

## Research:

# Learning From the Russian Experience: Regional Debt Defaults and Recovery 1998-2003

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Russian local and regional governments (LRGs) are once again borrowing on the capital markets after a deep slump in 1998-2000 that followed numerous defaults. Over 2003, the Russian LRG bond market more than doubled in size and now totals \$2.2 billion. Since 2001, there have been no publicly recorded defaults, except for that of Primorsky Krai, which defaulted on a small bond issue in 2001.

As the bond market reaches new heights and new issuers enter the market, investors have become ever more concerned about potential defaults and adequate assessment of entities' creditworthiness. This article analyzes common default triggers and recovery rates, and compares the circumstances of the 1998-2000 default wave with the present situation.

For the purposes of this study, a default is a nonpayment of interest or principal or coercive exchange in which the creditor has no real alternative but to accept the offer, which is unfavorable.

Delay or nonpayment to the federal government is not regarded as a default for the purposes of this study. Borrowing from the federal budget is a component of the Russian intergovernmental budgetary system. Budget loans are repeatedly prolonged, written off, or used to replace grants.

Publicly available data only represents the top of the "default iceberg". Poor disclosure of LRG defaults is common in Russia, as in many other European countries. Lack of data on municipal defaults makes it impossible to include them in this study.

## ■ Will There Be More Mass Defaults?

Low credit ratings in general suggest that single defaults are likely. Only one regional default occurred during 2001-2003, however. Regional borrowing on the capital markets is now concentrated among the most creditworthy regional governments (RGs). On the other hand, less creditworthy RGs are now entering the market, and defaults are more likely to occur because these new borrowers are more exposed to the risks that were common default triggers in 1998-2000.

Most credit risk factors, including an unstable intergovernmental budgetary system, tax base concentration, and dependence on a shallow national capital market, are ubiquitous among Russian RGs. On the other hand, improved liquidity, due to the elimination of noncash payments and longer debt maturities, is a significant improvement on the late 1990s. Willingness to pay will continue to play a crucial role in the determination of RGs' probability of default.

Improvements in financial management quality give Standard & Poor's Ratings Services some hope that mass defaults will not be repeated and that more attention will be paid to the credit quality of individual entities in the sector. Improved enforcement mechanisms and credit discipline—such as clear mechanisms or the complete absence of ad hoc bailouts by the federal government—will be key to the provision of creditor protection and reduced borrowing costs for RGs.

## ■ Numerous Defaults After the Crisis of 1998

Russian RGs' direct debt started growing rapidly after the stabilization of the national capital market in 1996. By 1998, direct regional debt amounted to at least 25% of consolidated regional budget revenues, up from 15% in 1997. The simultaneous increase in debt service payments caused by a high proportion of short-term debt, with an average duration of less than one year, combined with yawning gaps in budget balances, increased exposure to debt refinancing risks.

An increase in interest rates significantly worsened borrowing terms in the first half of 1998. Coupled with urgent social expenditures, this increase prompted several RGs to default in May-June.

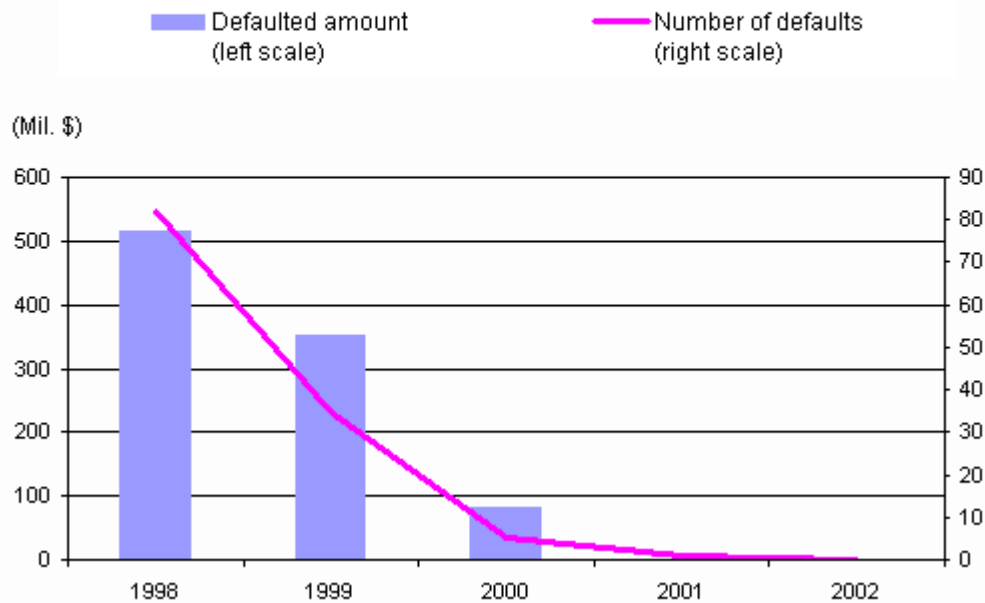
On August 17, 1998, the federal government announced the devaluation of the ruble, the halt of federal government bond trading, and a moratorium on corporate external debt payments. This prompted an avalanche of regional defaults, driven on by the growth of debt service payments on foreign currency debt, the collapse of the national capital market, and RGs' poorer liquidity.

During 1998-2001, at least 57 Russian RGs, out of a total of 89, defaulted. Information on 123 overdue obligations, with a total amount of 22 billion Russian rubles (RUR; \$771 million in current prices), is publicly available.

By 2001, the number of defaults had fallen sharply.

Chart 1

### Defaults by Russian Regions

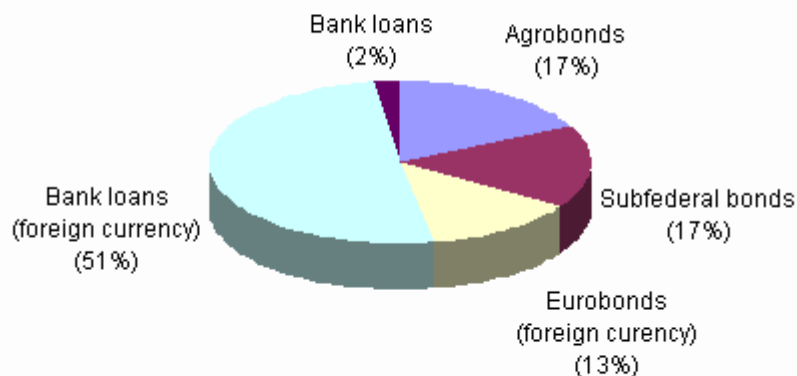


Foreign currency-denominated debt accounted for two-thirds of total defaulted obligations. The largest defaults, representing more than RUR2 billion each, were committed on foreign currency-denominated obligations. For example, Nizhniy Novgorod Oblast's obligation was eurobonds, and those of the republics of Tatarstan and Sakha, the Leningrad Oblast, and the Yamal-Nenets Autonomous Okrug (YNAO) were syndicated loans.

Bonds and bank loans each account for about one-half of total defaulted obligations. In practice, however, the proportion of bank loans is inevitably higher because loan restructurings are often not made public (see chart 2).

Chart 2

### Russian Regions Default by Debt Instruments



### ■ Default Triggers

In general, RGs defaulted due to a lack of debt service capacity or a general unwillingness to pay. In 1998-1999, several RGs including Tatarstan, Nizhniy Novgorod, and YNAO defaulted because impending debt service payments totaled 26%-29% of their budget revenues.

In contrast, in 2000, the cities of Moscow and St. Petersburg met their obligations in full and on time even though their debt service was at the critical level of 27% of revenue for both cities. This divergence in behavior highlights the importance of willingness to pay as a factor for LRGs' creditworthiness. In difficult financial situations, and unlike corporates, which are subject to bankruptcy and liquidation laws, prioritization of payments plays a crucial role.

Moscow, St. Petersburg, and some other regional governments managed to meet their debt obligations owing to an efficient set of emergency measures. Their initiatives included active debt management, such as purchase on the secondary market, postponing and cutting current expenditures, and suspending capital projects.

Common default triggers included:

- Poor liquidity--noncash payments, high seasonality of revenues, and high arrears;
- Lack of financial flexibility--inability to raise revenues or cut expenditures;
- Economic and financial crises;
- High-risk debt profiles--short-term debt, bullet maturities, and high foreign exchange risk;
- Poor debt management; and
- An unsupportive intergovernmental budgetary system.

The unwillingness of RGs to pay during this period was often caused by:

- Refusal to pay debt contracted by previous governments--corruption or inefficiency was often blamed;
- The forced nature of debt obligations--the obligatory conversion of enterprises' debt into regional debt by the Ministry of Finance, for example;
- Inefficient enforcement procedures--regions used loopholes in legislation that made it almost impossible for creditors to get their money back through the courts; and
- The default example set by the federal government.

### **Poor liquidity.**

RGs' liquidity was constrained by the widespread practice of collecting budget revenues in noncash forms, such as mutual settlements, commercial paper, the delivery of goods and services, and tax exemptions. This practice was very specific to Russian RGs. In 1997, noncash revenues accounted for one-half on average of regional budget revenues, and up to 90% in some regions.

The actual financial position of RGs accustomed to noncash budget execution was considerably poorer compared with that arising from official financial statements in 1998-1999. Below-par actual value of noncash revenues and expenditures differed widely across RGs and prevents any reliable adjustment of RGs' financial figures for that period.

Cash reserves were consequently insufficient to support liquidity when LRGs faced significant debt payments. Reserves totaled only 2.5% of revenues in 1997.

Revenues are often highly seasonal. In some cases, only 15% of revenue is collected during the first quarter of the year and 40% during the last. Mounting arrears aggravated the problem.

### **Lack of financial flexibility.**

Rigid spending structures did not leave RGs much opportunity to cut budget expenditure. Capital expenditure covered only pressing investment needs, was already low, and was usually urgent. The majority of current expenditure was obligatory--wages and social allowances--earmarked, or delegated by federal government. Deferrable expenditure had already been postponed by accumulating accounts payable, which reached 21% of total expenditure on average in 1999, even on "obligatory" expenditures. Due to tight control over tax rates, shares, and collection by the central government, LRGs also had little room for maneuver in terms of revenues.

### **Economic recession and financial crisis.**

The recession of 1998--manifested in a 6.4% drop in GDP--affected budget revenue collection. Several RGs barely managed to collect 70%-80% of their budgeted revenue. In addition, the collection of a large part of revenues in noncash forms meant that they could not be used for salaries or debt repayment.

The collapse of the banking system, a typical event for countries in default, undermined liquidity and complicated tax collection and debt payments. Cash reserves deposited in insolvent banks were frozen. Tax arrears rose because insolvent banks, having no funds, could not execute taxpayers' payment orders.

### **Risky debt profiles.**

RGs' financial positions were further sapped by their exposure to high foreign exchange and refinancing risks. Debt was largely short term, only 200-250 days on average in 1998, with bullet maturities. This was the natural result of the shallow and speculative Russian capital market. In 1997, borrowing for refinancing purposes exceeded net borrowing and amounted to 9% of consolidated regional budget revenues. Sharp increases in interest rates, up to 100%-150% in the summer of 1998, prevented new borrowing by most LRGs. High foreign-exchange risk manifested itself when the ruble value of foreign currency denominated obligations tripled in summer 1998.

RGs with onerous foreign currency debt could not cope with the increased debt burdens and had to default. The Republic of Sakha's debt burden, for example, increased to 60% of budget revenues from 17%.

### **Poor debt management.**

Excessive borrowing was the predictable result of RGs' aggressive and shortsighted financial policies and inefficient regulation by the federal government.

Speculative use of borrowed funds and the channeling of borrowed money to cover current expenditure deficits undermined debt service capacity. Some RGs invested borrowed funds in risky securities, such as federal government bonds, or deposited them in commercial banks. These investments were lost as a result of the federal government's default and the collapse of the banking system.

### **Unsupportive intergovernmental budgetary system.**

General financial support from the federal government was irregular and could not be relied upon. Even grants were distributed unevenly within a financial year. Financial assistance in distress situations was not forthcoming because the government had problems of its own. Such a break of intergovernmental fiscal arrangements in a period of sovereign distress is typical for developing countries and represents a significant risk for RGs, especially those highly dependent on the intergovernmental budgetary system.

### **Unwillingness to repay debt contracted by preceding administrations.**

Some RGs defaulted after changes in administration owing to regional elections. Newly elected governors refused to repay debt contracted by their predecessors, claiming that these obligations were contracted illegally or used ineffectively and therefore should not be repaid.

### **The forced nature of debt obligations.**

RGs often refused to repay debt that they considered to be "imposed" on them. This was the case with the "agrobonds" issued in 1997-1998 by 70 RGs. They were "forced" to convert the guarantees they issued to support agricultural enterprises into direct obligations in the form of bonds. Issued bonds were passed to the Ministry of Finance. The ministry then placed the bonds among private creditors through auctions. Many regions felt that this debt was not their true obligation.

### **Inefficient enforcement procedures.**

Inefficient and irregular enforcement procedures contributed to the corruption of RGs' credit culture. RGs missed debt payments, supposing that creditors would not succeed in enforcing payment. The Budget Code stipulates that the claims of creditors may only be satisfied after all other planned budget expenditures. Even if creditors obtained a court judgment in their favor, the authorities often failed to enforce the payments.

In 2000, the Budget Code introduced an alternative legal procedure for dealing with insolvent RGs. The federal government could now impose external control over regional budgets. To date, however, the federal government has not applied this regulation to any insolvent RGs. Attempts by creditors to oblige the government to do so have also failed.

### **Default by the federal government.**

Several RGs followed the example of the federal government and defaulted on certain debt obligations in 1998-1999. These RGs claimed to have a moral right to default because their debt service capacity was affected by the impact on the federal government of the growth of foreign currency debt service, the collapse of the banking system, and the tax base recession. The federal government's examples of "selective default" and protracted negotiations regarding the terms of debt restructuring were often followed by RGs.

## **■ Restructuring and Recovery**

The restructuring of overdue debt was generally protracted and coercive. Restructuring terms were usually unfavorable for creditors. Enforcement procedures could not protect creditors' rights, and so they had no alternative but to accept the terms offered by the RGs. They consequently incurred significant losses.

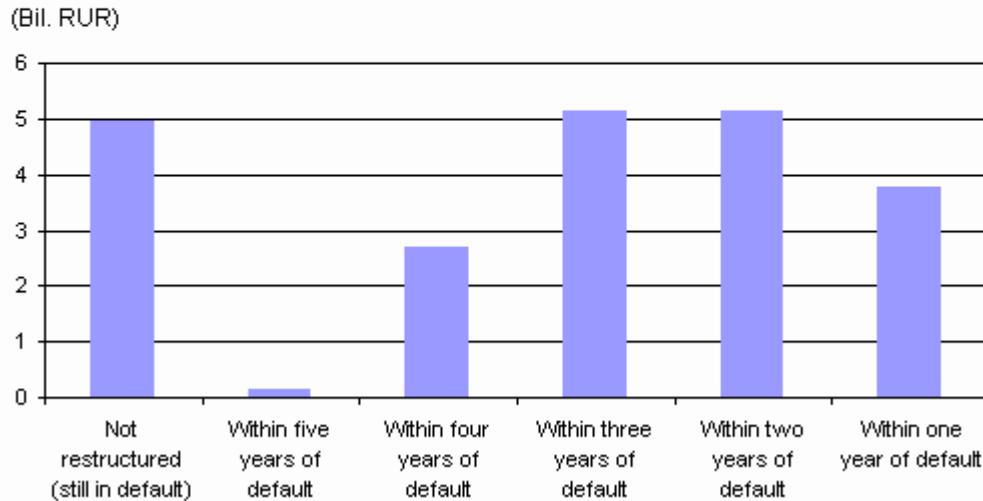
### **Duration of default--one to two years.**

Restructuring was usually protracted. No more than one-third of overdue debt was restructured within the year of default (see chart 3). About one-quarter has not yet been restructured.

The length of the restructuring period depended on the willingness of the RG to pay, the creditor's efforts to recover debt, and the type of debt obligations. In general, external debt obligations, such as eurobonds and bank loans, were restructured more quickly. The restructuring of agrobonds, often overdue because of unwillingness to pay, dragged on for years.

Chart 3

### Russian Regions Period of Defaulted Debt Restructuring



#### Coercive restructuring terms.

Overdue debt was often repaid in noncash assets, such as new bond issues, stocks, property, and goods obtained through noncash budget revenue collection, with only a few exceptions, including bonds held by individuals. Overdue debt also could be exchanged for tax exemptions or accepted as tax payments or budget loan repayments.

Creditors exchanged overdue debt obligations for assets offered by the RGs at auctions, usually for less than face value. Many creditors incurred losses by attempting to convert debt obligations into cash as soon as possible, because the market price of assets offered by RGs was obviously significantly below par. There were also several cases of forced debt swaps at below-par rates, including by Novosibirsk Oblast.

#### Low recovery rates on both domestic and external debt.

Noncash repayment schemes and the lack of data complicate the assessment of recovery values. Lack or unreliability of data on the prices of defaulted regional bonds is explained by the fact that the liquidity of overdue issues was extremely low. Moreover, RGs often suspended trading of overdue regional bonds on the stock exchange until restructuring was complete. Trading on Novosibirsk's three bond issues, which had a total value of RUR233 million, for example, was suspended for 54 months.

Generally, creditors incurred significant losses due to protracted restructuring even if the overdue debt was repaid in full nominal value.

Recovery rates on ruble-nominated bonds were quite low. Low recoveries originated from a protracted restructuring process, the low liquidity of defaulted bonds, unclear restructuring terms, and great uncertainty about repayment of debt instruments received by investors in exchange for defaulted bonds. Recovery on Omsk Oblast's bonds, which defaulted in 1998-1999, for example, averaged 47%, varying from a mere 33% up to a more significant 75%, owing to the nonsimultaneous redemption of different issues. This was completed by December 2003.

Recovery rates on bank loans were even more dispersed than for bonds. The lower dispersion for bonds was a result of the general uniformity of bond obligations and similarity of court procedures. Bank loans, regulated by uniquely structured contracts, experienced more differentiation and less predictable recovery.

Recovery rates on external obligations, such as eurobonds and syndicated loans held mainly by foreign creditors, were on a par with recovery rates on ruble-denominated obligations. Creditors recovered 38%-48% on the Nizhniy Novgorod Oblast defaulted Eurobonds, for example.

Similar recovery rates on external debt could be explained by the balance of RGs' stronger willingness to pay on the one hand, but poorer debt service capacity where RGs had substantial external debt on the other. RGs' concerns about their reputation among foreign investors and better documentation of external debt deals strengthened RGs' willingness to pay. It resulted in shorter periods and better terms of restructuring for creditors, including full repayment in cash and accrual of interest on capitalized amounts of debt. Heavy debt burdens, however, which had tripled after the drastic devaluation of the ruble, exhausted their debt service capacity and demanded extension of repayment schedules.

#### Continued default.

Some RGs are still in default. Overdue debt obligations include agrobond issues, bank loans, foreign currency guarantees

(Kaliningrad Oblast), and domestic bonds (Primorskiy Krai). In total, 17 RGs still have overdue debt obligations.

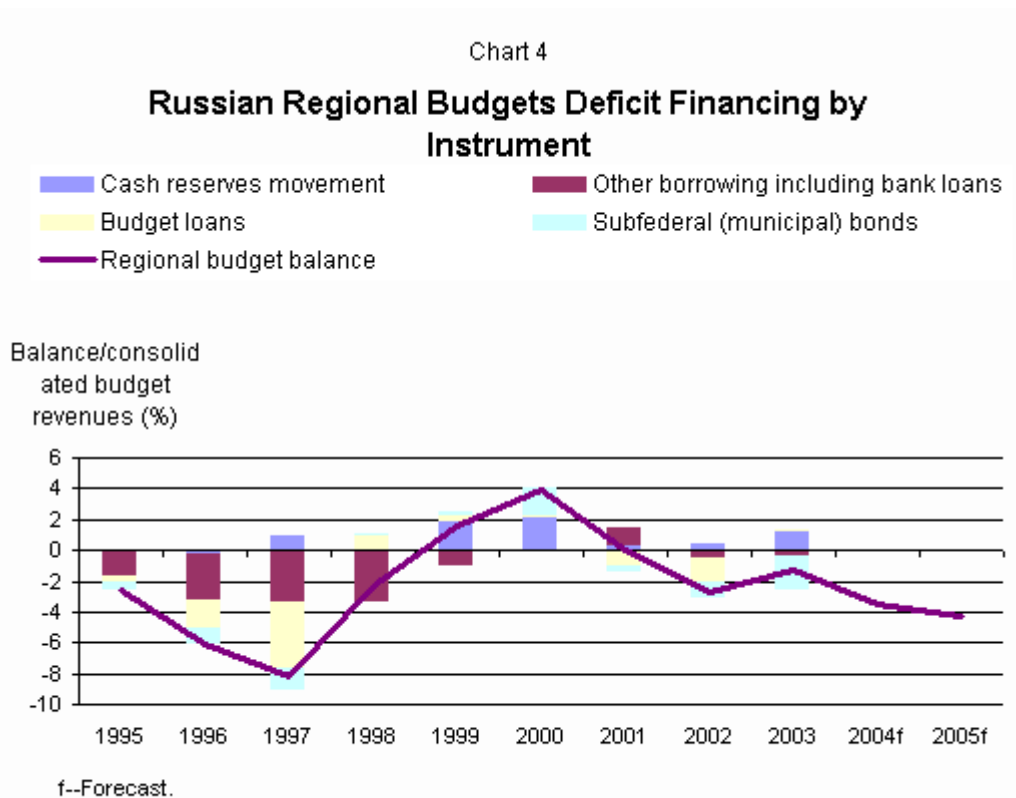
It is evident that less favorable borrowing conditions are offered to RGs with poor credit histories. Nizhniy Novgorod, therefore, did not issue bonds in 2003 because potential underwriters offered placement at yields of 30%. Yields on bonds issued by the cities of Moscow and St. Petersburg, the most creditworthy RGs, were 9%-12%.

## ■ The Future

### Debt is expected to grow in the medium term.

Raising funds from capital markets is becoming an ever more important source of infrastructure investment for RGs because current resources--budget surpluses--cannot meet growing regional investment needs.

RGs' debt burdens are expected to grow in the medium term, although they remain low by international standards (see chart 4). During 2002-2003, regional direct debt as a percentage of operating revenues increased by 5.5 percentage points compared with 2001. The central government's initiatives to reduce regional borrowing from the federal budget and delegate additional expenditure responsibilities, such as raising the salaries of budget-sphere employees, will prompt RGs to borrow from capital markets. Debt limits set in the Budget Code are quite generous and should not limit debt growth in the medium term.



### Creditworthiness remains low despite some improvements.

The current financial and debt situation of Russian RGs is very different from the precrisis, predefault position of 1997-1998. In 2002, the stronger financial performance of rated RGs was indicated by higher operating budget balances--a median of 21.7% compared with 13.5% in 1998 and deficits of 1.3% in 1997--and manageable debt service--a median of 5.2% of revenues compared with 12.4% in 1998. Budget revenues are collected wholly in cash because noncash settlements were prohibited in 2000. Liquidity is supported by growing cash reserves--4% in 2002 compared with 2.5% in 1997--and better borrowing terms.

Although RGs' creditworthiness has improved, credit risks remain high, as the noninvestment-grade credit ratings continue to indicate. Major constraints on creditworthiness include low-quality financial management, weak financial flexibility, and exposure to economic risks and a volatile intergovernmental system. The RGs' debt structure still involves significant refinancing and currency risks.

### Legal restrictions remain ineffective.

As a partial answer to the numerous LRG defaults in 1998-1999, the Russian federal government introduced the legal debt limits set in the 2000 Budget Code. These limits include requirements that:

- Total debt is less than budget revenues minus transfers from the federal budget;
- Total budget revenues are greater than current expenditures;
- Budget deficits are less than 15% of budget revenues minus transfers from the federal budget (this regulation indirectly limits net borrowing to 15% of own revenues);

- Interest payments are less than 15% of budget expenditures; and
- Guarantees issued within one year are less than 5% of budget expenditures.

These limits are quite generous, however, and in Standard & Poor's opinion they fail to restrict borrowing to a level manageable by emerging countries.

In addition, poor discipline undermines the effectiveness of these restrictions. At the beginning of 2003, 41 RGs were in breach of at least one of these restrictions.

### **Refinancing and currency risk exposure is lower but remains important.**

The structure of regional debt has improved considerably compared with its pre-1998 levels, but it still carries some currency and refinancing risks. Although the duration of debt liabilities has extended significantly, the debt obligations of even the most creditworthy RGs mature over two to three years--a lower average than international standards. Many RGs also remain exposed to foreign exchange risk because foreign currency denominated debt amounted to 25% of total regional debt in 2002. Although the 2000 Budget Code prohibited foreign currency denominated borrowing by RGs, they can still refinance foreign currency debt or incur debt fixed to an exchange rate.

### **Poor debt management quality is still a concern, but trends are positive.**

Debt management remains inadequate in most Russian RGs. Only the most progressive administrations are moving forward in terms of management quality. The debt policies of the majority remain shortsighted and poorly institutionalized compared with their peers in developed countries. Borrowed funds are spent ineffectively because borrowing plans are not incorporated into investment programs. Even though debt structures remain perilous, risks are not assessed and most risk management techniques are ignored. The transparency of debt operations remains low, due to poor disclosure and the weakness of accounting.

RGs may suffer significant shortfalls in budget revenues due to high exposure to large taxpayers or industries. Rainy day funds, conservative financial planning, and other hedging techniques are not applied widely among the regions.

### **Intergovernmental budgetary system and local self-government reforms lead to uncertainty.**

Ongoing intergovernmental budgetary system and local government reforms undermine the stability of regional finances in the short term. Irregular and sudden redistributions of tax revenues, financial aid, and expenditure responsibilities inherently lower the stability of regional finances and render any longer-term financial policies practically impossible. Recent federal government initiatives, including further equalization of per capita tax revenues and delegation of additional expenditure responsibilities, are expected to have a negative effect on the wealthier rated RGs.

The vulnerability of RGs to possible sovereign distress remains high. Their strong dependence on ever-changing intergovernmental fiscal arrangements represents a considerable risk factor despite the recent improvements in sovereign creditworthiness.

### **Weak enforcement mechanisms do not offer protection to creditors.**

The default by Primorskiy Krai in 2001 clearly indicates that Russian RGs cannot be compelled to pay. In the mean time, creditors continue their unsuccessful attempts to recover debts, some more than five years old, such as the agrobonds issued by Saratov Oblast. Expected recovery rates remain low, owing to poor enforcement, which results in higher borrowing costs for all RGs. Until creditor rights are protected, long-term loans will be beyond the reach of most RGs.

In 2007-2008, the federal government plans to introduce a mechanism to enforce insolvent RGs to pay their debts--Temporary Financial Administration (TFA). TFA will be established in RGs with overdue obligations exceeding 30% of budget revenues. The TFA is expected to prepare a debt repayment plan and oversee its implementation. TFA does not, however, guarantee the protection of the creditor's rights because only the federal government can establish it. It cannot be introduced if overdue debt does not exceed 30% of revenues. Furthermore, the mechanism seems quite opaque.

### **Bailouts remain ad hoc.**

Recent bailout practices would be likely to cause debt discipline problems if repeated. The federal government helped Nizhniy Novgorod, for example, to repay its first tranche of the restructured eurobonds. Ad hoc bailouts do not contribute to the supportiveness and predictability of the intergovernmental budgetary system but rather worsen entities' unwillingness to pay. RGs may expect similar bailouts when in financial distress or when considering a default. This may encourage unsound financial policies and more reckless borrowing.

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