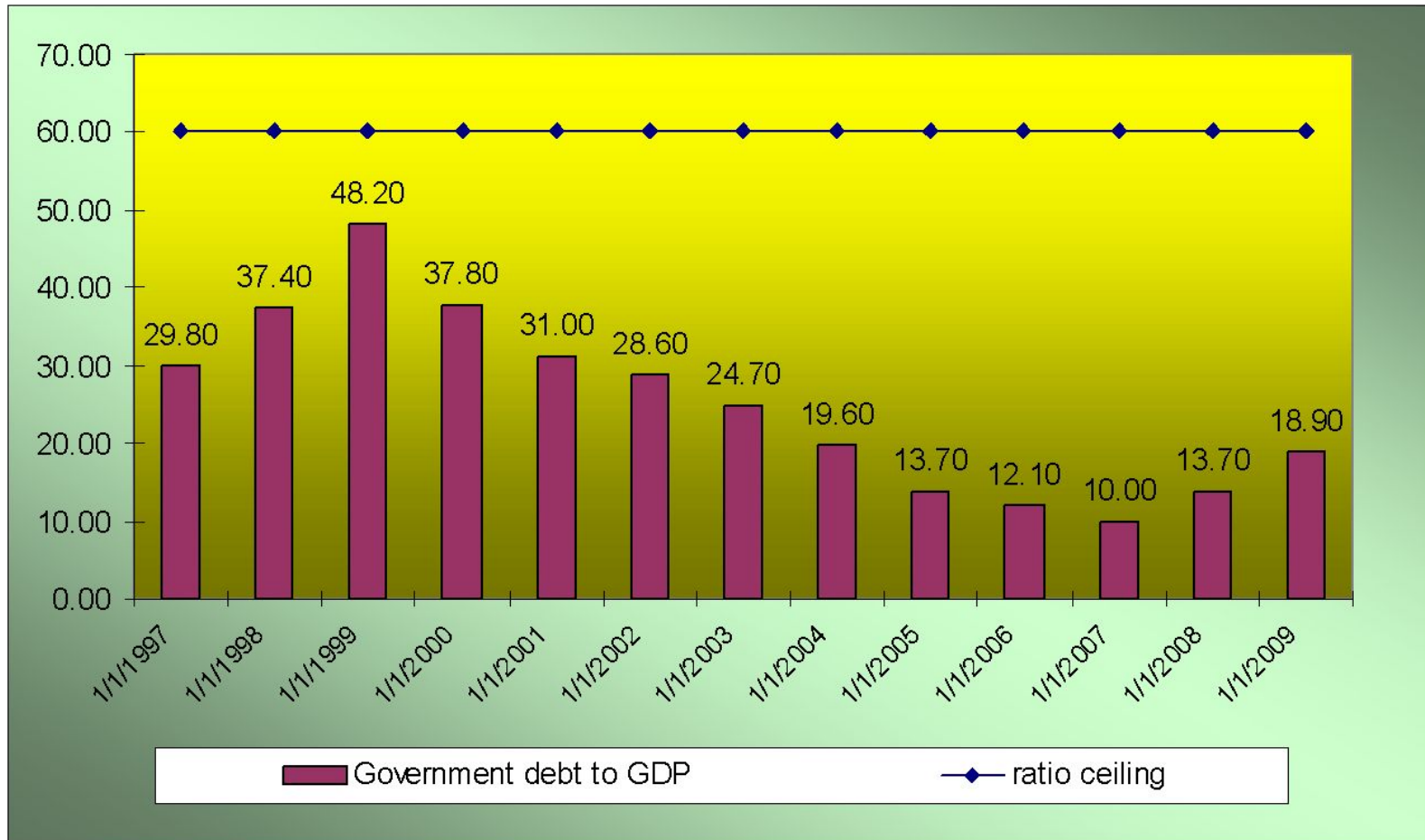
H/C and Cost

- No additional HC is required – requirement of handling the ‘2-way’ quotation as stipulated by position as PD will be covered by existing H/C, with assessment made in due course on recruitment of 1 additional ‘trainee’ if senior trader needs to devote more time to this activity.
- On operations side we need Back-office HC reinforcement as for Trading and Custody activity there is only 1 person part-time involved in other Capital Market transactions processing.
- On system side, we need to shift to ‘on-line mode’ of connection with NBU Depository and create full-range operational set-up with local Exchanges to handle secondary market activity and assure proper data-feed for MtM purposes on risk-management side.
- - K+ to be used as FO system
- Thus, some extra IT investments would be required with maximum cost of EUR 50k as one-time payment with extra maintenance fee up to 10kEUR per year.

The Domestic bonds share in debts structure

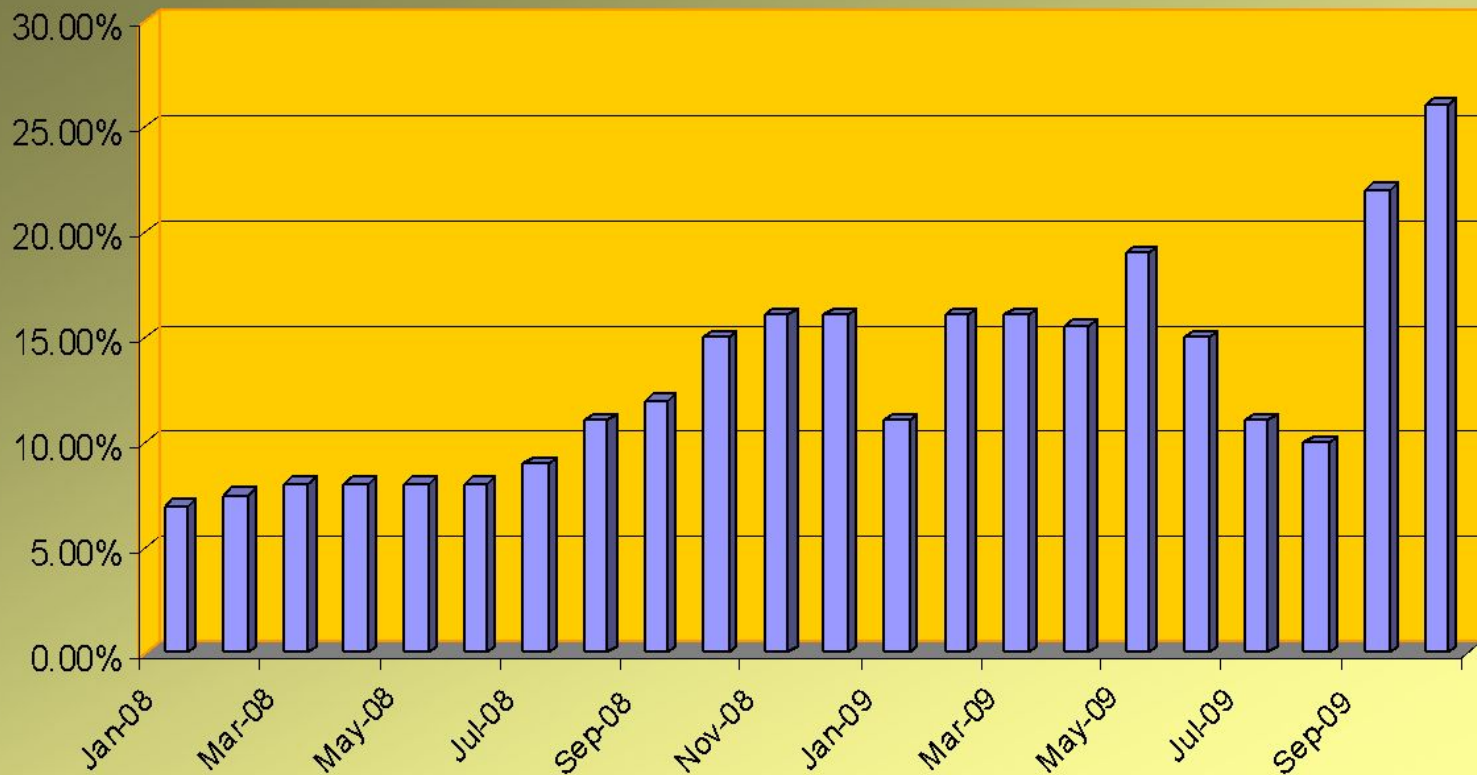


The Government debt/GDP ratio dynamics

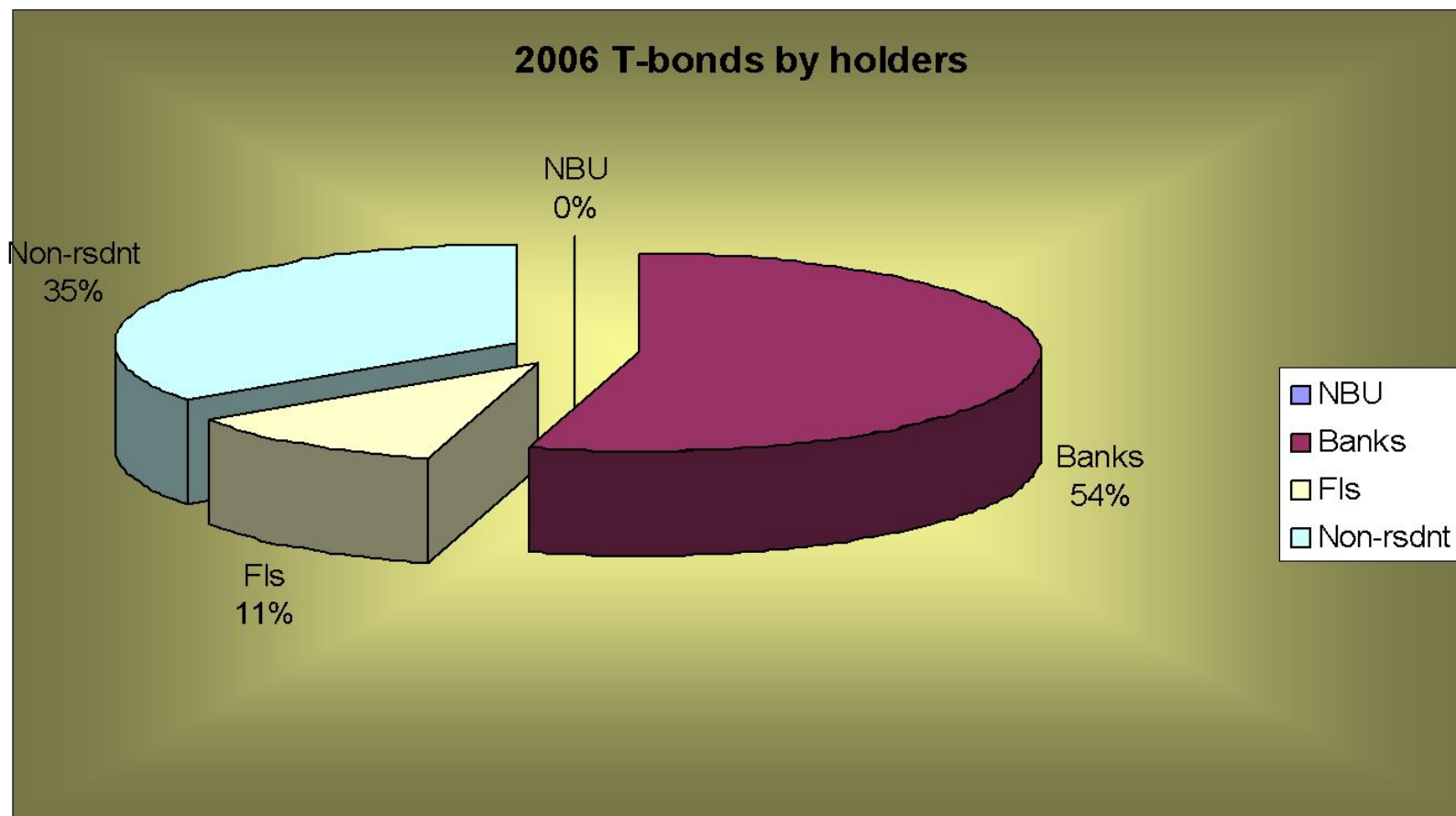


The yield dynamics over the liquidity squeeze period

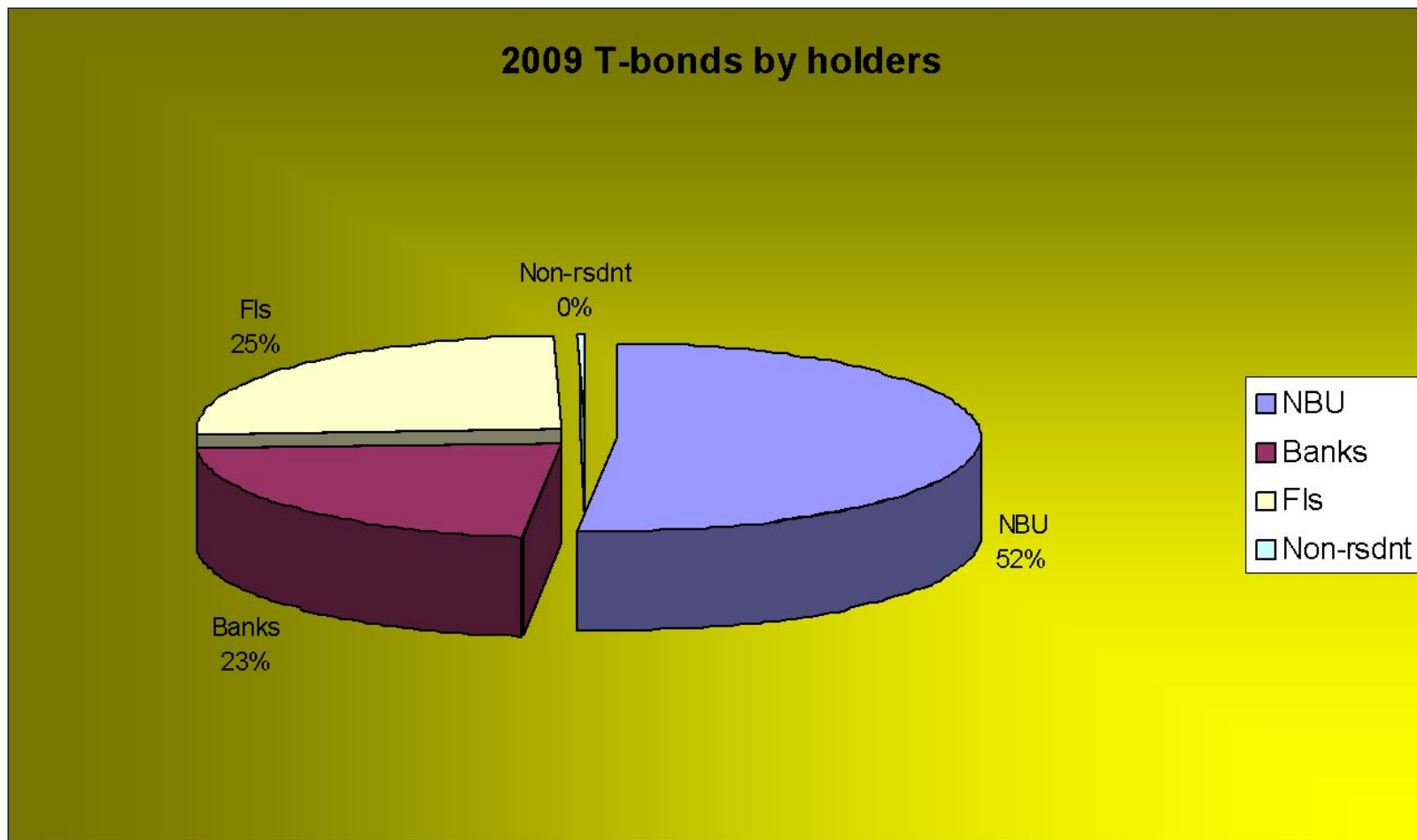
Average yield at primary placement



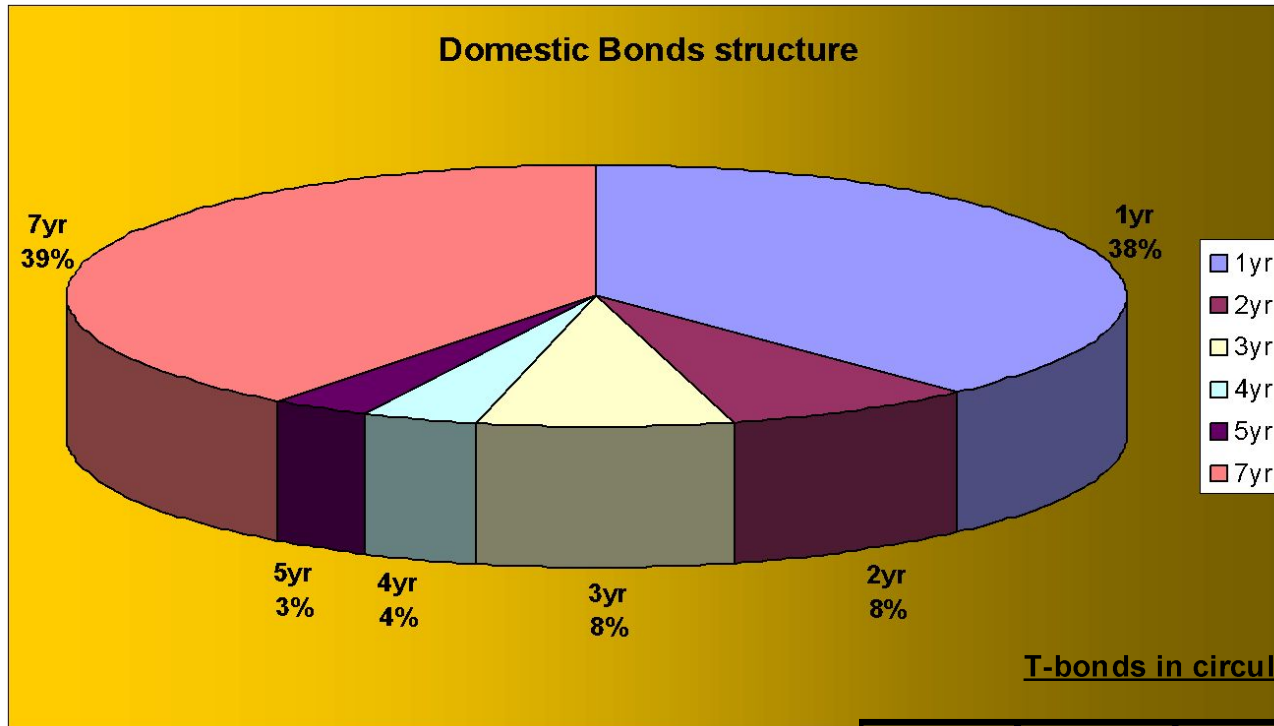
The UAH Bonds holders structure changes 2006-2009



The UAH Bonds holders structure changes 2006-2009



The UAH Bonds maturity structure changes



7-year bonds are specific issuance done by MoF in the process of local banks nationalization as equity injection form. The Bonds are bought and/or refinanced by Central banks.

T-bonds in circulation (in USD bln)

Year	Total	NBU	Banks	Fis	Non-rsdnt
2006	1.44	0.00	0.78	0.16	0.50
2007	1.85	0.00	1.11	0.31	0.44
2008	3.15	1.62	1.02	0.41	0.10
2009	9.01	4.65	2.06	2.27	0.02

Primary placement structure by tenors in USD bln

	1yr	2yr	3yr	4yr	5yr	7yr	Total
2008	0.23	0.21	0.74	0.60	0.14	2.61	4.53
2009	1.05	0.06	0.19	0.00	0.13	1.82	3.25

The request deadline

- The last date when new candidate for the primary dealership should present their applications to MoF - March 1st, 2010
- Should the MoF will select at this session (March 6th 2010) less than 2 names on top to existing ones i.e. the total number will be below 12 – the next session will be organized in three months (June 2010).
- In case of 12 but below 16 in total: next session will be held in 6 months (September 2010).
- Should they achieve 16 names: no session until somebody leaves the club for any reason.