

INSTITUTE FOR MARKET ECONOMICS

Series of papers

Review of the Bulgarian Economy

**LEGAL ASPECTS AND CHARACTERISTIC
FEATURES OF THE INTERNAL DEBT
INSTRUMENTS (ZUNK-BONDS)**

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

by

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**January 1996
Sofia**

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LEGAL ASPECTS AND CHARACTERISTIC FEATURES OF THE INTERNAL DEBT INSTRUMENTS (ZUNK-BONDS)

Introduction

In 1994, a large-scale financial operation was carried out in order to transform into government debt the non-performing loans (bad debts), which were accumulated by enterprises until 1990. The main task of this operation was to clear the credit portfolios of the commercial banks and the balance sheets of the state-owned enterprises, distributing at the same time the burden of servicing the debt between the budget, the financial system and the enterprises. For this purpose two types government long-term bonds were issued:

- government long-term bonds denominated in leva in exchange for loans and negotiated in leva; and
- government long-term bonds denominated in dollars in exchange for loans and negotiated in dollars.

The bonds are book-entry, freely convertible, maturing in 25 years, with a grace period of five years, repaid in equal semi-annual installments until maturity. The rate of interest of the leva denominated bonds is paid twice a year in arrears, its amount being defined in the first two years as one third of the Central Interest Rate (the CIR sets the Treasury's domestic borrowing requirements and is determined by the Bulgarian National Bank (BNB).) During years 3 and 4 the rate of interest will be half the Central Interest Rate, in years 5 and 6 - two thirds of the CIR, and from then on until maturity - equal to the CIR. The rate of interest, paid to the holders of government long-term bonds, denominated in dollars is equal to the LIBOR for the respective period. The BGL/USD exchange rate is the central exchange rate, as quoted by the BNB at the day of payment. The transactions with ZUNK-bonds on the secondary market are regulated by the Ordinance on the Terms and Procedure for Acquisition, Servicing and Redemption of Long-term Government Bonds, adopted by the Council of Ministers pursuant to the Law on Settlement of Non-performing Loans, negotiated until 1990 (LSNpL). The long-term government bonds could be used as a mortgage and security for refinancing of the commercial banks by the Central Bank and for participation in privatization under the terms of the Transformation and Privatization of State-owned and Municipal-owned Enterprises Act (TPSMEA). According to the LSNpL the issued bonds, denominated in leva, have a face value of US\$ 100. The transactions with dollar denominated bonds are made in leva at the central BGL/USD exchange rate at the day of payment. The Bulgarian National Bank calculates minimum accepted price in conformity with Ordinance N 14 of 12 April 1994, regulating the sanctions, imposed upon commercial banks for losses, incurred by the selling of the long-term government bonds below their market price. The ordinance is related to those commercial banks where the equity held by the state is more than 50%. The sale price is determined by the commercial bank, but it should not be lower than the minimum accepted price, defined by the BNB. The minimum accepted price is calculated on the basis of the discounted value of the bonds plus premium, reflecting their potential to be used in the payment of the privatization deals according to the present legislative basis. This price is determined by a methodology, adopted by the BNB, and is revised quarterly. The state of the financial markets and the changes in the Central Interest Rate are also taken into account, corrected by a coefficient, coordinated with the Council of Ministers. The Bulgarian National Bank informs the commercial banks of the minimum accepted price and the period when it will be applied. The minimum accepted prices for the long-term government bonds, issued under the LSNpL, for the period 1 July - 30 September 1995 are as follows:

1. for the bonds denominated in leva - 700 leva for 1000 leva face value; and
2. for the bonds denominated in dollars - 90 dollars for US\$ 100 face value.

Upon transferring the long-term government bonds to physical and legal persons, the financial institutions issue certificates on which the contracted price is written.

PROCEDURES FOR PAYMENT WITH ZUNK-BONDS IN PRIVATIZATION DEALS

Decree N 36 of 16 February 1994, adopted by the Council of Ministers, provides the possibility and specifies the terms for participation in the privatization with long-term government bonds, issued under the LSNpL. The long-term government bonds are purchased at market prices and are accepted in the privatization deals at face value. The contracted market price is written on the certificate and is verified by individuals representing the banks which sold the bonds. For the bonds which are denominated in dollars, the payment is effected in leva at the BGL/USD exchange rate, quoted by the BNB at the date of payment. The bodies negotiating the privatization deals under Art. 3 of the TPSMEA (Privatization Agency, ministries, committees and municipalities), accept the long-term government bonds from the investors as a means of payment after verification of the owner and the aggregate value of the bonds in the register, kept by the commercial bank which sold the papers. For this purpose the privatization body requires from the respective bank a certified letter.

It is very important to check, when receiving the certificate and the certified letter from the above-mentioned bodies, whether the bonds were acquired on the secondary market. According to Decree N 271 of 16 November 1994, which amended and supplemented the Ordinance on the Procedure and Conditions for Participation of Holders of Long-term Government Bonds, issued pursuant to the LSNpL, only long-term government bonds, bought from the BNB and the commercial banks, which replaced non-performing loans with bonds, may be used as a means of payment in the privatization deals.

Decree N 89 of 19 April 1995 stipulates that until 31 December 1995 the long-term government bonds under the LSNpL will be accepted as a means of payment in the privatization deals with a premium of 40%. The bodies negotiating the privatization deals, send to the Ministry of Finance the long-term government bonds, received as a means of payment and represented by a certificate of ownership together with a certified letter. After verification, the Ministry of Finance registers the certificates. The long-term government bonds, used in the privatization deals, are considered government securities with expired maturity.

LIST OF COMMERCIAL BANKS WHERE INVESTORS COULD BUY ZUNK-BONDS FOR PARTICIPATION IN THE PRIVATIZATION DEALS

1. BSI (BANK FOR BUSINESS INITIATIVE) " MINERALBANK"
2. CB "BULBANK" AD
3. CB "BALKANBANK" AD
4. CB "BIOHIM" AD
5. CB "HEBROS" AD
6. ECONOMIC BANK
7. CB "EXPRESSBANK" AD
8. CB "YAMBOL"
9. UNITED BULGARIAN BANK AD

USE OF BULGARIAN BRADY BONDS IN PRIVATIZATION DEALS

Upon conclusion of the agreement on its external debt, the Republic of Bulgaria issued to the creditor banks government bonds in exchange for non-restructured debt. There are three different options for issued bonds:

I. Front Loaded Interest Reduction Bonds (FLIRBs)

1. **Date of issuance** - 28 July 1994
2. **Maturity** - 28 July 2012
3. **Issue Size** - US \$ 1.6 bln
4. **Principal payment** - 21 equal semi-annual installments, beginning upon expiration of an 8-year grace period.
5. **Rate of Interest:**
 - Years 1 and 2 - 2.0% p.a.
 - Years 3 and 4 - 2.25% p.a.
 - Year 5 - 2.5% p.a.
 - Year 6 - 2.75% p.a.
 - Year 7 - 3.0% p.a.
 - Years 8 to 18 - 6 month **LIBOR** plus 13/16% p.a.Interest coupons are paid each January and July in arrears.
6. The **FLIRBs** were issued in two tranches:
 - Tranche A** - bonds issued in exchange for Eligible Debt, which is not Short-term Debt, together with 70% of bonds issued in exchange for Eligible Debt, which is Short-term Debt.
 - Tranche B** - bonds issued in exchange for 30% of Eligible Debt, which is Short-term Debt. Tranche **B** receives an extra interest of 0.5 % p.a.
7. **Form** - payable to the Bearer

II. Collateralized Discount Bonds (DICs)

1. **Date of issuance** - 28 July 1994
2. **Maturity** - 28 July 2024
3. **Issue Size** - US \$ 1.8 bln
4. **Principal payment** - bullet payment on maturity
5. **Rate of Interest** - 6 month **LIBOR** plus 13/16% p.a.
Interest coupons are paid each January and July in arrears.
Additional interest payments - for a given calendar year (the "first year") the Gross Domestic Product of Bulgaria equals or exceeds 125% of the GDP on a 1993 basis, and the GDP for the succeeding calendar year (the "second year") is greater than in the first year, additional interest at the amount of 0.5% p.a. on the outstanding debt is due for each per cent growth as defined above.
6. The **DICs** were issued in two tranches:
 - Tranche A** - bonds issued in exchange for Eligible Debt, which is not Short-term Debt, together with 70% of bonds issued in exchange for Eligible Debt, which is Short-term Debt.
 - Tranche B** - bonds issued in exchange for 30% of Eligible Debt, which is Short-term Debt. Tranche **B** receives an extra interest of 0.5 % p.a.
7. **Form** - registered

III. Interest Arrears Bonds (IABs)

1. **Date of issuance** - 28 July 1994
2. **Maturity** - 28. July 2011
3. **Issue Size** - US \$ 1.68 bln
4. **Principal Payment** - 21 semi-annual installments, starting upon expiration of a 7-year grace period. The installments represent a percentage from the initial amount of the principal and are paid as follows:
 - Installments 1 to 6 - **1.0%**
 - Installments 7 to 11 - **3.0%**
 - Installments 12 to 16 - **6.0%**
 - Installments 17 to 21 - **9.8%**
5. **Rate of Interest** - 6 month **LIBOR** plus 13/16 % p.a.
Interest coupons are paid each January and July in arrears.
6. **Form** - payable to the Bearer

The use of Brady bonds in the privatization process became possible after the Council of Ministers approved Decree N 278 of 25 November 1994 for the adoption of the Ordinance on the Terms and Procedure for Participation in Privatization with Government External Debt Bonds. It allowed and regulated the use of FLIRBs and DISCs as means of payment in the privatization deals, with the DISCs accepted at face value in the swaps and the FLIRBs at 50% of face value.

According to the foreign exchange regime within the country, the transactions are concluded in the national currency, and the value of the bonds in leva is calculated for each privatization deal on the basis of the average Bulgarian National Bank quoted BGL/US \$ exchange rate for the last six months, preceding the day of signature of the privatization contract.

The privatization deals are concluded after presentation of all required permits to the respective privatization body. The Law on the Business Activity of Foreign Persons and protection of Foreign Investment envisages permits in the following cases:

When a non-resident or a company, in which the participation of a non-resident, directly or through other companies with foreign participation, assures majority in the decision-making or blocks it, a preliminary permit has to be obtained:

- for production and trade with weapons;
- for performing banking activity and insurance services;
- for exploration, exploitation or extraction of natural resources;
- for acquisition of real estate in certain geographic regions, defined by the Council of Ministers (as such regions have not been defined at present, no regional limitations exist for the acquisition of immovable property by non-residents); and
- for acquisition of stocks shares, which assures majority in the decision-making of a company performing activities or owning immovable property in the above mentioned cases.

Permits are issued by the Council of Ministers and the Bulgarian National Bank.

Bulgarian Brady bonds could not be used for buying shares in the privatization through public offering or in the municipal privatization. No investment commitments, penalties under contract, taxes, tariffs, fixed rates and/or any other state or municipal takings should be paid with them.

The Ordinance was amended by Decree N 41 of 10 February 1995, which introduced some changes, restricting payment with Brady bonds. According to these changes, the buyer, under the contract, assumes an obligation not to transfer abroad the income earned from the shares, stocks or the enterprise, acquired under the deal for no less than four years, including an obligation not to transfer the liquidation quota or the price obtained from the sale of stocks, shares or an enterprise, acquired under the deal for no less than ten years.

Decree N 41 also restricted the amount of the acquisition value to be paid by Brady bonds to 50% from the negotiated price, without restricting the alternative means of payment - **ZUNK** - bonds or cash.

The same decree settled the claim of the buyer for interest on the coupon rates, accrued and not paid by the date of acquisition of the Brady bonds. This amount is deducted from the portion of the price of the acquired stocks, shares or interest under the privatization deal, which is not paid by the Brady bonds.

The Ministry of Finance, as a responsible body for the control over payment with Brady bonds in the privatization deals, issued Procedures for Payment with Brady Bonds in the Privatization Deals, pursuant to Decree N 278 of the Council of Ministers of 1994. This document stipulated the specific requirements which the privatization bodies, the investors, the BNB and the Ministry of Finance should follow and implement as a precondition for settling privatization deals with Brady bonds.

PROCEDURES FOR PAYMENT WITH "BRADY BONDS" IN PRIVATIZATION DEALS, PURSUANT TO DECREE N 278 OF 1994

1. The Privatization Agency and the other bodies under Art. 3 of the Transformation and Privatization of State-owned and Municipal-owned Enterprises Act (TPSMEA) sign contracts for payment in Brady bonds with investors, and a letter certifying that:

a) they are authorized owners of the securities in full form /face value and interest coupons/;

b) the Brady bonds are free from mortgage, guarantee, security and any other obligations; and

c) the person or the body, transferring the securities, is fully authorized to do that under the respective conditions of the exchange.

2. The privatization body requires the investors to transfer the securities in full form /face value and interest coupons/ in favor of the Ministry of Finance by Crediting the account of the Bulgarian National Bank in City Bank, London, or in Morgan Grenfell, London, or any other account of the BNB. All the expenses connected with the transfer are borne by the investor.

3. On the basis of the contract made out under Para 1, the privatization body notifies the Ministry of Finance, the "Government Treasury and Debt" Department, and the Bulgarian National Bank, "Currency Transactions" Department of the amount and the type of the bonds which will be used as a means of payment, the name of the investor, the object of the deal and the term of transfer of the securities.

4. Simultaneously, with the transfer of the Brady bonds, the investor should hand over to the privatization body the certificate of the securities in a standard form, as specified in the respective agreements for fiscal agency.

5. The privatization body under Art. 3 of the TPSMEA passes on the documents for the transfer of the securities to the Ministry of Finance.

6. The Bulgarian National Bank notifies the Ministry of Finance that the Brady bonds, as a means of payment under the privatization contract, have been transferred to the account in City Bank, London, or in Morgan Grenfell, London, or to any other of its accounts.

7. The Ministry of Finance informs the privatization body that the transfer of the Brady bonds is legally perfect.

8. The privatization body completes the deal.

9. The Ministry of Finance via the Bulgarian National Bank cancels the bonds and writes them off from the Depository of the BNB or uses them in other financial operations.

The investor is mainly required to authenticate his ownership right in Brady bonds and to confirm that they are free from mortgage, guarantee, security or any other obligations, and that he has the full authority to carry out the transfer. The payment is considered effected, when the Bulgarian National Bank confirms the transfer of the bonds to its account in Morgan Grenfell or in City Bank, and the Ministry of Finance notifies the privatization body that the deal is settled. The explicit acknowledgment by the financial institution, that the Brady bonds are transferred to it in full form (the principal and all the attached interest coupons), is a precondition for the payment to be regarded as legitimate.

There are no legal restrictions for the purchase of Bulgarian Brady bonds.

Dynamics of the price of the Government Securities issued under the LSNpL, sold to companies and individuals for participation in the privatisation.

