



FINREP Focus

DOMESTIC GOVERNMENT DEBT MARKET

September 27-October 1, 2010

Verkhovna Rada approved UAH 7.4 bln capital injection to Naftogaz through OVDP issuance. This will not increase the budget deficit beyond 6.5% of GDP as stipulated by the IMF memorandum, yet will add to public debt servicing costs. The market is assuming that this injection will be similar in nature to that conducted in FY'09 and that the NBU will be the ultimate recipient either outright or via a state-owned bank.

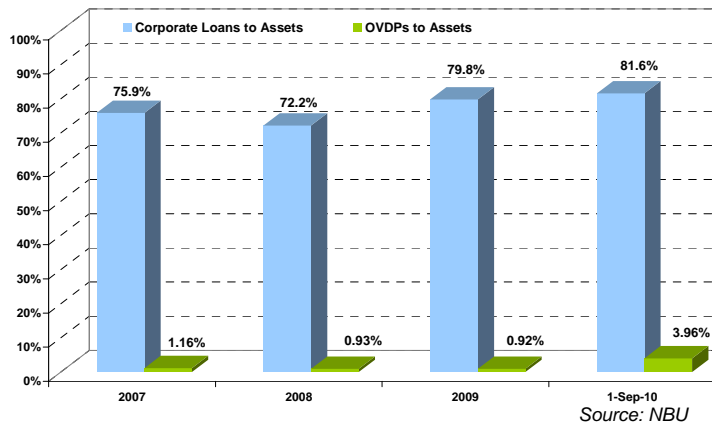
VAT arrears will be reduced to UAH 3 bln by October 1 and zeroed out by yearend. The Single Treasury Account (STA) currently has balance of approximately UAH 12.8 bln therefore goal of zero balance for VAT reimbursement seems reasonable.

Privatization of Ukrtelecom resolution was signed by Prime Minister Azarov. Funds realized from sale could reduce borrowing in the fourth quarter depending on timing of settlement of sale.

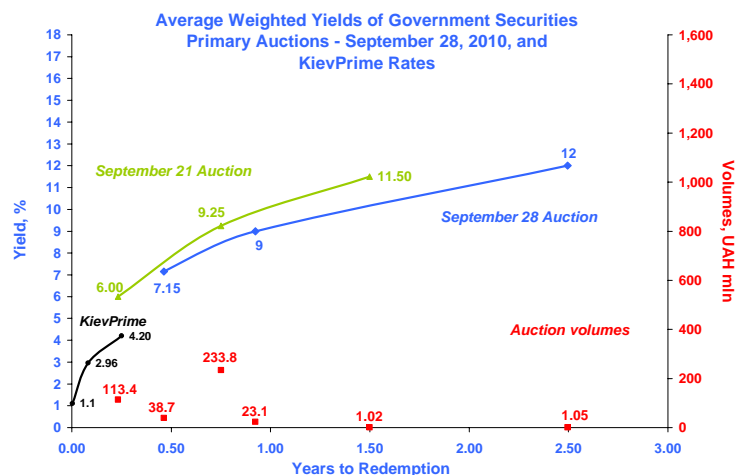
According to Bloomberg, at the time of writing the recently issued Eurobonds were trading as follows: the 67/8% bonds maturing in 2015 at a dollar price of 100.438 for yield of 6.769% and the 7.75% bonds due in 2020 were quoted at 100.38 for yield of 7.694%

The chart on the right illustrates that over the period dating from FY'07 till September 1, 2010 banks have increased their holding of OVDPs approximately ten (10) fold from UAH 3.9 bln to UAH 35.6 bln. This evidences the rapid development of domestic government securities market in Ukraine. There have been several articles and references by press and politicians regarding the dearth of loan creation and overreliance on holdings of domestic government securities by commercial banking system. However, the percentage of loans underwritten to corporate clientele, in fact, grew over this time. The period of FY'10 has been unique in that the increased issuance has been accompanied by a dramatic decrease in yields on domestic government debt. OVDPs, in their role as cornerstone for capital markets, have led to a dramatic lowering in borrowing rates for entities throughout the economy whether through their issuance of securities or direct bank borrowings.

Ukrainian Banks Assets Structure

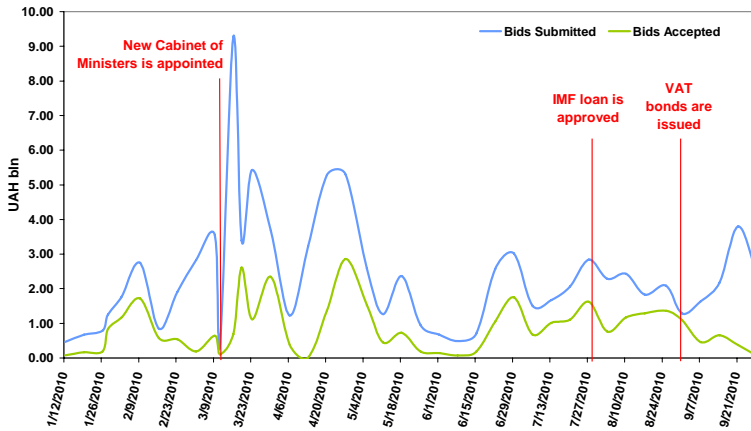


Banking system liquidity, although reduced, still remains high (UAH 22.07 bln) and with relatively small amounts maturing in the next couple of weeks (UAH 0.4 bln) allowed the MOF to continue to accept yields currently prevailing. The yields at Tuesday's auction decreased sharply in the front end of the yield curve: 6-month T-bills lost 1.85% and 11-month bills – 1.9% as compared to two weeks ago. Yields of 2.5-year OVDPs remained at 12%. However, slight amounts placed, including a rumored non-competitive bid for the shortest maturity auctioned, show that these rates do not reflect the market so far.





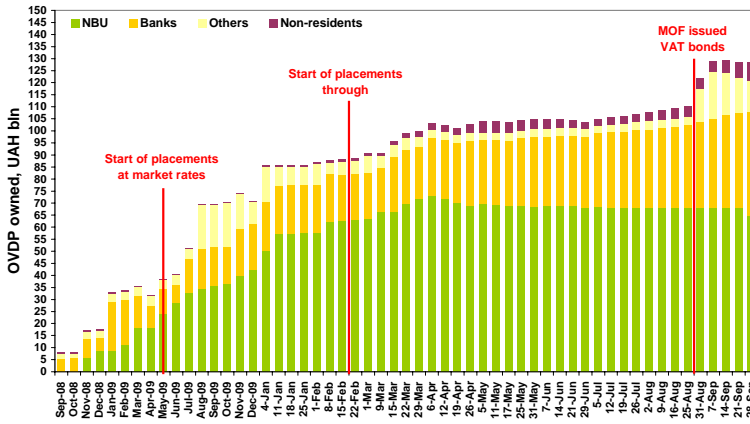
Amounts Submitted and Awarded at Primary Auctions in 2010



This week, the MOF accepted only UAH 0.066 bln from a total of UAH 2.46 bln tendered, i.e. 2.7%.

The continued decline in holdings by others implies the continuance of transfer of VAT bonds from holders, exporters, to banks and non-residents. This week's statistics on non-resident holdings would also lead to assumption that the additions included securities other than VAT bonds.

Dynamics of Domestic Government Bond (OVDP) Holders



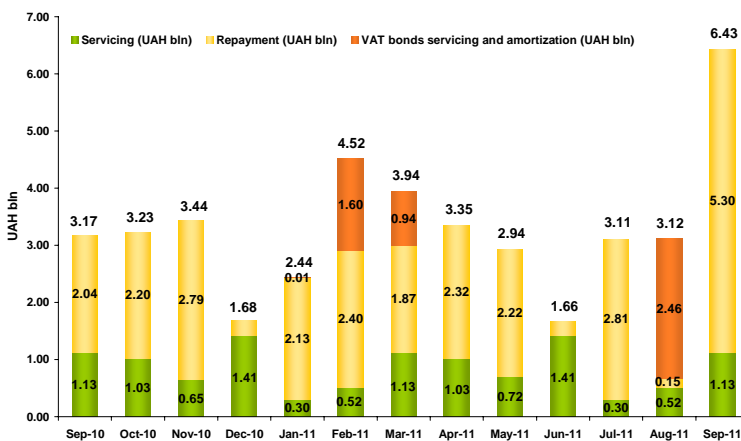
UAH bln

Date	Bonds Held by				Total
	NBU	Banks	Others	Non-residents	
9/21	68.06	39.49	14.69	6.39	128.63
9/28	64.79	42.98	13.22	7.49	128.48

Top 10 Banks by OVDP Holdings (as of the end of August)

Rank	Name of the Bank
1	Oshchadbank
2	UkrEximBank
3	Raiffeisen Aval
4	VTB Bank
5	Erste Bank
6	OTP
7	Ukrsibbank
8	Sberbank of Russia, Subsidiary
9	First Ukrainian International Bank (FUIB)
10	Universal Bank

Domestic Debt Servicing and Repayment in 2010-2011



State-owned banks
Non-primary dealers
Source: Erste Bank

The fourth quarter should present little in the way of pressure on borrowing rates for OVDPs. The continued abundance of liquidity in the banking system, large balances in the Single Treasury Account (STA), continued absence of large quantities of VAT bonds, investors' thirst for increased yield and manageable rollover amounts of maturing securities should allow continued financing at or around prevailing rates, barring any unforeseen shocks to the financial system. The opportunities to extend issuance on the yield curve abound and the MOF should avail themselves of these.