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SECURITIZATION OF THE POLISH SOVEREIGN DEBT IN THE INTERNATIONAL MARKETS

Introduction

This paper is an attempt to analyze usefulness and effectiveness of the initiatives aiming at converting the Polish sovereign debt owed to foreign creditors into marketable securities.

Unlike modern securitization techniques of future flow receivables which employ the whole spectrum of instruments of financial engineering, the issue analyzed below concerns mainly a past, restructured debt, which at the earlier stages used to be a non-performing debt. We are talking here about the debt which in the 1990s Poland owed mostly to the developed countries, but also several dozen of other countries from the emerging markets.

Following the economic transformations in Poland a need arose not only to restructure the earlier debts in order to allow their service by the debtor on conditions negotiated with creditors, but also to make marketability of the hitherto passive debt possible. To this end conversion of obligations into market bonds was necessary, in other words securitization. From that moment on, the debt in the form of standardized securities was the subject of turnover in international markets, mainly in the non-public inter-bank market. The investors in the new market segment were mostly financial institutions for which the new instruments became an attractive alternative to other treasury bonds, apparently of the same issuers from the emerging markets. It was so because owing to their relic character and origins of restructuring, these securities had a much worse rating in the market (and consequently a higher yield) despite a similar credit risk of the issuer's bankruptcy as in the case of modern eurobonds which were issued a bit later.

Authors of the article deal with international financial markets issues, also as practitioners. Research is based on their empirical experiences and observations.

1. Brady bonds

Used since 1989 and for several years later the so called Brady plan (named so after U.S. Treasury Secretary) contributed to the reduction of a significant part of the developing countries' debt and formation of the secondary market of the emerging markets' bonds[1]. Within the framework of debt restructuring – governed by numerous conditions – most frequently the credit obligations were converted into the so called Brady bonds (*debt-equity swap*) or less frequently the conversion option was used for "new money" or "buy-backs". Since that moment the secondary market of Brady bonds has been the domain of several big international banks.

The negotiations concerning restructuring of the Polish public debt owed to foreign creditors associated in the London Club were concluded on 14.09.1994 with signing an agreement between the Polish government and the creditors. More than a half of the debt was then converted into bonds, and the rest was written off. Polish Brady bonds constituted 4.7% of the value of all securities of this type which were the result of the conversion of the debt worth USD 170 billion owed by 17 countries from the emerging markets, mostly from Latin America.

The Polish issue of Brady bonds amounting to USD 8.25 billion was carried out on 27.10.1994[2]. Six series of bonds were issued and they were listed on the Luxembourg Stock Exchange and became the subject of turnover in the international over-the-counter (OTC) market. They included:

– 30-year collateralized deep discount bonds (deep discount of 45% from par value of the principal sum; maximum value of the issue – USD 3 billion; the bond capital was secured by 30-year zero-coupon bonds of the US government, deposited in the Federal Reserve Bank of New York),

1 P. Mauro, N. Sussman, Y. Yafeh: *Emerging Markets and Financial Globalization: Sovereign Bond Spreads in 1870-1913 and Today*. Oxford University Press, Oxford 2006, p. 18.

2 Regulation No. 78 of the Minister of Finance of 26.10.1994 concerning the issue of bonds for the execution of agreements concluded with commercial banks associated in the London Club on reduction and reorganization of Polish debt (unpublished).

– 20-year bonds from the conversion of past due interest bonds (PDIs) of the nominal value of USD 2.8 billion,
– 30-year collateralized Par bonds (1988 'DDRA' debt restructuring agreement based bonds) into which long- and medium-term debt was converted; they amounted to USD 0.95 billion and were also guaranteed by the American government bonds deposited in the Federal Reserve Bank of New York,
– 30-year collateralized RSTA Par bonds (Revolving Short-Term Agreement bonds), converted for the debt on account of short-term revolving credits, of the nominal value of USD 0.95 billion which like Par bonds were guaranteed by the American government bonds,
– 25-year Debt Conversion Bonds (DCBs) representing the value of USD 0.4 billion,
– 15-year New Money bonds (NMBs) worth USD 0.15 billion.

From the very beginning Polish Brady bonds enjoyed great interest from investors, which was also caused by the decreased yield of American securities, increased attractiveness of the emerging markets and a relatively high profitability. Also the 1999 announcement that the revenues from sales of blocks of shares in privatized state enterprises and banks to foreign investors will be allocated to the earlier repayment of foreign debt contributed to the increased interest in Polish Brady bonds. However, budget needs (among others, problems of the Polish Social Insurance Institution (ZUS)) put off the plans of the bond buy-back to the following years. As scarce instruments of the type, Polish securities enjoyed decent rating, which entailed their lower profitability in comparison to other issuers from the so called emerging markets[3].

Later, in order to reduce the debt service costs, the Ministry of Finance decided to restructure foreign debt, thus changing the Brady bond debt to domestic debt or eurobonds, more modern and "prestigious" than Brady bonds (associated with insolvency of the Polish People's Republic).

The buy-back before the maturity date was accomplished with the use of funds raised by the Ministry of Finance from:
– The National Bank of Poland issues of treasury bonds denominated in USD and accounted in PLN; this type of a buy-back operation was carried out in May 1997 (USD 1.69 billion) and at the end of 1998 (USD 748 billion). First the discount bonds which had a high and variable coupon rate were bought back as they were costly in service.

[3] Polish Brady bonds, apart from the Slovenian ones, were among the safest and hence with the least yield in this market segment. Similar Latin American and East-European (e.g. Bulgarian) bonds were characterized by much higher spreads (margins) above the yield of comparable US government securities, reaching several hundred basis points.

- The issue of international bonds:
  - eurobonds – the funds raised from them in March 2001 were partly (1/3) used for a buy-back of Brady bonds (RSTAs of the nominal value of USD 290 billion). Amortization of the bought-back securities allowed the issuer to regain collaterals which were made up of 30-year zero-coupon bonds of the American government worth USD 70 billion and next year sell them with a profit;
  - the so called global bonds and medium term euronotes – the funds raised from them in the years 2002-2003 were used in October 2002 and in 2003 for a buy-back of Brady bonds of the PDI and DCB type before the maturity date.
- Privatization; with a part of funds coming from the sale of shares in TP SA (Polish Telecommunication), on 11.10.2000 the issuer, i.e. the Ministry of Finance, for the first time used a "call" option embedded in these securities and summoned all the owners of Brady bonds of the Discount type (USD 804 million) and NMB-type (USD 138 million) to a buy-back before the maturity date. As a result, on 31.10.2000 bondholders regained the invested amounts (according to the nominal value, i.e. 100%), together with accrued interest.

Owing to these operations, creditability of Poland grew in international markets and the costs of foreign debt were reduced, whereas the demand for other Polish Brady bonds and eurobonds increased.

Buy-back operations are undertaken gradually via large investment banks cooperating with the issuer. These securities possess an embedded "call" option which is intended for a buy-back before the maturity date which occurs semiannually on the days of coupon payments. However, instead of a buy-back at a nominal price (in the case of "call" option execution), usually a more profitable course of events for the issuer is a buy-back of securities from the market whenever a favorable opportunity arises. In particular such an opportunity occurs at the moments when foreign investors have fears concerning the future of emerging markets as well as when the interest rates in USD grow.

To some extent, when in 2001 the issuer converted a part of Brady bonds into eurobonds, it followed the footsteps of the countries which enabled investors an exchange of different series of their Brady bonds for modern global bonds or eurobonds. In 1996, Mexico was the country which initiated this operation for the first time in order to get rid of its whole debt by 2003. In subsequent years, Venezuela, Brazil, Colombia and the Philippines paid off Brady bonds in their entirety.

This type of debt restructuring had a positive impact on the way Poland and Polish issuers were perceived especially on the eve of the Polish accession to the

European Union. Maintaining the relics of the debts having their roots in the past still positioned Poland among emerging markets, which was not very advantageous, especially in the situation when Poland was rated higher than other countries from the same group. A significant advantage of restructuring is the removal from the market of the securities which were rather complex in their structure in comparison to other securities, i.e. Brady bonds. The coupon rate in the case of this type of securities is of a step-up character. It is established in advance in which year the interest grows by a specific number of basis points or remains at an unchanged level. Apart from the coupon rate the sinking fund and embedded options of callable bonds additionally complicate investors' calculations and introduce additional uncertainty.

After 2007 Poland's Brady bond debt fell to the level oscillating around an equivalent of 1 billion zloty, which was only less than 1% of the foreign sovereign debt. In 2000 the figures stood at PLN 23 billion and 17%, respectively[4]. Brady bonds were to be paid off by 2004 but starting with 1995 Poland bought them back before their maturity date. In the autumn of 2012 the Ministry of Finance decided about a buy-back of these securities before their maturity. Within the framework of this operation, on 27 October 2012 the bonds of the joint nominal value of USD 297 008 thousand were bought back, including:

– RSTA type (*collateralized RSTA Par bonds*) of the face value of USD 118 489 thousand,
– Par type (*collateralized Par bonds*) of the face value of USD 178 519 thousand[5].

As a result of the buy-back, the Polish Brady bond debt was completely eliminated. The operation of the buy-back before the maturity date was accomplished by means of the "call" option which gives the issuer the right to buy back a part or the whole of Brady bonds at a nominal price on each day of interest payment (twice a year)[6].

[4] www.mf.gov.pl (12 December 2012)

[5] http://www.archbip.mf.gov.pl/bip/20613.html (12 December 2012).

[6] Interest rate on RSTA bonds by the time of their buy-back before the maturity date stood at 4.75%, whereas on PAR bonds – at 4.0%. In accordance with the terms of issue starting with 2015 the interest rate on both instruments was to increase to 5.0%.

2. Delphes operation

One of the first in the world operations of securitization of an official bilateral debt was the conversion of a part of the French loan for Poland into the so-called Euro-Medium Term Note (EMTN – type of debt securities). The debt was restructured within an agreement with the London Club. At that time securitization of the Polish debt was much sought after by France which liquidated troublesome assets in order to improve public debt indicators before replacing the franc with the euro. Within the framework of the Delphes operation (the name of two special entities – Delphes No. 1 and Delphes No. 2 – issuing securities, registered in the tax paradise, i.e. the Isle of Jersey) which was carried out in February 1998 with great success (oversubscription), two tranches of securities, the so-called PBS (Polish Participation Backed Securities), were sold:

– 8-year euronotes worth FRF 1.25 billion, issued by Delphes No.1, which at the moment of issue indicated the yield of 175 basis points above the yield of French Treasury bonds (OAT), later listed on the Paris Stock Exchange, and
– 11-year euronotes worth USD 600 million, issued by Delphes No. 2, whose yield at the moment of issue was higher by 225 basis points than the yield the US Treasury bonds, later listed on the London Stock Exchange.

The securities were backed by the payments of the Polish government towards the French government agency – COFACE Export Crediting Society. In the case the Polish government defaulted on their debt, the securities were subject to accelerated amortization, i.e. the bondholders were entitled to earlier return of their principal capital on specified terms. Thus, these were asset backed securities (ABS), very popular in developed markets before the recent financial crisis.

Securities were in circulation until the time of their scheduled buy-back in May 2006 (FRF tranche, later – an EUR tranche) and in May 2009 (USD tranche).

3. Securitization of Brazilian “polonetas”

In autumn 2001, Brazil was planning an operation similar to the Delphes one. A collateral for the multi-year bonds, of the nominal value of USD 2.4 billion issued by this country was to be the Polish debts, the so called “polonetas” which were the loans taken in the 70s to import Brazilian goods.

Luckily, the Polish government did not give its consent to this operation. If Poland, which was the biggest Brazilian debtor, had approved of that transaction (as it happened in the case of the so called PBS – see above), the issuer, i.e. Brazil whose rating at that time was worse than that of its debtor, that is Poland, would have been able to sell the securities at a better price and would have endowed the issued securities with a higher Polish rating. At that time the difference in rating between Poland and Brazil reached as many as 5 to 6 grades. For Poland, this type of consent would have had rather negative consequences and Polish authorities were not interested in this venture. In the same segment of bond market, Brazilian securities, competitive to the Polish ones and of similar rating, could have appeared in international markets which might have had a negative effect on the attractiveness of Polish securities. If, however, the operation had been effected, also in this case the SPV (special purpose vehicle) mechanism would have been applied – a special company registered, for example in the Netherlands, would have been the issuer. This type of structure could have guaranteed to the investors that payments of the Polish debt would directly replenish the issuer's special trust account, omitting the Brazilian government.

Eventually, however, the Polish Ministry of Finance made a decision to pay off the debt in November 2001 that is long before the maturity date (the payment of the last installment was scheduled for 2009). The debt was paid off with a favorable for Poland discount (74%) as for the nominal amount of USD 3.32 billion the debtor paid only USD 2.46 billion. The funds for the debt repayment were raised mainly from the National Polish Bank issue of 2-year treasury bonds nominated in USD (symbol: DB1103).

Both parties benefited from the transaction: the Polish party – because the debt was bought back with a considerable discount; consequently the burden of foreign debt service by the state was significantly diminished in the following years. What is more, a space was created in the market for the issue of our own, cheaper in service, eurobonds. Brazil benefited by receiving cash, which it needed very urgently, at the same time avoiding the costs and risk related to the alternative issue of bonds.

4. Payment of the debt before it was due to other countries from the Paris Club as an alternative to securitization

Early repayment of the debt to Brazil in 2001 was the first of the three operations addressing Poland's creditors grouped in the Paris Club. Polish debts made in the 1970s in 18 countries grouped in the so called Paris Club (including Brazil, which beside France was the second largest creditor of Poland in the Club) were not converted into bonds (Brady bonds) in the 1990s as it had happened in the case of debts to commercial banks grouped in the London Club. However, they were restructured in the years 1991-1994 by means of reducing the principal sum and interest by half (to USD 26.4 billion), and spreading the payment of installments over the time of the next 20 years. A small part of foreign debt (ca. 2%) was changed into investments in the environmental protection in Poland within the so called ecoconversion.

Earlier debt repayment was to anticipate possible moves by some creditors which, like Brazilians before, considered the issue of bonds guaranteed by the Polish debt, which obviously would not have been advantageous for the Polish issuer. Poland is the only debtor of the Paris Club being a member of the EU and OECD. Naturally, like the relic of the previous epoch – Brady bonds – this has its impact when it comes to the reputation of Poland in international capital markets.

Another incentive for earlier repayment was optimization of Poland's foreign financing and a more effective adjustment of the dates of the Polish foreign debt service. Debt repayment prior to the maturity date was to contribute to the improved rating of Poland and in the case of creditors – like Germany – to facilitate a return to budgetary balance.

Poland financed a rescheduled and earlier repayment of its debt with the funds obtained from the issue of Eurobonds – more modern financial market instruments. Between 1995 and 2012, there were 84 issues of the treasury debt securities in foreign markets in several main currencies, nearly 40% in the euro. A part of thus raised funds was allocated to refinancing of earlier obligations.

Every time the operation of earlier repayments required bilateral negotiations with each country separately, which was not always easy. For example, in the beginning Japan and Belgium were not interested in earlier repayment as they did not want to give up high interests the resignation from which could lead to the increased budget deficit in these countries.

The second earlier repayment after the Brazilian one took place only on 31.03.2005 (USD 5.8 billion), when the debts were paid to several other countries, in some cases in full (Denmark, Finland, West Germany, Great Britain, the Netherlands). Despite the fact that Poland declared the will to sort out these issues, the third repayment – to France took place only in 2008 (USD 0.5 billion). Eventually, the debt to the Paris Club was repaid in accordance with the schedule on 31.03.2009 (USD 886 million). What was left was the debt of USD 118 million, which is to be paid to Japan in installments until 2014[7].

[7] *Spłata zadłużenia wobec Klubu Paryskiego*. www.mf.gov.pl (31 March 2009).

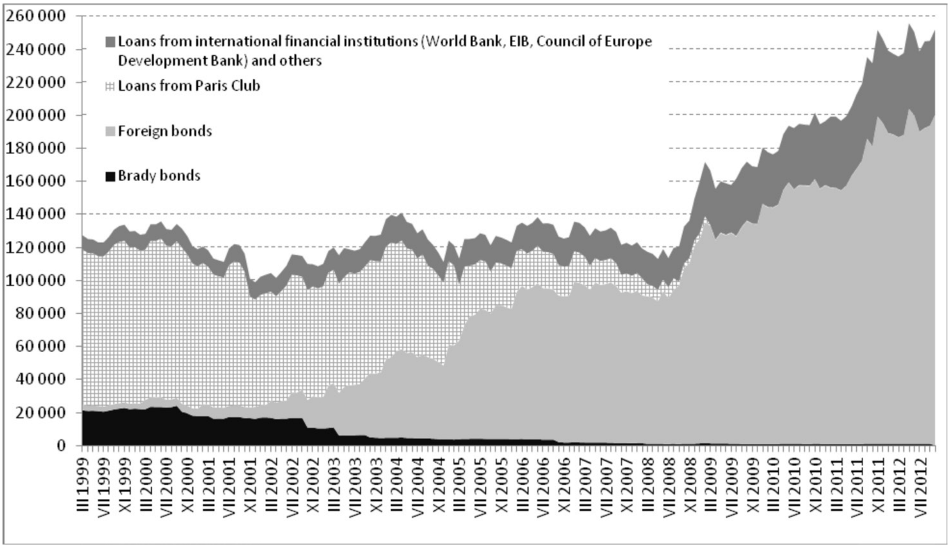

Figure 1. Foreign public debt of Poland in 1997-2012 (PLN million)
Source: Based on data of the Polish Ministry of Finance.

5. Securitization of future government receivables in euromarkets

Securitization is used successfully, also in the time of crises. It is used by the governments of emerging economies as a source of cheaper and more accessible financing. It seems that the governments of Latin America (especially Mexico and Argentina) specialize in it. In the 1990s, in international markets they used to issue – via the state owned companies- the bonds which were guaranteed by future flow receivables (ABS, Asset-Backed Securities) from exports, in particular of oil and gas, and then from the receivables from pay cards and telephone services, less frequently – from taxes collectable in future[8].

At the beginning of the present decade, the global market of securitization bonds secured by assets (other than mortgages), i.e. ABS, had developed dynamically until mid-2007. Later, especially at the turn of 2008/09, a slump occurred in this segment which was one of the most painfully hit by the current financial crisis. In 2008, the market shrank by ca. 80%; the joint value of issues fell from USD 1 188 billion in 2007 to USD 252 billion a year later. In the 2012 global ABS is-

[8] S. Ketkar, D. Ratha: *Securitization of Future Flow Receivables: A Useful Tool for Developing Countries*. „Finance and Development" March 2001, Vol. 38, No. 1.

suance market amounted for USD 321 billion, which was a remarkable increase (+44%) comparing with the 2011[9].

Apart from the described methods of converting past debts into international bonds, the Polish government quite seriously considered the use of securitization of future flow receivables as a means to finance the extra-budget development of strategic branches of economy, like for example construction of toll motorways. It was particularly crucial in the situation of very tight public finance during the 2008-2009 crisis and in pursuit of alternative resources for infrastructural investments.

The idea of the first “road” bonds by the state-owned Bank Gospodarstwa Krajowego (Bank of National Economy) managing the National Road Fund (KFD) appeared as long ago as the end of 2001, however, due to the tardiness of the Ministry of Infrastructure it could not be carried out[10]. Eventually, through London Deutsche Bank as a broker, the securities were sold in euromarkets as late as 2006. The buyers were mainly foreign institutional investors.

They were 10-year registered fixed coupon bonds of the nominal value of EUR 200 million. The bonds were guaranteed by future receivables from the exploitation of motorways, which allowed the government to obtain funds for road construction. The buy-back of these state collateralized securities is going to start in 2013 and from that year on, every year until 2016, a quarter of debt will be repaid. Another issue of eurobonds by the Bank Gospodarstwa Krajowego (BGK) was considered in 2009.

Apart from the BGK bonds, one must mention other state, self-government or quasi-state entities which in recent years, following the model of several dozen issues of bonds by the State Treasury and private entities, raise the capital by issuing debt securities in euromarkets. This path has already been used, among others, by Polish Airlines LOT (1998), PGNiG – Polish Petroleum and Gas Mining (2001), Bank Handlowy (1976-79, 1996), the cities of: Cracow (1998) and Warsaw, and the Province of Mazovia (the latter two – in 2009)[11]. Some of these issues were guaranteed by the State Treasury, others benefited from tax reliefs (Warsaw, Mazovia, Bank Handlowy) on the interest paid. However, these securities are

9 „Debt Capital Markets Review” 2009, Second Quarter; „Debt Capital Markets Review. Managing Underwriters” Full Year 2012; http://www.thomsonreuters.com/content/PDF/financial/league_tables/de/2009/2Q09_debt_capital.pdf (10 July 2009); http://dmi.thomsonreuters.com/Content/Files/4Q2012_Global_Debt_Capital_Markets_Review.pdf (17 January 2013).

10 „Gazeta Giełdy – Parkiet” (24 June 2004).

11 R. Płókarz: *Rynek polskich euroobligacji w warunkach kryzysu finansowego*. In: *Rynki finansowe w warunkach kryzysu*. Ed. by M. Kalinowski. CeDeWu, Warszawa 2009, pp. 137-152.

not secured by future flow receivables as it happens in the case of classical securitization.

Securitization can also deal with other predictable, regular receivables, for example from lottery games as well as on account of the increased value or lease of land property managed by the Agricultural Property Agency of State Treasury[12].

Following the example of private entities, government agencies could use the fund securitization formula which has been functioning in the Polish legislation since July 2004 for securitization of future flow receivables and their sale in euromarkets. The first private entity of the type, operating since May 2005, namely securitization fund S-Collect FIZ Non-standardized Securitization Fund, managed by TFI PKO/CS, sold non-public certificates to foreign investment companies: Credit Suisse Bank and the Czech company Reform Capital[13].

6. Conversion of foreign debt into shares

Apart from converting foreign debts into international bonds, transactions of converting public debt to instruments with owner's supervision, e.g. shares of privatized enterprises or proecological (the so called ecoconversion) or telecommunication (teleconversion) investments are less popular in euromarkets[14].

At the end of 1995, the Ministry of Finance prepared the operation of exchanging foreign sovereign debts for stocks and shares in Polish privatized enterprises (debt-for-equity swap). The owners of Brady bonds which were issued a year earlier could swap their bonds for the government indicated shares, mainly in the companies operating in the areas of high unemployment. Still in the autumn of 1994, during the restructuring of the Polish debt, the interest of foreign investors in Polish shares was fairly strong, but over time it faded[15].

In spite of this, in subsequent years the Parliament in its budget-related acts authorized the Minister of Finance to convert foreign debt to the Paris and London Club into capital investments in Poland. In the years 1995-1996 a certain con-

[12] „Rzeczpospolita" i „Gazeta Giełdy – Parkiet" of 5 March 2002.

[13] The fund allocated the capital raised in this way (PLN 85 million) was allocated to the purchase of 73 thousands zlotys of debts (cash, car, and card related) of the nominal value of PLN 660 million at about 8% of the nominal value from the quasi-state bank PKO BP, which was served in this respect by the Presco collection agency.

[14] R. Płókarz: *Konwersja zadłużenia na akcje i inwestycje w realiach polskich reform gospodarczych*. „Roczniki Naukowe Wyższej Szkoły Bankowej w Toruniu" 2009, nr 7(7).

[15] A. Słojewska: *Zamiana długu na akcje*. „Rzeczpospolita" of 15 November 1995.

straint was a requirement that the transactions should not cause increased outgoings from the budget or decreased income from enterprise privatization below that planned, and within the limits of USD 150 million. This operation, however, was not accomplished. Owing to higher credibility of Poland and Polish economic reforms, the price of Brady bonds increased year after year and both the State Treasury and investors preferred other forms of privatization.

Summary

Generally, our assessment of the usefulness and effectiveness of securitization of the sovereign debt is positive, although so far the character of these operations has rather been moderate. Despite the fact that their scale was large, debt restructurings, so far, have been incidental and unsymmetrical. They mostly concerned past debts from the 1970s. Yet, modern securitization methods of future flow receivables as a systemic form of innovative refinancing of sovereign debt are not common, either.

Global market of non-treasury securitization bonds (especially mortgages) after a very dynamic development collapsed after 2007. This, however, opened up new possibilities to treasury securitization bonds or commercial securities but guaranteed by governments[16].

Also past experiences of other countries from the emerging markets show that this financial technique was successful even in difficult market conditions, which provides new opportunities, to the Polish government too. Facing the challenge of finding funds for big infrastructural projects, the Polish government can and should use this financial engineering technique more extensively for refinancing of, e.g. the construction of motorways or co-financing of the EU projects within the private-public partnership.

New opportunities arise with the implementation of the so-called Polish Investment Programme (PIP), implemented in 2013 by Polish Government. The purpose of the PIP is the create conditions to ensure long-term financing of large scale investment projects of strategic importance for the State. Financial instruments of the Programme include mainly: debt financing ensured by the State-owned BGK Bank (credit and guarantees, subscription for bonds), Capital Investments of Polskie Inwestycje Rozwojowe SA (investment vehicle set-up in 2013),

[16] R. Płókarz: *Współczesne światowe tendencje w bankowości inwestycyjnej*. In: *Współczesna bankowość inwestycyjna*. Ed. by A. Szelągowska. CeDeWu, Warszawa 2009.

subscription for revenue bonds issued by municipal companies. In different stages securitization techniques may apply in order to raise new funds and securitize receivables.

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Summary

The paper describes the process of securitization of the Polish sovereign debt in the international markets, during the last 15 years. This tool has been applied in order to place past or future flow receivables arising from illiquid debts, henceforth embodied in transferable securities in capital markets. Debt restructuring through securitization enables the creditor to unfreeze his debt, the debtor – to increase his credibility, and give to third party investors an access to a new market instrument.

Unlike commercial entities using it mainly for future flow receivables, securitization remains rather occasional in Polish public debt management. In 1994, Polish government, and a few years later also the French one, used securitization to issue international bonds backed by former Polish Treasury debts. At that time, it helped Poland to return to international markets, whereas in the last few years Polish government has preferred old debt buy-backs and raising new funds through more innovative instruments, like eurobond issues.