GOVERNMENT DEBT INSTRUMENTS, DEBT-EQUITY SWAPS AND PRIVATIZATION IN BULGARIA

on the joint project "*Transparency of Capital Markets (in the Context of Mass Privatization*) financed by **ICEG** (San Francisco)

by

Galina Dimitrova

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January 1996
Sofia

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Institute for Market Economics
55 N. Rilski Str.
1000 Sofia, Bulgaria
tel/fax: (3592) 818 487; 874 135

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This paper describes the government debt instruments eligible for debt-equity swaps and current Bulgarian debt-equity arrangements and schemes. It also provides a general overview of the most serious problems in the Bulgarian economy and the way they can affect the commitments of the government to the debt conversion schemes and programs. It discusses the recent developments in this field and the manner in which debt-equity swaps can help the stabilization process of the financial sector, the government debt management policy and privatization.

The paper concludes that debt-equity swaps can help to make the debt burden of the country more manageable and can contribute to accelerating privatization and promote the inflow of capital into Bulgaria.

Description of government debt instruments and debt-equity arrangements

I. Domestic debt instruments and conversion schemes

Over the last 4 years, a large-scale operation was conducted in Bulgaria of transforming the non-performing debts of state-owned enterprises accumulated during the pre-reform period into public debt and their exchange for long-term government bonds. One can judge the scale of this operation by the fact that these loans made up 45% of the banks' claims against the non-government sector. The aim was to rid the banks' portfolios from the non-performing assets and the enterprises' balance sheets and at the same time to redistribute the burden of servicing the debts between the budget, the financial system and the enterprises themselves. The government assumed the debts and their servicing but at the same time exchanged these obligations for long-term, low-income government bonds thus transferring part of the burden to the banks. Bonds were issued pursuant to 4 normative acts: CM Decree No. 244 of 1991, CM Decree No. 234 of 1992, the Law on Settlement of Non-performing Credits (LSNC; so called ZUNK bonds) and CM Decree No. 3 of 1994 and are described in the following table. With the CM Decree No. 89 of 1995 concerning measures for rehabilitation of Economic Bank and Mineralbank, bad debts bonds with a total nominal value of BGL 58.314 billion, including dollar-denominated ZUNK bonds worth USD 824.3 million, were canceled and in exchange for them the Ministry of Finance (MF) issued new long-term government securities. (Issues 200 and 201 in the Table below).

Except for the bonds issued pursuant to the first act all other bad debt bonds are book-entry bonds with the registers kept by the BNB.

The interest is paid ex-officio by the BNB directly through the accounts of the financial institutions holding these bonds.

Only bonds issued under the LSNC are convertible into equities. Under the Law, two kinds of instruments were issued: dollar-denominated bonds and leva-denominated bonds. Payments of interest and redemption of principal as well as all transactions with dollar-denominated bonds are effected in local currency thus leaving the exchange rate risk with their holders.

Description of domestic bad debts government bonds

Normative Act	Date of issue	Debt outstanding as the date of issue	Debt outstanding as of 31 Aug. 1995	Interest coupons	Maturity	Grace period	Amortization
1. CM Decree No. 244 of 1991	1.1.1992	BGL 4.1276 billion	BGL 4.1276 billion	BIR* plus 1 point, payable semiannually on 1 July and 1 Jan.	20 years	5 years	Lottery redemption in equal installments beginning 1.12.1996
2. CM Decree No. 234 of 1992	1.7.1993	BGL 6.20947 billion	BGL 4.81683 billion	1st and 2nd year - 1/3 of BIR*;3rd and 4th year - 1/2 of BIR*;5th and 6th year - 2/3 of BIR*;7-th to 20th year - BIR* payable semiannually on the 1 July and 1 Jan.	20 years	5 years	End -of- period equal installments including interest and principal
3. LSNC of 1993, including:							
- Leva-denominated ZUNK bonds	1.10.1993	BGL 26.248 billion	BGL 23.046 billion	1st and 2nd year - 1/3 of BIR*;3rd and 4th year - 1/2 of BIR*;5th and 6th year - 2/3 of BIR*;7-th to 25th year - BIR* payable semiannually on 1 Oct. and 1 Apr.	25 years	5 years	End -of- period equal installments including interest and principal
- Dollar-denominated ZUNK bonds	1.1. 1994	USD 1.808 billion (BGL 96.977 billion at the exchange rate as of the actual date of issue; $1=BGL 53.658)	USD 0.9768 billion (or BGL 66.402 at the current exchange rate)	6-month LIBOR payable semiannually on 1 Jan and 1 July in BGL at the official exchange rate of BNB** at the day of payment	25 years	5 years	End -of- period equal installments including interest and principal payable in BGL at the official exchange rate of BNB** at the day of payment
4. CM Decree No. 3 of 1994	1.12.1993	BGL 1.999 billion	BGL 1.71298 billion	1st and 2nd year - 1/3 of BIR*;3rd and 4th year - 1/2 of BIR*;5th and 6th year - 2/3 of BIR*;7-th to 25th year - BIR* payable annually on 1 Dec.	25 years	5 years	End -of- period equal installments including interest and principal
Bonds issued pursuant to CM Decree No. 89 of 1995, incl.:							
- Issue No. 200	31.5.1995	BGL 22.051 billion	BGL 22.051 billion	BIR* payable semiannually on 29 Nov. and 29 May	7 years	4 years	End -of- period equal installments including interest and principal beginning on 24.11.1999
- Issue No 201	31.5.1995	BGL 36.264 billion	BGL 36.264 billion	BIR* payable semiannually on 29 Nov. and 29 May	7 years	4 years	End -of- period equal installments including interest and principal beginning on 24.11.1999
- Issue No 202	31.5.1995	BGL 1.176 billion	BGL 1.176 billion	BIR*	5 years		End -of- period equal installments including interest and principal
- Issue No 203	31.5.1995	BGL 1.00 billion	BGL 1.00 billion	BIR*	3 years		End -of- period equal installments including interest and principal

* Basic Interest Rate
** Bulgarian National Bank

II. Legal regime and procedures for acquiring and using the bonds in the process of privatization

The LSNC was accompanied by the adoption of a number of other legal acts concerning the secondary market operations for the bonds. They also imposed some restrictions on the trade of these bonds. The regulations were amended several times with the aim to liberalize the legal regime and to encourage the development of the secondary market.

Transactions with ZUNK bonds on the secondary market are executed in accordance with the Ordinance on the rules and conditions for the acquisition, servicing and redemption of long-term government bonds, issued pursuant to the LSNC adopted on 14 February, 1994.

The bonds can be used as legal tender in a number of transactions, effected by banks, firms and individuals. Bond security can be pledged, used as collateral for payment of third party claims and as a clearing instrument for mutual set-offs of companies' claims, etc. Recent amendments to the regulations allowed for the enterprises with transformed debts under the LSNC to use the bonds for retiring their debts to the budget. According to the rules applied, BGL 1000 face value of leva-denominated bonds retire BGL 800 debt and USD 100 of dollar denominated bonds retire USD 100 of debt.

The banks can post them as collateral for refinancing at the BNB. Initially, BNB was giving out as a credit 40% of the face amount of the bonds posted as collateral. Currently, this percentage is 50% for the leva-denominated bonds and 70% for the dollar-denominated bonds.

The banks with more than 50% state participation are not allowed to sell the bonds at a price lower than the minimum price established by the BNB every three months by a special methodology. It is basically the discounted value plus a premium, reflecting the possibility to use these bonds in privatization. This minimum price applies to all bank sales of bonds whether the bonds will later be used for privatization or not. Purchasing the bonds, the new holder receives a certificate issued by the bank, which is a security certifying a bond holder's claim issued in accordance with the LSNC. The negotiated price should be written down on the certificate. For the period 1 July - 30 September the minimum price for the leva-denominated bonds was established at BGL 700 for BGL 1000 face value and for the dollar-denominated bonds at USD 90 for USD 100 face value.

Bonds can be used in the privatization of state enterprises (recent amendments excluded municipal enterprises from this process) subject to rules and conditions set up by CM Decree N0. 36 adopted in February 1994.

Both leva and dollar denominated bonds can be used in privatization at their face value, with no regard to their purchase price (initially the dollar bonds were allowed to participate in privatization with the negotiated market price). Another feature of the dollar denominated bonds is that all transactions using them should be effected in Leva at the central exchange rate of the BNB on the day of settlement. The government agencies in charge of privatization require from physical and juridical persons willing to use the bonds in privatization the above mentioned certificate and a certified letter, also issued by the bank, certifying the total value of the bonds on its register. The Privatization Agency also requires a bank guarantee for the value of the stocks of the enterprise under privatization which are to be purchased. When a foreign legal person or a legal person through which a foreign company has a casting vote wants to buy government bonds and use them in privatization, he must receive a permit from the Council of Ministers (actually from the Interministry Foreign Investment Commission in charge of issuing such permits) and submit it to the government agency in charge of privatization when the privatized enterprise is in certain branches or regions (basically, military production and trade, banking and insurance and exploration, exploitation and extraction of natural resources). The privatizing agencies (the Privatization Agency and the branch ministries and committees) transfer the above- mentioned documents confirming the payment. The MF registers the certifies and notifies the BNB to cancel the bonds. The whole procedure should take about a month.

It is important to note that only bonds purchased from the BNB and the commercial banks-primary holders, which had exchanged bad loans for bonds, and which are not purchased on the secondary market can be used in privatization. There are plans to change this stipulation to allow bonds purchased from all banks, both primary and secondary holders and the State Savings Bank, to be used in privatization.

CM Decree No. 89 of 19 April, 1995 introduced a premium of 40% to the face value of all ZUNK bonds when used as payment instruments in privatization. This provision is valid until the end of 1995.

Secondary market transactions and bad debt bonds conversion experience

The secondary market of ZUNK bonds is underdeveloped and illiquid due to the following factors:

- Most of the ZUNK bonds were pledged as collateral for Lombard credits as a result of the BNB policy of shrinking the uncollaterized refinancing. Lombard refinancing against leva-denominated ZUNK bonds was introduced in March 1994 and against dollar-denominated ZUNK bonds in June 1994. The attractiveness of these transactions to banks can largely be explained by the fact that 50% (respectively 70%) of the face value given out by the BNB as credit makes up 71% (respectively 78%) of the market price of these bonds.

- Only bonds purchased from the primary holders of the bonds and the BNB are eligible for debt-equity swaps thus limiting the attractiveness of the bonds as investment instruments.

- The low return on the bonds, as a result of both below market interest rates and the administrative restrictions as to the minimum price, prevented them from becoming an attractive investment instruments.

- Part of the bad debt bonds are sold on the secondary market in the form of credits. In the purchases against credits, the price is the face value or close to it. However, the interest on this credit is more favorable.

- Prices of the bonds on the secondary market reflect, so far, scarcity in the supply of the bonds and the fact that bonds are used predominantly in Repo deals. They are also used as collateral for Lombard credits, and in such schemes between the banks and customers in which the buyers agree to purchase the bonds at prices near the nominal value of the bonds in exchange for loans from the banks with more favorable interest rates. In the period before April 1995, a factor influencing the supply and the prices of bonds was associated with the anticipation of the banks (major holders of the bonds) that the bonds will be purchased at par by the Central bank as part of a bail-out operation for banks with liquidity troubles, caused mainly by the low current yields on the ZUNK bonds. Thus the prices do not reflect real market demand and supply.

- Most of the deals between banks and non-banks are over-the-counter. However, the volume of deals with ZUNK bonds, concluded on the organized markets, is constantly increasing, making up the bulk of the total turnover of these exchanges.

- In 1994, within a bail-out program for Economic Bank, BNB bought all of its leva-denominated bonds worth Leva 8.8 billion at face value.

Recent improvements in the liquidity of the secondary market of ZUNK bonds are attributable to the following factors:

- In September, 1994 a decision taken by BNB was adopted, according to which the minimum required reserves of the commercial banks to the amount equal to the value of long-term government securities sold to individuals and companies will bear an interest rate of 1/2 of the BIR. Thus the banks were encouraged to increase the supply of bonds.

- Under the conditions of the liquidity crises in the banking sector, the volume of unsecured transactions on the interbank market shrank sharply in favour of secured transactions. Thus, the importance of the ZUNK bonds along with other government securities as collateral in such transactions grew and the banks and financial institutions started to use them more actively. The volume of the Repo market also increased and now offers a combination of both higher returns and higher liquidity. As the BNB restricted the non-banking financial institutions in some of their transactions, the importance of the Repo deals as a substitute for restricted transactions increased. Individuals and companies also started to use them more actively for purposes other than as a payment instrument in privatization. An indication of this is data on the volumes of ZUNK bonds bought and used in privatization. (see Table below)

	BGL ZUNK bonds bought	BGL ZUNK bonds used in privatization	USD ZUNK bonds bought	USD ZUNK bonds used in privatization
1994	BGL 3.130 billion	BGL 1.523 billion		
1995 as of 31 August	BGL 10.832 billion	BGL 1.134 billion	USD 8.3 million	USD 1.063 million
Total	BGL 13.962 billion	BGL 2.657 billion	USD 8.3 million	USD 1.063 million

Source: BNB and MF

- The introduction of a premium on the face value of ZUNK bonds in privatization and the increased demand for them allowed the banks (primary holders) to offer higher prices, thus lowering the losses incurred by the sale of the bonds below face value. Some of the banks are even offering them at prices above face value. This encouraged the banks to trade them more actively.

At the end of August 1995, ZUNK bonds with a total nominal value of BGL 2.657 billion and USD 1.06 million have been used as payment instruments in privatization, redeeming government debt with the same value. For comparison, revenues from privatization at the end of August 1995 amount to around BGL 9.415 billion according to the Privatization Agency.

Although there are no restrictions on foreigners to purchase and use the bonds in privatization they are not familiar with this opportunity due mainly to the lack of information. With the newly imposed restrictions as to the use of Brady bonds as a payment instrument in privatization (only 50% of a deal can be paid with Brady bonds) the significance of ZUNK bonds as a payment instrument for the remaining part of the deal for foreign investors will grow, thus contributing to the development of the secondary market.

- At the end of August 1995, enterprises with transformed debts have used ZUNK bonds with a total nominal value of BGL 39 mln and USD 4.8 million to retire debts on the bad credits to the budget. The total debt outstanding of enterprises' debt to the budget on the bad credits is estimated at about 92 billion (both dollar- and leva-denominated). The debt was reduced by writing-off the accrued interest and through rescheduling agreements.

- If in 1995, the privatization revenue target of BGL 10 billion is met in the form of bonds payments, economies worth BGL 140 mln of interest payments on the external debt and worth BGL 255 mln of interest payment on the domestic debt will be realized.

The Brady deal, the external debt instruments and debt-equity arrangements

Bulgaria declared default on its external payments, including interest payments on 29 March, 1990.

Partial payments on interest were resumed in 1992.

At the end of 1992, Bulgarian external debt totaled $12.7 billion, including $1.2 billion in convertible currency claims held by former CMEA members. Debt to commercial banks amounted to $9.3 billion of which short-term debt accounted for $2.8 billion and interest arrears $1.5 billion.

After nearly 3 years of negotiations, Bulgaria obtained a Brady deal. The agreements with the London Club creditors were signed on 28 July, 1994. The deal established a menu of options, including debt buybacks, discount bonds, past due interest bonds and front loaded interest reduction bonds.

The debt covered by the package amounted to $ 8.16 billion, which represented 88% of the qualified debt to commercial bank creditors. The break down of the debt among the four options and the features of the instruments is as follows:

- 60.7% of the debt exchanged at 50% discount for discount bonds: total debt outstanding - $ 1.85 billion; 30 year bullet maturity; market interest rate (LIBOR+13/16) payable semiannually; collaterized as against principal by 30 year US Treasury Zero Coupon Bonds and as against the 12-month interest on a rolling basis by short-term low-risk dollar-denominated securities. A value recovery clause for these bonds is also included in the agreement.
- 27% of the debt exchanged at par for Front-loaded interest reduction bonds (Flirbs); total debt outstanding - $ 1.658 billion; 18 year bullet maturity; step-up reduced interest rate (in the first 3 years - 2%, from the fourth to the eighth year increase by a step of 1/4 percentage points, afterwards - LIBOR plus 13/16) payable semiannually; collaterized as to the interest payments for the first eight years by STRIPs.
- The most short-term debt and a portion of the interest arrears were exchanged for Discs and Flirbs bearing LIBOR plus 15/16; total debt outstanding - $ 334 million.
- Past due interest payments less the down-payments before the conclusion of the deal and interest accrued on the debt included in the buy-backs were exchanged for Interest Arrears bonds (IABs) - total debt outstanding - $ 1.611 billion; 17 year maturity; amortization starts from 30 July, 2001; interest rate LIBOR plus 13/16 payable semiannually, uncollateralized.
- Around $ 990 million, including interest (12.5% of the total debt) was bought back at the officially offered price of 25.1875 cents for a dollar of principal and deriving interest.

Face value of all bonds is $ 250 000.

Bulgarian Brady bonds are registered on the Luxembourg Stock Exchange (Euroclear and SIMEX).

The agreement provides for a conversion of the FLIRBS and the Discount bonds into equity: Discs at par and Flirbs at 50% of their face value.

The Brady package allowed for a 47.1% reduction of debt and debt service. The initial cost amounted to $750 million mostly covered by IMF, WB and G-24 financing. The annual payments associated with the deal, according to the most pessimistic forecasts, amount to $ 270 million until 2000, $ 800 million in the period 2006-2008 and $ 180-200 million at the end of the maturity before 2020.

Debt-equity arrangements

The debt-equity arrangements were passed on 25 November, 1994, pursuant to the London Club agreements and the Law on privatization. Initially, the arrangements were among the most liberal in the world in terms of the participants in debt-equity transactions (all primary and secondary holders of the bonds, Bulgarian or foreign juridical and physical persons) in terms of the absence of any restrictions on the capital profit repatriation; in terms of the lack of any explicitly imposed additional charges, taxes or fees associated with the use of these instruments and in terms of the absence of any limitations on the enterprises which can be included in debt-equity schemes (with the exception of those envisaged in the Law on foreign investments) and requirements for new money. However , only two months later, at the end of February, the arrangements were changed to include restriction on capital repatriation of 10 years and on profit repatriation for 4 years and the introduction of 50/50 ratio of bonds to cash payments in privatization deals with the use of Brady bonds.

Description of Bulgarian debt-equity scheme:

The scheme provides for debt-equity conversion through the use of a mechanism designed to avoid the expansion of the monetary base. Under the provisions in the regulation, the bonds can be used in privatization deals of state-owned (but not municipal) enterprises directly as a payment instrument without having to pass through the local currency and the Central bank. According to the foreign exchange regime, all transactions should be effected in the national currency. The conversion rate at which the value of the bonds in national currency is calculated is the average official exchange rate of the BNB for the last six months before the conclusion of the privatization deal.

Brady bonds can not be used in privatization through public placement of the shares of state-owned enterprises as well as for other payment purposes such as future investment commitments, taxes, duties, fines, penalties for breaking a contract, fees and other liabilities to the central and local authorities.

No special list of enterprises is envisaged, which implies that investors have unlimited access to all enterprises in privatization.

Under the new arrangements not more than 50% of the value of the acquired shares, stakes or property can be paid with Brady bonds. However, the interest accrued, but not paid between the last interest payment and the date of the purchase of the bonds, will be considered as cash payment.

The procedure of payments with Brady bonds lasts about 1-2 months.

Policy considerations affecting the government's commitment to debt-equity swaps

The debt-equity schemes in the context of government debt and its management

Bulgaria entered 1995 with nearly BGL 1000 billion government debt to external and internal creditors which are almost twice its nominal GDP in 1994 (BGL 514 billion).

The external debt at the end of 1994 comprised: $ 5.1 billion to holders of Brady bonds, issued on 28 July, 1994; $ 538.9 mln to banks not participating in the Brady deal ($ 50 mln to the Polish National Bank and the rest to the Russian overseas banks, assumed later by the Russian Central Bank); $ 1.3 billion to the Paris Club creditors, $ 2.2 billion to IMF, the WB and G-24; $ 800 mln to the former CMEA banks - IIB and IBEC as well as unsettled liabilities to former CMEA-countries. The total amount in domestic currency is BGL 670 billion. Later in 1995, the claims of Russian banks were included in Russia's claims on Bulgaria and settled under the bilateral agreement for settling mutual debts between the two countries.

The domestic government debt to BNB, commercial banks and other holders of government securities as of 31 December, 1994 amounted to BGL 277.283 billion and as of 31 August, 1995 increased to BGL 328.144 billion.

At the end of 1994, more than half (BGL 156.582 billion) of the internal debt consisted of bonds, issued in exchange for the non-performing credits (pursuant to CM Decree No. 244 of 1991, CM Decree No. 234 of 1992, LSNC, and CM Decree No. 3 of 18 January 1994) of the state-owned enterprises to the commercial banks, negotiated until the end of 1990, which were transformed into public debt. In 1994, the debt on government securities to assume bad debt loans grew the most (by 250.9%) compared to the other components of the internal debt. This was a result of the inclusion of the lev equivalent of the dollar-denominated bonds worth $ 1.808 billion.(the dollar-denominated bonds under the LSNC were issued actually in June, 1995). The amount of this debt component and its servicing depends directly on the BGL/USD exchange rate. Despite the fact that the debt on the bad debt bonds was 57.2% of the total internal debt, due to the low interests on most of the issues, the expenditures for its servicing in 1994 made up only 8.7% of total expenditures for servicing the internal debt. In June 1995, a large-scale operation of transforming bad debts bonds with a total nominal value of BGL 58.314 billion into market interest government 7-years bonds was conducted within a bail-out program for Economic Bank and Mineralbank. As a result of this operation, the debt on the ZUNK bonds was substantially reduced and as of 31 August made up 30.5% of the government debt. In 1995, its servicing will amount to BGL 12.6 billion, which makes up 11% of total interest expenditures, 4.8% of all budget expenditures and 1.5% of GDP.

In 1994, this debt was reduced through debt-equity swaps by 5.8% or BGL 1.523 billion. The reduction was almost exclusively at the expense of the BGL-denominated bonds. In 1995, the expected effect of the debt-for-privatization deals on the reduction of interest payments was 5%. By the end of August 1995, the contribution of the conversion scheme to the reduction of the debt on the ZUNK bonds was only 0.8%.

The other part of the internal debt on government securities amounted to BGL 74.803 billion as of the end of 1994 and increased to BGL 127.9 billion as of the end of August 1995. The problem is that the maturity structure of this debt, despite recent improvements, is unfavorable with the share of the short-term securities (defined as securities with maturities of up to one year) at 47% of all government securities for budget deficit financing. This limits the opportunities for debt rescheduling and impedes its effective management and the more even distribution of debt burden over time, since the capacity of the capital market is limited and an increasing share of the revenues from the sale of new issues will be necessary to service the existing debt. A manifestation of this is the fact, that in 1994 78.7% of the revenues from new issues of government securities were used for interest, principal due and discount payments. Until the end of 1995, government securities, with total nominal value of BGL 42 billion, should be redeemed not including the new issues of short-term treasury bills. The interest payments on the securities for budget deficit financing for 1995 are projected at BGL 42.784 billion (at an average BIR of 51%).

Another characteristic feature is that the non-bank financing of the budget deficit through government securities operations, despite a recent rapid rise, is still only 10.52% as of the end of August 1995 with the rest of the securities held by the financial sector.

The budget expenditures associated with servicing the debt are 29% of all expenditures, including 21.4% interest and due principal payments on the domestic government debt. The share of interest payments is sensitive both to the BIR and the exchange rate movements.

The decrease in the ratio of interest payments in the budget revenues is directly dependent on the level of the BIR. During the year 1995, the BIR has been decreased several times from 72% in early 1995 to the present level of 34%. If no further changes in the BIR occur, the annual weighted average of the BIR will be about 50%. In the case of a rapidly growing inflation rate in the last quarter of 1995, a new increase in the BIR may become necessary. However, due to an unexpected low inflation rate since the beginning of 1995, inflation is not expected to exceed the projected target. Thus, no interest rate increases are likely until the end of the year.

On the other hand, further sharp decreases in the BIR may cause a depreciation of the national currency as the interest rate differential disappears, and again will increase the amount of interest payments in leva terms. However, since most of the foreign currency payments have already been made even more abrupt movements of the exchange rate can hardly be expected to cause significant changes in the interest payments.

Against this background of the size and structure of the external and internal debt, the following implications for the government policy concerning the debt-equity schemes can be drawn:

The external and internal debts are a heavy burden for the country in terms of volume, maturity structure and servicing. Thus, debt reduction seems an attractive policy. The significance of the debt conversion schemes in this aspect lies in of the fact that if Brady and ZUNK bonds are used in privatization this can both reduce the government debt and interest payments on it. The government will most probably seek to reduce both the debt and debt servicing and to shift the risk of servicing the claims to the investors through debt-equity swaps. However, the relative significance of the swaps in external and internal debt management will differ depending on a combination of factors. The domestic debt conversion schemes depend on the effects of both the internal interest rate and the dollar/lev exchange rate movements on the debt, on the outcomes of the stabilization measures for the financial sector and government policy of deficit financing.

Servicing the external debt in 1995 will amount to USD 750 mln. However, the importance of external payments will rise as the national currency depreciates and as the burden of principal and interest payments increases. Besides, payments on external obligations are unevenly distributed over time with one of the peaks in 1997. In view of the possible difficulties in servicing the debts, the government is likely to undertake actions to reduce the burden.

The importance of debt-equity swaps as an instrument of reducing the external debt will depend on the policy of managing the debt as a whole. It should be noted, however, that servicing the London Club debts in the near future is a relatively small part of all external payments, consisting mainly of interest and principal payments to official creditors.

For example, there are statements and information about possible buy-backs. The idea was launched in November and December last year, but was rejected by the caretaker government. Some preparations in the Ministry of Finance are said to have been already undertaken. The idea can be supported by figures for foreign exchange reserves and balance of payments: BNB reported an increase of foreign exchange reserves to about USD 1.6 billion (excluding the gold reserves) and trade balance surplus for 1994 of over USD 150 mln for the third quarter of 1994 and of USD 82.7 million (The National Statistics Institute puts it at USD 168 million) for the first half of 1995. The situation on the FOREX market is stable, due mainly to the shortage of leva liquidity of the commercial banks, trade balance surplus and substantial capital inflows as well as interest differential in favor of leva-denominated deposits. However, buy-backs will depend on the stand-buy agreement with the IMF and support from other international financial institutions.

The prospects of external debt conversion schemes will further depend on the external financing and achievement of liberal access to the international capital markets.

ZUNK bonds in the context of troubled banks' bail-out programs

The concept of the Law on the settlement of non-performing debts was to redistribute the burden of the old bad debts between the budget, the enterprises and the commercial banks. The practical implementation of the law, however, revealed its imperfections especially in terms of its impact on the commercial banks. The problems arose from two principal issues:

1. The bonds were unevenly distributed among the banks with 65% of the leva-denominated bonds and 78% of the dollar-denominated bonds concentrated in only three banks. Especially heavily affected were two major state-owned banks - Mineralbank and Economicbank: the ZUNK bonds made up 52.4% of the total assets of the Mineralbank and 65% of those of the Economic Bank.
2. ZUNK bonds are low-income bonds. At the same time, the cost of the Central bank refinancing and interbank financing as well as the interest rates on the deposits are high as a result of which both banks incur losses and liquidity troubles.

The deteriorating liquidity status of the two banks which finance key sectors of the Bulgarian economy and hold 20% of all assets of the banking system called for government actions to rehabilitate them. Finally, after long discussions, the following decision was taken:

ZUNK bonds in the amount of the debts of the two banks to the BNB and the State Savings Bank were exchanged for market-income government bonds. The new bonds were then used by the two banks to retire their debts to the Central Bank and the SSB. The effect of this operation was that the conversion of dollar-denominated ZUNK bonds with a total nominal value of USD 824.3 million were withdrawn from the market thus leaving one major holder of ZUNK bonds - the Bulbank. Thus the supply of ZUNK bonds will shrink and will largely be dominated by one player.

On the other hand, this operation involved direct costs for the budget amounting to around BGL 15 billion in the form of increased interest payments. To compensate this effect the government obviously seeks to encourage the use of ZUNK bonds in privatization by introducing a premium of 40% to the value with which the ZUNK bonds participate in privatization. Thus, it seems that the government places emphasis on the reduction of the internal debt servicing.

List of banks - primary holders of the ZUNK bonds as of September 1995.

Dollar-denominated ZUNK bonds	**Leva-denominated ZUNK bonds**
Bulbank	**Balkanbank**
Hebrosbank	**United Bulgarian Bank**
Balkanbank	**Hebrosbank**
Mineralbank	**Biochim**
Biochim	**Expressbank**
Economic Bank	**Sredetz Bank**
United Bulgarian Bank	**Yambol Bank**
Expressbank	**Bulbank**
	Karlovo Bank
	Mineralbank
	Economic Bank

External versus domestic debt

As described above, the regulations governing the conversion schemes of the domestic and external bonds differ substantially in some aspects. Transactions with domestic bonds are further subject to a number of restrictions aimed at mitigating the negative consequences of the instruments on liquid and profitable banks, while at the same time lowering their competitive advantages to potential investors. Thus, a conflict arises between the two types of instruments.

With the adoption of debt-equity arrangements involving Brady bonds, the domestic bonds seemed to be crowded out by the Brady bonds as payment instruments in privatization both because they were much more attractive to investors in terms of return and privatization costs (Brady bonds trade at a deeper discount than ZUNK bonds; for ZUNK bonds prices see Table below.) and because the total value with which they can participate in privatization is around BGL 150 billion, compared to BGL 90.5 billion for ZUNK bonds.

Average weighted purchase prices per BGL 1000 face value of the BGL-denominated ZUNK bonds, used in privatization in 1995

January	February	March	April	May	June	July	August
875.7	727.7	940.6	761.5	723.1	956.5	869.2	828.5

Source: BNB

With the new limitations on the Brady bonds, however, the position for the domestic bonds improved somewhat. For example, ownership worth BGL 665 mln or $ 10 mln when privatized with Brady bonds could be bought before the amendments for $ 3.9 mln or BGL 259 mln. In the case of privatization with domestic bonds, the investor paid the amount of BGL 452.2 mln (at the prevailing price of BGL 680 BGL for BGL 1000 face value of domestic bonds) or $ 6.8 mln. Under the new regulations the holder of Brady bonds would pay $ 6.95 mln (BGL 462.175 mln) for ownership worth $ 10 mln ($ 5 mln in cash and $1.95 mln for the Brady bonds). At the same time the costs to the investor who pays with domestic bonds will amount to $ 8.4 mln (or BGL 558.6 mln). This means a difference two times lower than earlier. With the introduction of the premium to the ZUNK bonds' face value, this difference was further diminished, but is still in favour of Brady bonds.

Still another problem arises in association with budget deficit financing, which seems to cause problems for the Ministry of Finance in 1995. In 1994, more than 85% of the budget deficit was financed on the domestic capital market. The problems arise from the specifics of the domestic government securities market. Major participants in this market are the commercial banks which, due to the restrictive policy of the BNB, now face enormous liquidity shortage as a result of which the MF has difficulties in placing the new issues of government securities. Moreover, since Brady bonds are more attractive as financial assets compared to all other government securities, they threaten to crowd them out from the portfolios of financial institutions or at least force the government to lower prices of treasury securities.

From the above follows, that the fate of the debt equity swaps will depend to a great extent on solving the conflict between Brady bonds, on the one hand, and ZUNK bonds and deficit financing, on the other.

Internal market for Brady bonds

The internal market for Brady bonds is nonexistent in Bulgaria due mainly to a lack of information and expertise in dealing in the international markets of debt and the foreign exchange restrictions on the export of capital, which such transactions involve. However, Bulgarian banks and companies, especially private with positive cash flows, are potentially big buyers of Brady bonds. Firstly, because these bonds can yield high returns (currently between 18% and 23% depending on the type of instruments) and are therefore considered an attractive investment, especially in view of the still limited investment opportunities in Bulgaria. Secondly, they are still more attractive as payment instruments in privatization compared with other payment instruments and schemes. And thirdly, the Brady bonds can be used successfully as collateral for credits from both abroad and in the country.

This is especially true for the commercial banks:

11 of the Bulgarian banks now hold universal licenses allowing them to purchase bonds on the international markets without any special permission from the BNB. If, however, they buy the bonds on behalf and on the account of their clients, special permission from the BNB is required.

Already there is information about Bulgarian banks building-up holdings of such bonds. There are various reasons:

- It is a way of improving their profit and loss statements, since the bonds are recorded in the financial statements at par, the difference between the purchase price and the face value being recorded as revenues for the current accounting period.

- This is a way of improving their asset portfolios.

- From the perspective of the country as a whole, the interest payments, associated with the bonds held by Bulgarian individuals, banks and companies, will remain in the country instead of flowing abroad and exerting pressure on the balance of payments and the exchange rate. Thus, encouraging Bulgarians to buy Brady bonds at least by the removal of the barrier to their access to international markets might turn out to be a good issue in the debt management policy. Although this may result in a certain outflow of capital, it might as well lead to a return of flight capital.

A new development on the internal market is the emergence of new financial instruments, based on the Brady bonds. Two Bulgarian banks are already offering so called Brady currency deposits to their customers (backed by Brady bonds), and in just one month succeeded in attracting USD 7 mln.

Debt-equity swaps and privatization

It is commonly acknowledged that the introduction of the debt-equity scheme has largely contributed to the acceleration of market privatization. The importance of debt instruments, eligible for debt-equity as payment instruments in privatization, becomes evident from the following data for the period from the start of privatization until the end of August 1995: According to MF information Brady bonds with a total face value of USD 117 mln have been used in 27 privatization deals. Most of the deals involve Bulgarian investors. So far, almost exclusively, Flirbs were used (USD 115 mln) due to deeper discount on the secondary market, they trade in smaller packages in comparison to the other two instruments which trade in packages of USD 250 000, which allows for the payment of smaller deals and due to lower interest (currently about 1% for 6 months) and therefore lower costs for the investor in case the interest would not be admitted as cash payment.

For the same period, the total number of all privatization deals concluded was 171, including 27 deals with the use of Brady and over 100 deals with the use of ZUNK bonds. In some of the deals both Brady and ZUNK bonds were used. The privatization revenues from these deals are estimated at BGL 9.413 billion. The share of Brady bonds in the total revenues is therefore 42%. (Note: Flirbs participate in privatization with half of their face value; exchange rate used is $1 = BGL 68.) Payments with ZUNK bonds make up 29% of all revenues.

However, fears exist that the implementation of the new schemes of the so called social privatization (mass privatization and management-employee-lessee-buy-outs) will be preferred at the expense of market privatization. If the scope of these schemes expands this may hinder somewhat the market privatization and in particular debt-equity swaps.

It should be noted, however, that according to the privatization program of the new government, priority will be given to those schemes that combine minimum cash payments and payments with Brady and domestic bonds. Moreover, from the list of enterprises for mass privatization, those enterprises or majority shareholding stakes which enjoy serious investor interest will be excluded. Thus, although the scope of debt-equity swaps would be somewhat limited at the expense of voucher privatization it is expected that due to the latter, privatization as a whole will be accelerated thus widening the investment opportunities in the country. Due to the lack of sufficient domestic savings, debt instruments will continue to play an important role in the privatization process.

Concluding remarks

This paper has attempted to identify some of the perceived potential advantages of debt-equity swaps for the country, the most important among these being the replacement of the the fixed external and internal payment obligations of the government with a repayment stream that depends on the profitability of the equity investment. Further reduction of the debt and debt servicing; the acceleration of the privatization process; and the development of the domestic capital market, which subsequently can provide attractive uses of domestic savings and reduce the motivation for and reverse capital flight. The difference in costs between a debt-equity swap transaction and a regular direct investment transaction may also be incentive for investors and compensation for the economic risks associated with the investments in the country as well as those arising from possible changes in government policy affecting such kinds of transactions.