European & Emerging Markets

Russia's MinFin Default Leaves Only Eurobonds Sacred --- But Officials Warn This Could Change, Cite Example of Pakistan

By Andrea Chipman
Dow Jones Newswires
1,107 words
21 April 1999
The Wall Street Journal Europe
14
English

MOSCOW -- The Russian government's acknowledgement Tuesday that it will default on $1.3 billion of Ministry of Finance bonds maturing on May 14 leaves its Eurobonds as the only class of debt on which the country hasn't reneged.

News of default on the bonds, known as MinFins, is likely to make holders of Russia's $16 billion in Eurobonds queasy. Russia has already defaulted on Treasury debt as well as on Paris and London Club obligations. And two Russian banks have set a Eurobond precedent by defaulting on them.

"The situation now is that, unfortunately, it will be not possible for Russia to pay MinFin 3 bonds," First Deputy Finance Minister Mikhail Kasyanov said at the annual meeting of the European Bank for Reconstruction and Development in London.

Mr. Kasyanov said the interest payments on tranches six and seven of the bonds, which represent Russian debt incurred after the collapse of the Soviet Union, will be paid "without any doubt."

MinFins have occupied a murky place in Russia's debt hierarchy.

Russia's foreign-debt agent, Vnesheconombank, issued five tranches of the bonds after it defaulted on client deposits and other obligations in 1991. Tranches six and seven were issued later. The first two tranches have already matured and been paid off.

Although the bonds are classified as domestic debt, they are denominated in dollars.

The government has already asked to restructure Soviet-era debt it owes to creditors in the Paris and London Clubs. As a result, many MinFin holders have long assumed the government would fail to fulfill its obligations on the bonds -- an assumption that has been reflected in the price of the Series 3 MinFins as they neared the May maturity date.

The series 3 MinFins are currently suspended from trading since their May 14 maturity date is approaching. They were last priced at 40% of face value, giving them a spread of more than one million basis points, or one-hundredths of a percentage point, over equivalent U.S. Treasurys.

In addition to the principal payment on the series 3 MinFins, the Russian government is due to pay an additional $300 million in coupon payments on later tranches. Of this amount, payments on the sixth and seventh tranche of the debt total $78 million.

Mr. Kasyanov didn't say whether the government is prepared to make coupon payments on the earlier tranches, adding that the Finance Ministry would finalize the government's position later Tuesday.

The government will hold discussions with creditors to avoid a cross-default on the other tranches due to the failure to pay the series three bond, he said. The government will seek a "mutually acceptable resolution" with creditors on the restructuring of the securities, the first deputy finance minister added.

But one analyst said the government's efforts to classify the last two tranches of MinFins as post-Soviet debt is an artificial distinction.

"They were all issued for the same purpose, to pay back Vnesheconombank's obligations," said Philip Poole, head of Emerging Europe & Middle East Research for ING Barings in London. "The original obligation was a former Soviet obligation. I find it somewhat difficult to understand the distinction."

With the cash-strapped Russian government dependent on foreign loans, the government has made paying post-Soviet-era debt a priority. Despite its financial strains, the government has remained up-to-date on its payments to foreign lenders, including the International Monetary Fund.

An IMF mission is currently in Moscow hammering out the details of a new loan deal to which both sides have already agreed in principle. The loan is expected to provide enough money to help Russia roll over its remaining IMF obligations for the year and perhaps to make $1.2 billion in Eurobond payments due before the end of the year.

But a top Vnesheconombank official suggested Monday that Eurobonds won't necessarily remain off-limits if Russia's situation worsens.

Alexei Akinshin, head of the bank's Hard Currency Financial Operations Department, cited the example of Pakistan, which in recent negotiations with the Paris Club of sovereign creditors was told to include outstanding Eurobonds as part of any sovereign debt rescheduling.

The Pakistan example could set a precedent for restructuring supposedly immutable securities such as Eurobonds, Mr. Akinshin noted, adding that Russia faces similar financial straits as does Pakistan.

The case of Pakistan also calls into question the issue of the treatment of creditors, Mr. Akinshin said.

"Should this large block of state debts be divided into multiple categories, each of which takes a different approach to restructuring, or not?" the Vnesheconombank executive asked.

It's a question Russia's numerous creditors are likely to be grappling with.

The government defaulted on what was then around $40 billion in Treasury debt on Aug. 17 of last year, and missed a $362 million Principal Note payment to the London Club on Dec. 2. Russia also has a little more than $2 billion in arrears to the Paris Club, Mr. Kasyanov said. A total of about $10.6 billion of MinFins are outstanding.

Mr. Akinshin said Vnesheconombank officials have been looking at a number of models for restructuring the MinFins, including copying the restructuring of the government's Treasury debt -- known as GKOs and OFZs.

Foreign GKO holders have bitterly denounced the government's restructuring terms as confiscatory. Under the terms, holders would receive 10% of their investment in devalued rubles and the majority in three to five-year bonds.

But the conditions might be more attractive to MinFin holders, Mr. Akinshin said, noting that these investors face no currency exposure and many hold securities with much longer maturities than those offered to holders of defaulted Treasurys.

Such a restructuring arrangement would even be beneficial for holders of the MinFin series three, many of whom purchased their bonds late last year on the secondary market at around 20% of their value, Mr. Akinshin said. The cash payment would boost the securities to around 30% to 35% of their nominal value, he said.

"I think most investors would go for that deal," Mr. Akinshin said.

First, though, the government needs to try to get its creditors on its side.

"What presumably the Russians would want to try to do is to arrange some sort of voluntary exchange (of securities)," ING's Mr. Poole said. "But they are only a month away from the payment, so negotiating a solution is going to be extremely difficult."