Comment

Collateralized Brady Bonds Upgraded

Analysts
Morgan Harting, CFA
+1 212 908-0820
morgan.harting@fitchratings.com

Roger M. Scher
+1 212-908-0240
roger.scher@fitchratings.com

David Riley
+44 207 417-6338
david.riley@fitchratings.com

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■ Overview

Concurrent with the application of both Issuer Default Ratings and Recovery ratings to sovereigns, the ratings of twenty-seven collateralized Brady bonds issued by eleven sovereigns with an aggregate face value of US$12.7 billion were upgraded. The ratings on other bonds issued by these sovereigns remain unchanged –including those of uncollateralized Brady bonds. The upgrades of the collateralized Brady bonds reflect Fitch's view that in the event of default the recoveries on these securities are likely to exceed the recoveries of senior unsecured bonds, an assessment based on a review of actual recoveries in recent sovereign bond exchanges.

In the case of Argentina, which has outstanding unsecured and collateralized bonds in default as well as unsecured bonds not in default, the effect of applying Recovery ratings to its bonds generates two rating changes. For issues currently in default, the application of the Recovery ratings methodology generates a change in their ratings to 'CC' for unsecured notes and to 'CCC–'

Brady Bond Ratings

Issuer	Issue	Currency	IDR	Recovery Rating	Bond Rating
Argentina	Par	USD	DDD	RR3	CCC–
Argentina	Par	DEM	DDD	RR3	CCC–
Argentina	Discount	USD	DDD	RR3	CCC–
Argentina	Discount	DEM	DDD	RR3	CCC–
Brazil	Par	USD	BB–	RR3	BB
Brazil	Discount	USD	BB–	RR3	BB
Dom Rep	Discount	USD	B–	RR3	B
Ecuador	Discount	USD	B–	RR3	B
Ecuador	Par	USD	B–	RR3	B
Panama	Discount	USD	BB+	RR3	BBB–
Panama	Par	USD	BB+	RR3	BBB–
Peru	Discount	USD	BB	RR3	BB+
Peru	Par	USD	BB	RR3	BB+
Peru	FLIRB	USD	BB	RR4	BB
Philippines	Par A	USD	BB	RR3	BB+
Philippines	Par B	USD	BB	RR2	BBB–
Poland	RSTA	USD	BBB+	RR3	A–
Poland	Par	USD	BBB+	RR3	A–
Uruguay	Fixed A	USD	B+	RR3	BB-
Venezuela	Discount	USD	BB–	RR3	BB
Venezuela	Discount	DEM	BB–	RR2	BB+
Venezuela	Par	DEM	BB–	RR2	BB+
Venezuela	Par	FRF	BB–	RR2	BB+
Venezuela	Par	ITL	BB–	RR3	BB
Venezuela	Par	CHF	BB–	RR2	BB+
Venezuela	Par A	USD	BB–	RR3	BB
Venezuela	Par B	USD	BB–	RR3	BB
Vietnam	Discount	USD	BB–	RR3	BB
Vietnam	Par	USD	BB–	RR4	BB–

Source: Fitch Ratings, Bloomberg.

for collateralized Brady bonds in recognition of their respective average and above-average expected recoveries. The ratings on bonds not currently in default are unchanged.

The Recovery Rating Scale and its Relationship to Issuer Default Ratings

Fitch's Issuer Default Ratings (IDRs) are forward looking assessments of a sovereign issuer's capacity and willingness to honor its existing and future debt obligations in full and on time. As such, the IDRs are the benchmark *probability of default* ratings. Specific bond issues are now rated at, above, or below the IDR depending on whether the expected recovery rate on these securities in the event of default is deemed to be average, above- or below-average. Recoveries gain importance at lower rating levels because the likelihood of default in the near to medium term is often quite high and differences in recovery values have a more meaningful impact on loss expectations. Recovery ratings range from RR1 to RR6 and are defined as follows:

Recovery Scale

Recovery Rating	Recovery Prospects in Event of Default
'RR1'	Outstanding (historically 91%-100%)
'RR2'	Superior (historically 71%-90%)
'RR3'	Good (historically 51%-70%)
'RR4'	Average (historically 31%-50%)
'RR5'	Below average (historically 11%-30%)
'RR6'	Poor (historically 0%-10%)

Note: The recovery scale shows the historical average recovery rates. For a given issuer's securities, no assurance can be given that the actual recoveries will fall precisely within the ranges shown for a respective recovery rating.

Whereas senior unsecured debt is generally deemed to have average recovery prospects given default (31% to 50% of face) and is therefore assigned an RR4 recovery rating, collateralized Brady bonds generally have better recovery prospects and can be assigned higher Recovery ratings. The expected incremental recovery and the associated notching on the Recovery ratings scale are estimated based on the value of collateral, which varies by issue. At current market prices, the zero-coupon bonds securing Brady bonds are mostly valued at between 30% and 60% of face because their maturities are primarily in the 2020's. Where the collateral value pushes the expected recovery into the 51% to 70% of face range, an RR3 Recovery rating is assigned and the issue is rated one notch above the IDR. Similarly, where expected recovery is estimated at between 71% and 90% of face, an RR2 Recovery rating is assigned and the bond is rated two notches above the IDR for speculative grade sovereigns and one notch above the IDR for investment grade sovereigns.

Potential Ratings for Defaulted Issues

Recovery Rating	Potential Issue Rating
'RR1'	'CCC+/B–/B'
'RR2'	'CCC/CCC+'
'RR3'	'CCC–/CCC'
'RR4'	'CC/CCC–'
'RR5'	'C/CC'
'RR6'	'C'

Note: Portrays typical ratings that would be assigned to issues of defaulted issuers (issuer default rating of 'D' or 'RD'). Actual ratings will depend on specific circumstances of the issuer and issues.

In two cases, the Brady collateral is inadequate to warrant an RR3 Recovery rating instead of the RR4 Recovery rating assigned for senior unsecured sovereign debt. Collateral for the Vietnam Par Bond covers only half of principal and it does not cover interest, so it is worth about 17% of face at current prices. The long tenor of the bond also diminishes the present value of the principal guarantee. Because the collateral falls short of the 20% of face required to lift its expected recovery from the 31% minimum for RR4 to the 51% minimum for RR3, the rating on the Vietnam Par bond is not notched up from the IDR. Similarly, the collateral for Peru's FLIRBs is valued at about 2% of face and therefore falls well short of the 20% of face in incremental recovery prospects required to notch up from the IDR.

Recovery Ratings Effect on Issue Ratings of Performing Sovereign Issuers*

Recovery Rating	Investment Grade	Speculative Grade
RR1	2	3
RR2	1	2
RR3	1	1
RR4	0	0
RR5	–1	–1
RR6	–1 to –2	–2 to –3

* Indicates expected notching up or down of the rating of a security relative to the Issuer Default Rating (IDR) for a given Recovery Rating (RR).

Expected recovery for collateralized Brady bonds is calculated by first adjusting face value of the original bond for cash collateral released (the "Brady residual"). That is, the Brady residual for a bond with collateral valued at 40% of face is 60% (100%-40%).[1] A 31% recovery assumption is applied to this Brady residual, consistent with the most conservative end of the 31%-50% RR4 recovery range. For the example given, a 31% recovery on a 60% Brady residual would be 31% * 60% = 18.6% (the "residual recovery"). To the residual recovery, the collateral is added back and the sum of these is the expected recovery. That is, to the 18.6% residual recovery in the example given, adding the 40% of face in collateral equals a total expected recovery of 58.6%. This approach is based on the empirical evidence of recoveries in recent sovereign distressed debt exchanges such as Argentina, Ecuador and Uruguay.

Markets clearly value collateralized Brady bonds more than uncollateralized bonds with similar characteristics, believing that the collateral value will not be wiped out as a result of discriminatory terms vis-à-vis unsecured bonds. Treatment across securities in exchanges has varied in the recent cases of Argentina, Uruguay and Ecuador. But discrepancies have resulted primarily from attempts to equalize terms across maturities rather than to penalize Brady holders. Additionally, although Brady collateral has been credited against original face value in certain cases, this adjustment can be viewed as akin to a prepayment of principal rather than an uncompensated reduction of it.

■ Two Brady Restructuring Cases

Argentina

The government of Argentina declared a suspension of payment on most classes of public debt in December 2001, and in December 2004 the president authorized the offer to exchange defaulted securities for new ones with substantially inferior terms. Following the first missed interest coupon, and in accordance with the terms of the bonds, the fiscal agent for Argentine Par and Discount bonds made interest payments by liquidating interest collateral beginning in July 2002. Interest collateral covered 6% of principal for the Pars and 8% of principal for the Discounts, set in both cases to equal to one year of interest. By the time of the debt exchange, interest collateral for both Pars and Discounts had been fully depleted. For Pars and Discounts not tendered in the exchange, the full face value of both bonds remains covered with principal collateral in the form of a special-issue zero-coupon bond of the same maturity. For Pars and Discounts denominated in USD, this collateral is currently valued at about 44% for face; for the DEM-denominated bonds it is worth about 53% of face.

As Argentina entered its default, investors correctly anticipated that these collateralized Brady bonds would enjoy higher recoveries in the exchange than unsecured bonds with similar characteristics. Whereas the USD Brady Par bond paying a fixed 6% annual coupon and maturing in 2023 priced at $50 on November 8, 2001, a 2020 Global bond paying a fixed 12% coupon priced at $31 on the same day. Considering the Global 2020's earlier maturity and substantially higher coupon, absent collateral and assuming similar liquidity, it should have been priced substantially higher than the 2023 Par bond. Conversely, had the Par bond offered a 12% coupon, it would have been valued even higher. The price discrepancy between the securities owed to the collateral, which at the time was valued at about $29 for the principal and close to $6 for interest. "Stripped yields" that exclude the value of Brady collateral from bond prices showed the two securities to be much closer in market value (36.2% of principal for the Par and 43.7% for the Global) and within a range that could be explained primarily by superior liquidity for the Brady, which had US$2.3 billion in principal outstanding at end-2001, compared with the Global 2020's US$122 million outstanding.

After netting collateral released in respect of principal and interest, the terms of the exchange for both the 2023 Par and the 2020 Global were the same for holders opting to receive the new "discount" bond. A face value haircut of 66.3% was imposed on the remaining principal of both eligible securities. In effect, the Brady Par and Brady Discount holders received the economic value of their principal in cash, whereas the net present value of principal on other bonds was substantially eroded by having its maturity extended and its interest coupon reduced.

Ecuador

Whereas the Argentina exchange terms netted collateral against the principal value of bonds eligible for tender, the Ecuador exchange of August 2000 did not, enhancing recovery. The terms of the Ecuador exchange did impose a haircut to face

[1] In calculating the value of collateral, current market prices for the underlying zero coupon bonds are adjusted for a 1% increase in market yields.

value for collateralized Par and Discount bonds, and did not for the uncollateralized 2002 and 2004 Eurobonds. But this adjustment was made to equalize exchange terms across maturities rather than to offset the collateral that Pars and Discounts enjoyed but Eurobonds did not. Because the Par and Discount Brady bonds matured in 2025, the present value of their principal was significantly less than the present value of principal on the much shorter-term Eurobonds. Thus, the exchange terms sought to equate the present value losses across securities *before* considering the value of collateral. The collateral for Pars and Discounts, with a present value equal to about 24% of principal at the time of the exchange, was therefore roughly equivalent to the incremental recovery for these bonds.

As with the case for Argentina, relative prices of Ecuador's bonds at the time of the exchange announcement correctly anticipated that collateralized Brady bonds would have higher recoveries, and that the recoveries relative to unsecured bonds would approximate the collateral value. At the announcement of a suspension of payments of interest on certain sovereign bonds in late August 1999, the collateralized Discount 2025 traded at US$35 (38% of par) and the unsecured PDI 2015 traded at US$23 (19% of par). The price of the PDI bond exceeded its market value as a percentage of par because certain interest payments prior to the exchange were capitalized, increasing the par value relative to the original issue face value. Both bonds paid floating coupons of Libor plus 0.8125%, making them easier to compare. Given the shorter maturity of the PDI, the equivalent coupon would suggest that it should price higher than the Discount, assuming similar liquidity. The principal and interest collateral, valued at about 24% of par, was therefore similar --but slightly larger-- than the price spread between the bonds. This discrepancy could be explained by an upward sloping yield curve, which would effectively increase the average discount rate for uncollateralized cash flows from the Discount 2025, reducing its relative price.

■ Issuers Not Currently Rated Would Likely Receive Same Treatment

Nigeria and Cote D'Ivoire are not currently rated by Fitch and have collateralized Brady bonds outstanding. In the event that Fitch were to rate issuer, their respective Brady bonds would receive the same rating treatment as other Brady bonds, according to Fitch's assessment of the value of their Brady collateral at that time.

■ Potential Changes In Recovery Assessments

Over time, Fitch may revise its assessment of the incremental recovery prospects for collateralized Brady bonds in a manner that could result in changes to their ratings, either upward or downward.

As the zero-coupon principal collateral accretes to par, the incremental recovery prospects should improve, ultimately warranting RR1 Recovery ratings. At such point, the bonds would be rated three notches above the IDR for speculative grade sovereigns or two notches above the IDR for investment grade sovereigns. This rests on the assumption that there will be no change in our expectation that collateralized Brady bonds not be treated prejudicially in future distressed debt exchanges. The additional cover from collateral required to definitively boost a Recovery rating from the 31% to 50% rate assumed at RR4 to the 91% to 100% range of RR1 would be 60%. How soon this occurs will be a function of time and price changes in the US treasury market. Bonds with nearer maturities will pass the post first. At current prices, collateral cover for the 2020 Venezuela USD Discount bonds just exceeds the 60% of par threshold and for the Pars it is equal to nearly 58% of collateral. But because principal collateral is in the form of a zero-coupon bond, its duration is high, so its value very sensitive to changes in market yields. A 0.5% rise in yield on the Discount's collateral, for example, would push its value below 58% of par. Considering Fitch's expectation that global rates will rise over the next year, there is still not enough cushion built into the

Unrated Collateralized Brady Bonds

Country	Bond Issue	Bloomberg #	Maturity	Amount outstanding ($1000) at Sept 26	IDR	Recovery Rating	Bond Rating
Ivory Coast	Discount	TT330835	03-31-2028	$ 22,313.00	N/A	N/A	N/A

Source: Fitch Ratings, Bloomberg.

collateral value to warrant an RR1 Recovery rating on the Venezuela Discounts.

A more comfortable market value for the collateral for such a move would be able to sustain a 1% rise in market yields. Where collateral is priced close to a threshold between one Recovery rating and another, the 1% yield shock is used as a test for robustness. If the price is sustained above the relevant threshold even assuming a 1% yield shock, the higher expected recovery category is used.

Depending on treatment of collateralized Brady bonds vis-à-vis other securities in potential future distressed debt exchanges, Fitch's assumption that Brady collateral is fully cumulative in recovery assessments could be revised, causing the bond and Recovery ratings to be downgraded. This could take the form of an announcement that collateral would be netted against the principal value of bonds eligible for tender in an exchange beyond an amount set as "pre-payment" or beyond an amount set with the objective of equating terms across maturities in present value terms.

■ A Dying Asset Class

Brady bonds are a dying asset class, so their principal amounts outstanding are expected to decline and could be eliminated even before their last maturity in 2028 for the Vietnam Pars and Discounts. They were issued as part of the resolution of default on commercial bank loans, much of which dated to the 1980s. Their objective was primarily to facilitate an exchange of illiquid claims for marketable securities. Most governments covered in the Brady plan have since been able to issue conventional bonds in international capital markets and have sought to retire their collateralized Brady bonds by exercising calls or announcing exchanges. Repurchasing them allows the issuers to release the underlying collateral, which over time has accreted to a substantial portion of face value, reducing gross debt in face value terms. For dedicated emerging market sovereign investors, unsecured bonds represent a straight sovereign risk play and are therefore usually more attractive.

Brady Bond Recovery Calculation and Ratings

Issuer	IDR	Issue	Currency	(a) Value of collateral assuming 1% yield rise	b=(1-a) Brady residual	c=b*31% 31% recovery on Brady residual	d=a+c Residual recovery plus collateral	Recovery Rating	Notches above IDR	Bond Rating	Maturity	Amount outstanding (1000)	Bloomberg IDs
Argentina	DDD	Par	USD	37%	63%	20%	57%	RR3	n/a	CCC–	03-31-2023	$2,259,561	TT3135296, TT3106917
Argentina	DDD	Par	DEM	45%	55%	17%	62%	RR3	n/a	CCC–	03-31-2023	DEM284,450	TT3117435
Argentina	DDD	Discount	USD	37%	63%	20%	57%	RR3	n/a	CCC–	03-31-2023	$800,497	TT3135288, TT3105570, TT3106909
Argentina	DDD	Discount	DEM	45%	55%	17%	62%	RR3	n/a	CCC–	03-31-2023	DEM281,930	TT3117427
Brazil	BB–	Par	USD	41%	59%	18%	59%	RR3	1	BB	04-15-2024	$1,572,473	TT3163181, TT3163199
Brazil	BB–	Discount	USD	43%	57%	18%	61%	RR3	1	BB	04-15-2024	$1,333,031	TT3163207, TT3163215
Dominican Rep	B–	Discount	USD	40%	60%	19%	59%	RR3	1	B	08-30-2024	$328,550	TT3149263
Ecuador	B–	Discount	USD	40%	60%	19%	59%	RR3	1	B	02-28-2025	$33,292	TT3183452, TT3183882
Ecuador	B–	Par	USD	38%	62%	19%	57%	RR3	1	B	02-28-2025	$64,452	TT3183460, TT3208408
Panama	BB+	Discount	USD	37%	63%	20%	57%	RR3	1	BBB–	07-17-2026	$13,146	TT3220254
Panama	BB+	Par	USD	35%	65%	20%	55%	RR3	1	BBB–	07-17-2026	$9,733	TT3220262
Peru	BB	Discount	USD	32%	68%	21%	53%	RR3	1	BB+	03-07-2027	$197,525	TT3256217
Peru	BB	Par	USD	30%	70%	22%	52%	RR3	1	BB+	03-07-2017	$64,526	TT3256233
Peru	BB	FLIRB	USD	2%	98%	30%	32%	RR4	0	BB	03-07-2017	$1,150,331	TT3256225
Philippines	BB	Par A	USD	56%	44%	14%	70%	RR3	1	BB+	06-01-2018	$126,060	TT3102999
Philippines	BB	Par B	USD	58%	42%	13%	71%	RR2	2	BBB–	12-01-2017	$410,964	TT3135395
Poland	BBB+	RSTA	USD	39%	61%	19%	58%	RR3	1	A–	10-27-2024	$448,566	TT3183700
Poland	BBB+	Par	USD	39%	61%	19%	58%	RR3	1	A–	10-27-2024	$744,670	TT3179583
Uruguay	B+	Fixed A	USD	52%	48%	15%	67%	RR3	1	BB-	02-19-2021	$15,233	TT3093636
Venezuela	BB–	Discount	USD	55%	45%	14%	69%	RR3	1	BB	03-31-2020	$874,658	TW308026, TW308025
Venezuela	BB–	Discount	DEM	65%	35%	11%	76%	RR2	2	BB+	03-31-2020	DEM130,840	TT3080278
Venezuela	BB–	Par	DEM	59%	41%	13%	72%	RR2	2	BB+	03-31-2020	DEM507,740	TT3077365
Venezuela	BB–	Par	FRF	60%	40%	12%	72%	RR2	2	BB+	03-31-2020	FRF321,350	TW3077376
Venezuela	BB–	Par	ITL	57%	43%	13%	70%	RR3	1	BB	03-31-2020	ITL318,880,000	TW3077384, TX3077382
Venezuela	BB–	Par	CHF	68%	32%	10%	78%	RR2	2	BB+	03-31-2020	CHF100,000	TX307739, TT307739
Venezuela	BB–	Par A	USD	52%	48%	15%	67%	RR3	1	BB	03-31-2020	$1,638,396	TT306955, TT317081
Venezuela	BB–	Par B	USD	52%	48%	15%	67%	RR3	1	BB	03-31-2020	$719,531	TT307740, TT317082
Vietnam	BB–	Discount	USD	31%	69%	21%	52%	RR3	1	BB	03-13-2028	$24,552	TT329954, CP504855
Vietnam	BB–	Par	USD	14%	86%	27%	41%	RR4	0	BB–	03-12-2028	$228,243	TT329953, CP504860

Source: Fitch Ratings, Bloomberg.

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