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Abstract

This Article completes the analysis of the first decade of the modern emerging market's operation by considering two further periods: (iv) Adolescence: March 1989 to October 1991; and (v) Young Adulthood: October 1991 to December 1993. The primary importance of the market in these periods, as will be discovered, lies in its promotion and facilitation of the Brady Plan.

THE FACILITATION OF THE BRADY PLAN: EMERGING MARKETS DEBT TRADING FROM 1989 TO 1993

*Ross P. Buckley**

INTRODUCTION

The modern secondary market in the debt of less developed countries ("LDCs"), now known as the emerging market, grew out of the debt crisis of 1982. The first six years of the market's development were considered in an earlier Article,[1] which analyzed the evolution of the market in the following periods: (i) Birth: 1982 to May 1985; (ii) Infancy: May 1985 to May 1987; and (iii) Childhood: May 1987 to March 1989. The Article concluded that the market's principal effects were to force a degree of realism upon a bank's loan loss provisions, to provide an exit from LDC lending for certain banks, and to facilitate a range of debt exchanges including debt-equity swaps and debt buy-backs.

This Article completes the analysis of the first decade of the market's operation by considering two further periods: (iv) Adolescence: March 1989 to October 1991; and (v) Young Adulthood: October 1991 to December 1993.[2] The primary importance of the market in these periods, as will be discovered, lies in its promotion and faciliation of the Brady Plan.

I. *THE TUMULTUOUS YEARS OF ADOLESCENCE: MARCH 1989 TO OCTOBER 1991*

A. *The Period's Major Events*

The period between 1989 and 1991 began with increasing political tensions in Latin America. In early March 1989, the staid and sober pages of the *Wall Street Journal* rung with the

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1. Ross P. Buckley, *The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading from 1983 to 1989*, 21 FORDHAM INT'L L.J. 1152 (1998).

2. The regulation of the market and the role of the Emerging Markets Traders Association were not considered in this research.

warning that "[w]hile the Bush administration searches for a new U.S. policy on Third World debt, the red ink is turning to blood."[3] The article told how over 300 people had died in riots in Venezuela protesting austerity measures imposed by the government at the behest of its creditors.[4] Political opposition to unrelieved debt service was growing strongly throughout the region.[5]

Tensions were also increasing in the U.S. banking industry. In 1988, the negotiation of rescheduling packages and their attendant new money obligations had become difficult and protracted in the face of stiff bank resistance.[6] Increasing numbers of regional U.S. and European banks were simply refusing to advance fresh funds; the secondary market had provided a back door out of the debt crisis and the banks were using it.[7] For banks with smaller exposures, the sale of loans on the market was an attractive option.

By early 1989, the Baker Plan and its strategy of rescheduling with new money was a dead letter. Banks had wearied of forever advancing new funds.[8] Countries had wearied of their ever-rising level of indebtedness. The International Monetary

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3. Walter Mossberg & Peter Truell, *Another Round: Bush Aides Are Likely to Offer a Plan Soon on Third World Debt*, WALL ST. J., Mar. 9, 1989.

4. *Id.* The government reported 287 fatalities. Some commentators have placed the death toll as high as 1500. *See* FERGUSON, VENEZUELA IN FOCUS - A GUIDE TO THE PEOPLE, POLITICS, AND CULTURE 5 (1994); *see also* GREEN, SILENT REVOLUTION - THE RISE OF MARKET ECONOMICS IN LATIN AMERICA 164-175 (1995).

5. Carlos Menem, the Argentine president, advocated a five-year suspension of interest payments on Argentina's debt. *See* Alan Riding, *Venezuela Seeks Unity on Latin Debt*, N.Y. TIMES, Jan. 9, 1989, at D8. Ferdinand Collor de Mello, the Brazilian president, advocated that maturities be extended over forty years with a fixed interest rate. *See* James Brooke, *Latin America Pursues Recovery on Two Fronts*, N.Y. TIMES, Aug. 28, 1989, at D6. In Mexico's July 1988 general election, Carlos Salinas de Gortari received only 51% of the vote, the lowest vote ever received by a presidential candidate from the official party, the PRI, which has dominated Mexican politics for over half a century. *See* Branigan, *Mexican Launches Election Protest Campaign: More Than 200,000 Attend Rally*, N.Y. TIMES, July 16, 1989, at A1. *See generally* Green, *supra* note 4, at 167-69 (listing riots and protests against IMF Structural Adjustment Programs and resulting austerities).

6. Lee C. Buchheit, *Whatever Became of Old New Money?*, INT'L FIN. L. REV., Dec. 11, 1990, at 12.

7. Rory MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 328-29 (1995).

8. In the words of M. Peter McPherson, the Executive Vice President of Bank of America, in testimony before a Senate subcommittee: "Many banks had concluded by the Spring of 89 that their primary recourse was, in fact, to withhold new money. Each new money exercise was harder and harder; by the time Secretary Brady proposed his plan, new money, I believe, was about gone under the old system."

Fund's austerity programs were no longer politically tenable in Latin America. Their continuation could have led to the overthrow of some of the democratic governments that had come to power during the 1980s and the return of totalitarian regimes to the region.[9] Such developments would have been against U.S. interests. A new approach was needed from the U.S. government. The Brady proposal was that approach. In time it would transform the secondary market.

1. The Brady Plan

This new initiative, the Brady Plan as it came to be known, represented a sharp departure from the Baker Plan.[10] That much, initially, was clear. However, Treasury Secretary Nicholas Brady was deliberately vague[11] when he made his speech on March 10, 1989.[12] His vagueness reflected the U.S. Treasury's incapacity "to orchestrate a full-scale 'plan' and make it work."[13]

Secretary Brady proposed (1) a series of individual market-based transactions, (2) in which creditors would be invited to participate voluntarily, (3) with debt relief tied into the conversion of loans into collateralized bonds, (4) with debtor nations permitted to repurchase their own discounted debt on the secondary market, and (5) with debt-equity schemes being promoted.[14] The proposal was seen as an expression of increased urgency from the U.S. government about the resolution of the debt crisis, a strong call for the development of capital-market-based solutions,[15] and an official acceptance that some debt forgiveness was essential. At long last, it seemed, the calls for debt

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9. Hearings on the Lesser Developed Countries' Debt Crisis Before the House Committee on Banking, Finance, and Urban Affairs, 101st Cong., 1st Sess. 332 (1989)(statement of Professor Luiz Carlos Bresser Pereira)[hereinafter Statement of Prof. Pereira].

10. *See* Buckley, *supra* note 1.

11. Calverley & Iversen, *Banks and the Brady Initiative, in* THIRD WORLD DEBT - MANAGING THE CONSEQUENCES 129, 133 (1989).

12. Secretary Brady delivered his speech to a joint meeting of the IMF and the World Bank in Seoul, South Korea, on March 10, 1989. *See* Brady, *Remarks to a Third World Debt Conference*, DEP'T OF STATE BULL., May 1989, at 53-56.

13. Calverley & Iversen, *supra* note 11, at 133.

14. *See* Lee C. Buchheit, *The Background to Brady's Initiative*, INT'L FIN. L. REV., April 29, 1990, at 30; Leslie Fraust, *Debt Plan Spurs Interest in Securitizing LDC Loans*, AM. BANKER, Mar. 28, 1989, at 55.

15. Fraust, *supra* note 14, at 55.

relief were to be heeded.[16]

The Brady proposal dealt only with debt to commercial banks.[17] As such, it offered little to African debtor nations as their principal indebtedness was, and is, to official agencies, development banks, and other governments.[18]

As usual in these matters, Mexico was in the vanguard. Mexico's strategic importance to the United States was seen as likely to result in the most favorable precedent for other debtor nations and, in 1989, Mexico was in relatively good economic shape.[19] Negotiations began in earnest between Mexico and its commercial bank creditors in May 1989. An agreement in principle was announced on July 23, 1989.[20] The terms sheet was settled and distributed to banks in September 1989,[21] the debt reduction package was signed in February 1990,[22] and the bonds issued in late March 1990.[23] It was a slow process dragging hundreds of banks to the table when most were resisting strenuously. Mexico's Brady scheme represented a significant departure from Secretary Brady's proposals as it was a one-off scheme in which creditor participation was effectively compulsory. The U.S.

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16. MacMillan, *supra* note 7, at 313-14.

17. Missing from the Brady proposal, to the chagrin of many commercial bankers, was any call for debt forgiveness by the official lenders. Many commercial bankers felt it was unfair to be asked to carry the burden of debt forgiveness alone, when official lending accounted for around 40% of total LDC loans. *See* Calverley & Iversen, *supra* note 11, at 133. In 1990, these criticisms were met to a very limited extent when the association of official lenders, the Paris Club, permitted debt relief in the form of principal or interest rate reductions or very long maturities in the restructuring of the official indebtedness of severely-indebted low income countries. These were principally African nations. Bolivia was the only Latin American nation to be granted such relief. *See World Bank Report*, 24 LATINFINANCE 12-14 (1991).

18. *Africa's Unpayable Debts*, ECONOMIST, Nov. 2, 1991, at 18. *See generally* GREENE, INTERNATIONAL ECONOMICS AND FINANCIAL MARKETS - THE AMEX BANK REVIEW PRIZE ESSAYS 103 (1989)(discussing debt crisis in Africa in 1980s).

19. *See* Cohen, *Give Me Equity or Give Me Debt: Avoiding a Latin American Debt Revolution*, 10 U. PA. J. INT'L. BUS. L. 89, 92 (1988)(discussing U.S. interests in Latin American political stability and economic health).

20. *The Debt Agreement*, MEXICO SERVICE, July 27, 1989. The resolution of the fine details was very time consuming. *See* Bruce Wolfson, *Paving the Paper Trail*, 26 LATINFINANCE 49 (1991); *At Last?*, ECONOMIST, Jan. 13, 1990, at 94; JONATHON HAY & NIRMALJIT PAUL, REGULATION AND TAXATION OF COMMERCIAL BANKS DURING THE INTERNATIONAL DEBT CRISIS 3 (1991).

21. *Hurricane Heading for Brady Plan*, 794 INT'L FIN. REV., Sept. 23, 1989, at 12; *Mexico Terms Are Out*, 794 INT'L FIN. REV., Sept. 23, 1989, at 24.

22. *Mexico Signs Debt Reduction Package*, 813 INT'L FIN. REV., Feb. 10, 1990, at 32.

23. *LDC Finance - Mexico*, 820 INT'L FIN. REV., Mar. 31, 1990, at 35; *see* Wolfson, *supra* note 20, at 49; *At Last?*, *supra* note 20, at 94; HAY & PAUL, *supra* note 20, at 3.

Treasury swiftly accepted the virtues of necessity and embraced the bonds as a product of the Brady proposals.[24] Many banks were reportedly "disgusted" with the deal but in the end had to go along with it.[25] The die had been cast for future Brady style restructurings. The banks were offered a choice from the following three options for their Mexican loans.[26]

> 1. The banks could have their loans converted into newly issued 30-year bonds paying Libor plus 13/16 percent. The principal of these bonds would be discounted thirty-five percent from the loans. Repayment of principal would be guaranteed by zero coupon bonds issued for the purpose by the U.S. Treasury, acquired by Mexico, and held in escrow. In addition, there would be a rolling guarantee of eighteen months interest.[27]
> 2. The banks could have their loans converted into "par bonds" — bonds with the same face value as the loans which paid interest at the discounted, fixed rate of 6.25%.[28] The term and collateral for these bonds were as for the discounted principal bonds considered above.[29]
> 3. The banks could elect to participate in new loans to Mexico in the coming four years to the extent of twenty-five percent of their medium and long-term exposure to Mexico.[30]

The new money option contained a paradox. It was crucial

24. Buchheit, *supra* note 14, at 29.

25. *Hurricane Heading for Brady Plan*, *supra* note 21, at 12; *Commercial Bankers Say Brady Plan is a Non-Starter*, 795 INT'L FIN. REV., Sept. 30, 1989, at 8.

26. As the restructuring would result in bonds being issued in the United States, the Securities Act of 1933 would on its face apply. To avoid the complexity and expense of complying with its strictures, counsel for Mexico obtained a no-action letter from the Securities and Exchange Commission which provided, in effect, an exemption from registration under the Act for the issuance of the bonds and defined the terms upon which subsequent sales of the bonds could be made in the United States. *See* Letter of March 23, 1990, from Cleary Gottlieb Steen & Hamilton on behalf of Mexico and Shearman & Sterling on behalf of the bank advisory committee for Mexico and SEC reply of March 28, 1990 (1990 SEC No-Act. LEXIS 572).

27. *The Debt Agreement*, *supra* note 20; Alberto Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. Rev. 66, 79 (1991). This provision and the longer term are the only differences from the Aztec bonds of 1988 — the provenance of this proposal is clear.

28. At the time of Mexico's restructuring agreement, July 1989, LIBOR was 8.81%. The usual interest rate on Mexico's debt was LIBOR plus 13/16th. The par bonds at 6.25%, fixed, thus represented an interest saving of nearly 3.4%. By way of comparison, 30-year U.S. Treasury bonds were yielding 8.14%.

29. *The Debt Agreement*, *supra* note 20; Santos, *supra* note 27, at 79.

30. *The Debt Agreement*, *supra* note 20; Santos, *supra* note 27, at 79.

that sufficient banks opt for new money as it was required to assist with the payment of interest on the above bonds and for the continued economic growth of Mexico.[31] However, the extension of new money eroded the debt-reduction effect of the proposal. If too many banks opted for new money, moreover, there may have been a net increase in Mexico's indebtedness.[32]

This approach of offering the banks a range of restructuring options was known as the "menu" approach.[33] It allowed banks to choose the option most suited to their view on interest rates and debtor prospects and their individual tax, regulatory, and accounting situation.[34]

The prospects of the Brady proposal were greatly enhanced by a letter of July 14, 1989, from the Securities and Exchange Commission ("SEC") to David Mulford, Under Secretary of the Treasury.[35] The letter "clarified" the application to the Mexican Brady restructuring of Financial Accounting Standards No. 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings" ("FAS 15").[36] The relevant part of FAS 15 provides that if, in full settlement of a debt, a creditor receives assets of which the fair value is less than the recorded value of the debt, then the creditor must record the shortfall as a loss. If an active market exists, fair value is market value. In the absence of such a market, fair value is to be estimated based on expected cash flows discounted for risk.[37]

David Mulford is commonly regarded as the Washington architect of the Brady Plan and he had requested, and doubtless shaped, the letter of July 14, 1989, from the SEC. In the name of applying FAS 15 to Mexico's restructuring, the SEC wrote that a loss need not be recognized if "the total future undiscounted

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31. In addition, depending upon the proportions of discount and par bonds chosen, the new money may have been required to assist with the acquisition of collateral for those bonds.

32. Because loans are usually required to fund the acquisition of collateral, the issuance of par bonds usually results in an increase in the total stock of debt, albeit at lower rates of interest. *See* John Clark, *Debt Reduction and Market Reentry under the Brady Plan*, 18 FED. RESERVE BANK-NY, QUARTERLY REV. 38, 47 (1993-94).

33. *See* Statement of Professor Pereira, *supra* note 9, at 336-37; Buchheit, *supra* note 14, at 30.

34. *See* Clark, *supra* note 32, at 44-45.

35. *See* HAY & PAUL, *supra* note 20, at 126.

36. *Id.* at 159-60.

37. *Id.* at 159.

cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, equal or exceed the book value of the loan."[38] This letter is a remarkable document.[39] Upon this criteria, the banks could accept Mexico's Brady Bonds in exchange for their loans without having to recognize a loss.[40] This would be true notwithstanding that shortly after issue the par bonds would trade at forty-two percent of face value and the discount bonds at sixty-three percent.[41] The analysis in this SEC letter represents the apotheosis of the popular debt crisis game of images and mirrors by treating interest as principal and making the value of money in thirty years equal to its value today. By ensuring that Brady bonds could be accepted by banks without provisions or writedowns,[42] the SEC made the Mexican restructuring far more palatable for U.S. banks.[43] It is a pity that this end could not have been achieved without defining black as white. The turning of water into wine should perhaps be reserved for higher authorities than the SEC.

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38. *See* HAY & PAUL, *supra* note 20, at 128 (reproducing SEC letter and attachment); *see also* Manuel Monteagudo, *The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective*, 28 INT'L LAW. 59, 74 (1994).

39. Upon its manifestly clear meaning, FAS 15 does not mean to exclude the time value of money from the calculations nor to treat interest as principal. Compare the approach of the Bank of England: discount bonds were to be placed on bank books at their face value of 65% with the loss of 35% to be charged to provisions. Par bonds, on the other hand, could be recorded at face value provided the current provisions against Mexican debt were otherwise adequate. *See* HAY & PAUL, *supra* note 20, at 43. Given that discount and par bonds were designed to be of equal value and were treated by the international banks as such, this approach, which lays great weight on the face value of the bond and ignores the interest rate, is quite artificial, although not nearly as artificial as the SEC's approach.

40. Monteagudo, *supra* note 38, at 75. The SEC was careful to point out that its analysis of FAS 15 did not derogate from the general requirements of FAS 5 that loan losses must be recognised when a loan (or bond) is determined to be uncollectible in whole or part. *See* HAY & PAUL, *supra* note 20, at 129.

41. *Indicative Prices for Developing Country Debt*, 823 INT'L FIN. REV., Apr. 21, 1990, at 29.

42. "Banks were able to account for both the par and discount bonds issued in Mexico's 1990 debt exchange without recognizing a restructuring loss." *See Guideline: Exposure to Designated Countries*, *reproduced in* HAY & PAUL, *supra* note 20, at 114-15.

43. *See* HAY & PAUL, *supra* note 20, at 29. While the exchange of loans for Brady bonds did not lead to writedowns for accounting purposes, an Internal Revenue Service Ruling provided that such exchanges may lead to losses for income taxation purposes. *See* Internal Revenue Service Advance Revenue Ruling 89-122, on Determination of Amount and Recognition of Gain or Loss, Issued Nov. 3, 1989 (26 CFR 1.1001-1) *reproduced in* HAY & PAUL, *supra* note 20, at 141. Hence, there is the bizarre possibility that banks recorded a loss from participating in a Brady bond exchange which reduced their overall tax liability without providing for reserves on account of the transaction.

This restructuring was of all of Mexico's medium and long-term debt to the commercial banks.[44] A great deal of arm-twisting by regulators was required to secure the participation of all banks.[45] Many were reluctant to participate but bankers usually find overt pressure from their home regulators difficult to resist. Of the indebtedness, forty-one percent was converted into discounted principal bonds, forty-nine percent into discounted interest ('par') bonds, and the banks holding the remaining ten percent agreed to advance new money.[46] Of the three options, new money was to prove by far the most lucrative and Citibank's foresight in taking that option exclusively was richly rewarded.[47] Yet, in 1990, substantial pressure was needed to make banks holding the required ten percent of exposure agree to advance new money.[48]

These overall figures mask major differences between the banks of different countries that serve to highlight just how much "international banks" remain influenced by the nations of their birth.[49] The following table shows the total percentage of debt exchanged for par or discount bonds or left in place by banks from different countries:

Bank Choices in the Mexican Restructuring[50]

Country	Par Bond	Discount Bond	New Money
France	79%	9%	12%
United States	58%	24%	19%
Japan	18%	81%	0%
Canada	48%	52%	0%
Germany	80%	20%	0%
United Kingdom	48%	45%	6%

As the table demonstrates, there were dramatic differences between the choices of banks from different countries. For instance, Japanese banks chose to take roughly eighty percent of

44. Some US$54 billion of medium and long-term Mexican debt was restructured. *See* Santos, *supra* note 27, at 79.

45. Interview with Professor Riordan Roette of Johns Hopkins University in Washington D.C. (April 29, 1993).

46. Testimony of William R Rhodes, Federal News Service, March 21, 1990.

47. Interview with Michael Pettis, now a Managing Director of Bear Stearns & Co., New York (Feb. 20, 1996)[hereinafter Pettis Interview II].

48. *Id.*

49. *See generally* WELLONS, PASSING THE BUCK - BANKS, GOVERNMENTS AND THIRD WORLD DEBT (1987).

50. *See* HAY & PAUL, *supra* note 20, at 10.

their loans as discount bonds and the rest as par bonds and the German banks chose to take eighty percent of their loans as par bonds with the rest as discount bonds. Perhaps the principal reason for these differences is the variations in the regulatory and taxation regimes of countries.[51]

The terms of the bonds differed from the loans in a number of respects. The bonds were negotiable instruments designed to be traded and the sharing clause and mandatory prepayments clause typical of syndicated bank loans were absent.[52]

The acquisition of the collateral for these bonds — the zero coupon bonds and the rolling interest guarantee — was funded as follows: US$1.3 billion from Mexico, US$2 billion from Japan, and US$3.7 billion from the International Monetary Fund ("IMF") and the World Bank.[53] In committing World Bank and IMF funds to this purpose, the United States was, for the first time, putting taxpayers' funds into the resolution of the debt crisis — a politically courageous act within domestic U.S. politics.[54] Nevertheless, the plan has been severely criticized for affording inadequate debt relief,[55] criticisms with which this author agrees.

51. *Id.* at 9-10.

52. Carsten Ebenroth & Rudiger Woggon, *The Development of the Equal Treatment Principle in the International Debt Crisis*, 12 MICH. J. INT'L. L. 690, 717-19 (1991). Furthermore, there were some other less than usual provisions of this restructuring: (i) the Mexican government agreed to permit US$1 billion of debt-equity conversions per annum for the next three years; and (ii) debt payments would be increased on discounted principal and par bonds if after July 1996 Mexico's earnings from oil exports exceed 1989 levels in real terms or if the real price for Mexican oil after 1996 exceeds US$14 per barrel. These potential increases in debt payments were both capped and counterbalanced in a complex scheme. The increase in repayments due to improved oil exports is limited to 30 percent and interest rates on the par bonds are capped at 9.25%. Furthermore, if oil prices fall below US$10 per barrel during the life of the agreement the banks can be required to advance further new funds of up to US$800 million. *The Debt Agreement*, *supra* note 20.

53. *See The Debt Agreement*, *supra* note 20. Depending upon the proportion of banks taking up the various options, further funds for acquisition of collateral would have had to come from funds advanced under the new money option. *See id.*

54. The U.S. Treasury issued the zero coupon bonds which Mexico acquired to collateralize the principal payments on the Brady bonds. The extent to which the whole Brady Plan was highly controversial within the United States is reflected in the debate that raged for months over whether these zero coupon bonds had been sold to Mexico at arm's length or whether Mexico had received a subsidy of up to US$192 million. *See Mexico's Zeros Revisited*, 840 INT'L FIN. REV., Aug. 18, 1990, at 21; *Some Mathematics*, 840 INT'L FIN. REV., Aug. 18, 1990, at 22.

55. Santos has described the Plan as "irreparably flawed" for this and other reasons. *See* Santos, *supra* note 27, at 79-80; *Of Banks, Borrowers and Brady*, ECONOMIST, Apr. 29, 1989, at 13 (stating that "[c]ommercial banks must be encouraged to take the pain

This Mexican restructuring was perceived to be a crucial first test of the Brady initiative. Secretary Brady's proposals were generally treated in the press as entirely novel and without precedent, but the idea had been considered for quite some time.[56] Indeed, the genesis of Brady's proposal was in Latin America not Washington: in the Aztec bonds, developed at Mexico's request, in 1988, and in even earlier proposals by Brazil to convert its foreign debt into 35-year bearer bonds with the same face value as the loans and below market fixed interest rates.[57] The agenda for this restructuring was "established not in Washington, but in Mexico City."[58]

A crucial element of the Mexican debt negotiation strategy was the insistence on debt reduction and interest relief. The secondary market played a major rôle in making these policies acceptable. "The fact that LDC debt routinely traded at large discounts to par value on the secondary market gave Mexico a fundamental basis to argue that banks were already assuming an eventual writedown on the debt—and thus that Mexico should be allowed to capture part of the discount."[59]

The actual savings to Mexico from its Brady restructuring are difficult to assess. Different analysts produce very different assessments of the savings.[60] At the wildly optimistic end of the

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of reducing third-world debt. They can afford it."). *But see Brady's Bazaar*, ECONOMIST, May 12, 1990, at 81 (stating that "the bosses of most of America's big money-centre banks bristle with rage at any mention of the Brady plan. They fume at the write-offs they have had to make on their developing-country debt portfolios . . . ."); *Schulman Speaks Out*, LDC DEBT REPORT, Sept. 21, 1992, at 4.

56. *See Third World Debt — Watch Out Securitisation is On Its Way*, 703 INT'L FIN. REV., Dec. 12, 1987, at 3876 (reporting that Emilio Lamar, managing director of Merrill Lynch's International Exposure Management Group, predicted exchange of debt for bonds during 1988); *see also Brazil — Time to Securitise Its Debt*, 663 INT'L FIN. REV., Mar. 7, 1987, at 763; *LDC Debt Securitisation*, 723 INT'L FIN. REV., May 7, 1988, at 1444.

57. *LDC Debt — The Deep Discount Bushfire*, 690 INT'L FIN. REV., Sept. 12, 1987, at 2947. Note, with the exception of collateral, how closely these bonds proposed by Brazil resemble the par bonds ultimately issued nearly three years later in Mexico's Brady style restructuring. *See* Statement of Professor Pereira, *supra* note 9, at 336-37.

58. *The Debt Agreement*, *supra* note 20, at 6. The receptive ear in Washington necessary for Mexico's ideas to gain credence was that of David Mulford, then Assistant Secretary of the Treasury. To his credit, Mulford ran with Mexico's ideas and when Nicholas Brady became Treasury Secretary, Mulford had a superior who too was willing to listen. Mossberg & Truell, *supra* note 3.

59. *The Debt Agreement*, *supra* note 20, at 6.

60. The game of images and mirrors may well have been the creation of Herman Hesse, so enduring is its attraction, and so seductive its appeal, for academics, bankers,

range,[61] Clark calculated savings of US$21.1 billion in claims payable to banks by Mexico, which represents some 43.5% of the loans eligible for restructuring.[62] At the other end of the spectrum, some researchers claim Mexico's Brady restructuring left its total indebtedness unchanged:[63] the debt relief afforded by the discount bonds was offset by the new money advanced.[64]

These disparate views can be reconciled. Clark's footnotes reveal that his figure for reduction in claims payable does not include the new money that was central to the restructuring and that must be included in any analysis of its overall effect.[65] Furthermore, about sixty percent of this saving comes through lower interest payments on the par bonds calculated at the floating rates prevailing at the time of the restructuring. Floating rates declined, however, after the restructuring and at the end of this period interest on Mexico's debt[66] was about the same as if the restructurings had not occurred,[67] i.e. declines in floating interest rates had offset the interest rate savings from the fixed interest par bonds.

The Brady restructuring did benefit Mexico in one way: the nation is now more protected against interest rate rises.[68] It also corrected the major anomaly of the 1970s lending boom—the form of credits as loans rather than bonds.

The Brady restructuring failed, however, to help Mexico at all on one important measure. Mexico's net annual transfer to the banks before the restructuring was US$3.24 billion. After

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commentators and debtors. *See generally* HERMAN HESSE, THE GLASS BEAD GAME — MAGISTER LUDI (1990).

61. Clark's calculations were described by Pettis as "totally absurd." Pettis Interview II, *supra* note 47.

62. Clark, *supra* note 32, at 38 & 46.

63. Although the total outstanding debt was not reduced, the interest burden was lessened due to the reduced fixed interest rates on the par bonds.

64. Monteagudo, *supra* note 38, at 80.

65. It is unclear if Clark's figures include the other loans undertaken to fund acquisition of the collateral for the bonds.

66. Interest on Venezuela's debt similarly was the same as if the restructurings had not occurred.

67. Clark, *supra* note 32, at 49.

68. In this regard, the restructuring corrected one of the real anomalies of the lending boom of the 1970s—the preponderance of floating interest rates. *See* Peider Konz, *The Third World Debt Crisis*, 12 HASTINGS INT'L & COMPAR. L. REV. 527, 528 (1989). Floating rates left the debtor nations horribly exposed to precisely the sort of interest rate fluctuations that the late 1970s and early 1980s brought. Ironically, interest rates were to fall and remain low for the seven years after Mexico's Brady restructuring.

the restructuring it was US$3.59 billion.[69] This is because before Brady, most of the interest payments were funded by new money. Once again, however, figures do not tell the full story. The Brady process served an important function in breaking the upward spiral of total indebtedness and in reducing the demands on the scarce time of government ministers and civil servants that arose from the periodic restructurings of the 1980s. In Clark's words,

> The Brady restructurings did not achieve significantly more near-term cash flow relief for debtors than the previous approach. But they did provide a more stable long-run financial framework that, in combination with structural reforms by debtors and a favorable environment of lower global interest rates, helped to restore market access.[70]

Shortly after the Mexican restructuring, the commercial banks negotiated agreements with the Philippines, Costa Rica,[71] Venezuela, and Morocco in that order.[72]

At the time, the Filipino restructuring was referred to as a Brady scheme.[73] It was not a classic Brady style restructuring, however, as discount and par bonds were absent.[74] Banks were offered the choice between advancing new money or selling their current exposure back to the Philippines at around fifty cents on the dollar.[75] This restructuring resulted in a reduction of almost thirteen percent of the Philippines external bank debt.[76] The Philippines government had indicated that over the following year or two there would be additional debt reduction initiatives, such as par bonds, in a series of voluntary, market based transactions[77]— true to the original spirit of Treasury Secretary Brady's proposals. When these further debt reduction ini-

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69. Clark, *supra* note 32, at 47-48.

70. *Id.* at 62.

71. *See Debt Buyback Takes Center Stage in Costa Rican Agreement,* XIII Bank Letter, Oct. 30, 1990, at 2 (discussing Costa Rica's restructuring); HAY & PAUL, *supra* note 20, at 5-6.

72. *See* Suk Hun Lee & Hyun Mo Sung, *The Reactions of Secondary Market Prices of Developing Country Syndicated Loans to the Brady Plan,* a paper dated Jan. 15, 1993, Appendix at 19 (copy on file with the *Fordham International Law Journal*).

73. *See* HAY & PAUL, *supra* note 20, at 4-5.

74. Buchheit, *supra* note 14, at 29, 31.

75. *Id.*

76. INTERNATIONAL MONETARY FUND, ANNUAL REPORT 1990, at 28-32.

77. Buchheit, *supra* note 14, at 29, 31.

tiatives were implemented, however, they were in the form of a classic, Mexican-style, one-off Brady scheme.[78] The menu offered to banks included collateralized twenty-five-year interest reduction registered bonds,[79] fifteen-year interest reduction bearer bonds with less collateral,[80] or new money.[81] After the 1990 restructuring the Philippines had US$5.3 billion of bank debt. The second restructuring in early 1992 reduced this by a further US$1.5 billion.[82]

The original proposals of Secretary Brady had emphasised that debt relief and restructuring would be voluntary and Mexico's restructuring was religiously referred to by all involved as a voluntary exercise.[83] The first Filipino restructuring incorporated relatively less debt relief and more new money than Mexico's.[84] The response to it was illuminating as "bankers eagerly noted that the Philippine agreement is more 'voluntary' than the Mexico settlement."[85] Its other interesting aspect was that the Philippines was permitted to repurchase about US$1.3 bil-

78. The Philippines and its commercial bank creditors agreed to a Brady style debt reduction agreement in late August, 1991. *See Philippine Brady Plan*, 894 INT'L FIN. REV., Sept. 7, 1991, at 20. The agreement was not finalized with the endorsement of the IMF, World Bank, and the Japan Export-Import Bank (each of which was providing support with the acquisition of the collateral) until April, 1992. The delays involved the non-renewal of the leases on the U.S. military bases in the Philippines. This later restructuring was presented as if it were the Philippine's first Brady restructuring. *See* JOYCE CHANG, ET AL., REPUBLIC OF THE PHILIPPINES - CONSOLIDATING ECONOMIC REFORMS 6-7 (1992) (Salomon Brothers) (copy on file with the *Fordham International Law Journal*). This would have surprised those engaged in the 1989 exercise, but was tenable because the 1989 restructuring was such an atypical Brady restructure.

79. The 25-year bonds had full collateral for principal and a rolling guarantee of 14 months interest and a fixed coupon of 4.25% in year one, rising progressively to 6.5% in year 6 and thereafter. *See* CHANG, ET AL., *supra* note 78, at 6; *Philippine Brady Plan, supra* note 78, at 20; *Philippines Concludes Debt Reduction Accord,* 917 INT'L FIN. REV., Feb. 22, 1992, at 27.

80. The 15-year bonds had a rolling guarantee of 12 months interest for the first six years and fixed rates commencing at 4% in year one rising to 6% in year six and the floating rate of Libor plus 13/16th % for years 7 to 15. Principal was not collateralized.

81. The new money option was to advance new money equal to 25% of a bank's exposure. The new money would be in the form of 17-year bonds bearing interest of Libor plus 13/16%. These bonds are eligible for conversion into equity.

82. CHANG, ET AL., *supra* note 78, at 6.

83. Masuda, *Mexico's Debt Reduction Agreement and the New Debt Strategy,* 11 EXIM REVIEW 26, 30 (1991).

84. Peter Truell, *Philippine Accord On Debt Reflects U.S. Strategy Shift,* WALL ST. J., Aug. 17, 1989.

85. This response involved the game of images and mirrors again. *See* HAY & PAUL, *supra* note 20, at 5 (stating "[t]his [Philippine] agreement was more voluntary than the Mexican one.").

lion of its debt for roughly the debt's secondary market price.[86] As Peter Truell wrote, the "Philippine offer thus represents something of an endorsement of the secondary market's valuation of the Third World bank debt".[87]

Venezuela received the next Brady-style restructuring because their economic program met with U.S. approval.[88] Argentina and Brazil would have to adapt their domestic economic policies further towards the model of the Washington technocrats before either would be granted a Brady style restructuring.[89]

Venezuela's 'Brady' rescheduling was announced on June 25, 1990.[90] The menu included the following five options:[91]

1. The exchange of loans for thirty-year collateralized principal discount bonds paying Libor plus 13/16%.[92]
2. The exchange of loans for thirty-year collateralized par bonds paying a fixed rate of 6.75%.[93]
3. The acquisition of new money bonds equal to 20% of a bank's loans[94] and conversion of those loans into debt-

86. *See A Taxing Burden of Debt*, ECONOMIST, Sept. 8, 1990, at 101 (analyzing debt buy-backs as often not being in debtor's best interests).

87. Peter Truell, *Philippines Offers $650 Million to Buy Debt of $1.3 Billion*, WALL ST. J., Oct. 12, 1989.

88. In the words of Barber Conable, President of the World Bank, "it's absolutely essential to differentiate between debtors in terms of support." Mossberg & Truell, *supra* note 3. The President of the World Bank is here emphasizing that support in the form of debt relief must be reserved, and used as a reward, for those debtor countries which toe the official line on economic policy.

89. Mossberg & Truell, *supra* note 3. At this time both Argentina and Brazil were substantially in arrears on their interest payments. Peter Truell, *Bolivia and Brazil Reach Accord on Plan to Cut $300 Million of Each Other's Debt*, WALL ST. J., May 11, 1990.

90. EVALUATING THE VENEZUELA 1990 FINANCING PLAN — CHOOSING AMONG THE FINANCING OPTIONS 5 (July 1990)(Salomon Brothers)[hereinafter THE VENEZUELA PLAN](copy on file with the *Fordham International Law Journal*). The bonds were not issued until December 18, 1990. *See* Vankudre, *Brady Bonds*, 26 LATINFINANCE 48, 53 (1991).

91. *See* HAY & PAUL, *supra* note 20, at 6; VENEZUELA PLAN, *supra* note 90, at 5-6; Peter Truell, *Venezuela Reaches Debt Settlement With Major Banks*,Wall St. J., June 29, 1990.

92. The discount bonds had a face value of 70% of the amount of a bank's loans. Principal was secured by zero coupon U.S. Treasury bonds and there was a 14 month rolling interest guarantee.

93. These par bonds had the same collateral as the discount bonds above. Both the par and discount bonds described above provided for higher interest rates after 6 years if oil prices exceeded US$26 per barrel.

94. That is, if a lender acquired new money bonds, its entire portfolio of loans would be converted into bonds eligible to be swapped into equity. 40% of these new money bonds pay interest at Libor plus 1%, the balance at Libor plus 7/8%.

conversion bonds eligible for conversion into equity.[95]

4. The exchange of loans for seventeen-year temporary interest reduction bonds.[96]
5. The sale, in effect, of loans to Venezuela for forty-five cents on the dollar[97] which was roughly the secondary market price[98] for Venezuelan debt at this time.[99]

As is readily apparent, Venezuela's rescheduling was broadly similar to Mexico's, one year earlier, with the addition of temporary interest reduction bonds and the option of selling loans back to Venezuela at the secondary market price.[100]

Nonetheless, the banks made very different choices in Venezuela's Brady scheme than in Mexico's.[101] Discounted principal bonds attracted only nine percent of debt (as opposed to forty-one percent for Mexico), par bonds thirty-four percent (forty-nine percent for Mexico), new money thirty-four percent (ten percent for Mexico), temporary interest reduction bonds eleven percent and, finally, the holders of nine percent of the debt sold

95. The debt-conversion bonds have a 17-year term and a coupon of Libor plus 7/8%. Both the new money and debt-conversion bonds are bearer bonds, as opposed to the discount and par bonds which are registered. *See* JOHN PURCELL, ET AL., DEVELOPING COUNTRY SOVEREIGN BONDS: RECENT DEVELOPMENTS IN A NEW ASSET CLASS 1-2 (September 1991)(Salomon Brothers)(on file with the *Fordham International Law Journal*). Bearer bonds are more attractive for some investors and are generally considered more difficult to restructure. For this reason rating agencies subsequently rated bearer Brady bonds at times more highly than registered Brady bonds.

96. The temporary interest reduction bonds paid interest at 5% for two years, 6% for two years, 7% for one year then Libor plus 7/8% thereafter. These bonds carried a rolling interest guarantee for the first five years.

97. This sale of loans was effected by the exchange of loans for a short-term, fully-collateralized, 91-day note equal to 45% of the amount of a bank's loans. This global note was collateralized by U.S. Treasury bills and was simply a different way of structuring a buy-back option. There was, for obvious reasons, a cap on the amount of loans which could be tendered under this option, which was set at US$5.5 billion, face value, of loans.

98. *Venezuela Reaches Debt Settlement With Major Banks*, *supra* note 91.

99. Accordingly, this buy-back price (which was accepted by holders of 9% of Venezuela's debt) represents a confirmation of the secondary market's valuation of this debt; as with the Philippines restructuring.

100. As was the case with Mexico, an effective exemption from the Securities Act was obtained for this issuance of bonds in the U.S. *See* Letter of Oct. 17, 1990, from Arnold & Porter for Venezuela and Milbank Tweed Hadley & McCoy for the bank advisory committee for Venezuela to the SEC and the SEC reply of Oct. 17, 1990 (1990 SEC No-Act. LEXIS 1193).

101. *See generally* Calderon & McCarthy, *New Money for Old*, 20 LATINFINANCE 73 (1990).

it back to Venezuela.[102] As with Mexico's restructuring, the new money option was to prove the most financially attractive, and with the Mexican experience behind them, far more banks took the risk and chose that option.

Subsequently, a Brady-style agreement was negotiated with Uruguay which involved a buy-back of much of Uruguay's debt.[103] Chile's debt was also restructured but due to its relatively robust economic health, no discount or par bonds were involved. Chile's restructuring was conventional and involved new money plus the right for debt buy-backs and debt-equity conversions.[104] The assistance of a Brady-style restructuring was not required.

Brazil's Brady scheme had a long and checkered history as the nation's economic policies and performance failed to satisfy the Washington-based decisionmakers at the IMF, World Bank, and U.S. Treasury. In August 1991, Brazil proposed a menu of options which included 30-year collateralized par bonds,[105] thirty-year collateralized discount bonds,[106] two types of temporary interest reduction bonds,[107] and a new money option.[108]

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102. McCarthy, *After Brady: the Debt Dust Settles*, 24 LATINFINANCE 30 (1991); *Venezuela Signs Final Portion*, 856 INT'L FIN. REV., Dec. 8, 1990, at 28. The principal participants in the buyback option were Japanese banks and market traders. McCarthy, *supra* at 30.

103. Uruguay's Brady restructuring options were agreed to by the banks in October 1990. Banks were offered a simplified choice of 30-year par bonds with a 6.75% coupon and the usual collateral, new money equal to 20% of current loans with the current loans rendered eligible for conversion into equity, or a debt buyback option at 56 cents on the dollar. *See Uruguay's Turn*, 22 LATINFINANCE 12 (1990); HAY & PAUL, *supra* note 20, at 7. In December, 1990, banks chose to convert 33% of Uruguay's US$1.64 billion of medium and long-term debt into par bonds, sell 39% back to Uruguay at 56 cents on the dollar, and advance new money loans with respect to the balance of 28% of the nation's debt. *See Secondary Marketplace*, 24 LATINFINANCE 14 (1991); *Uruguay to Pay 56 Cents for Debt*, 852 INT'L FIN. REV., Nov. 10, 1990, at 29.

104. *A Curiously Insubstantial Treasury*, ECONOMIST, Sept. 22, 1990, at 91; Murphy, *Moving Up*, 25 LATINFINANCE 55, 62 (1991); John Clark, *The Structure, Growth and Recent Performance of the Latin American Bond Market*, Federal Reserve Bank of New York Research Paper # 9416, Oct. 1994 at n.4.

105. The proposal was for the par bonds to bear a coupon of 4.8% and carry a guarantee of principal but no rolling interest guarantee, which had been the most difficult aspect of the earlier Brady bonds to price.

106. The discount bonds were to be for 62.5% of the face value of the loans.

107. The temporary interest reduction bonds were to carry reduced fixed interest rates for the first six years and, in one case, a fixed rate of 8% for the balance of the total term of 25 years, and in the other case an interest rate of Libor plus 13/16% for the balance of the total term of 15 years.

108. The new money option was for a bank to advance new money to the extent of

The announcement of the agreed terms of Brazil's restructuring was eagerly anticipated from August to October 1991. Most market participants thought, wrongly as it transpired, that the terms of the scheme would be agreed in this period.

2. Further Loan Loss Provisions

In late 1989, another round of provisioning began among U.S. banks partly in response to continuing declines in secondary market prices and partly to strengthen the banks' position in ongoing rescheduling negotiations with major debtors. JP Morgan, Chase Manhattan, and Manufacturers Hanover all increased LDC loan reserves in the same week.[109] Morgan's move was the most newsworthy as it increased its reserves by US$2 billion to 100% of its exposure to the most heavily indebted nations.[110] As always after a major increase in reserves, prices dropped sharply as traders feared the extra supply of debt the banks could now afford to put onto the market.[111] Citicorp added US$1 billion to its provisions in the fourth quarter of 1989, but the leader in 1987 was now trailing the pack with reserves equal to only thirty-eight percent of its LDC debt.[112] Across the Atlantic the U.S. lead was followed by all four major British banks. By mid-1990 the loan loss reserves of the nine largest U.S. commercial banks and the four large U.K. clearing banks were on average about fifty percent of their LDC loans.[113] By year end, two of the four U.K. banks had further increased their reserves to sixty-five and eighty-five percent of their exposures.[114]

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25 percent of its current exposure. *See generally* Gosian, *Starting Point*, 30 LATINFINANCE 48 (1991); *LDC Finance — Brazil: A Long Way to Go*, 900 INT'L FIN. REV., Oct. 19, 1991.

109. Hubbard, *U.S. Bank Provisions Unsettle LDC Debt Market*, REUTERS, Sept. 25, 1989.

110. *Id.*; *Commercial Banks Raise Loan Loss Provisions*, 794 INT'L FIN. REV., Sept. 23, 1989, at 28. Among the regionals, Bank of Boston added US$370 million to loan loss reserves at a time when it was already 100% reserved against all non-trade LDC debts.

111. *Secondary Market Report*, 795 INT'L FIN. REV., Sept. 30, 1989, at 33.

112. Rea, *Citicorp 4th Qtr Operating Profits Poor — Analysts*, REUTERS, Jan. 16, 1990.

113. *See* Santos, *supra* note 27, at 83; Froman, *Still Exposed After All These Years*, 20 LATINFINANCE 57 (1990). The level of reserves in the United States ranged from Citicorp's at 31% through to JP Morgan's at 116%. All four British clearing banks had added to their reserves in mid-1990 to bring their provisions to around 50% of their LDC portfolios. *See UK Clearing Banks*, 786 INT'L FIN. REV., July 29, 1989, at 27.

114. *Market Slips Further as Year-End Selloff Continues*, XIII BANK LETTER, Nov. 13, 1995. In November 1989, NatWest increased its provisions to about 65% of its exposure and Lloyds increased its provisions to 85% of its exposure. *See UK Banks Set Up 1.8 bn pds Against LDC Debt*, 801 INT'L FIN. REV., Nov. 11, 1989, at 36; *At the Bank's Bidding?*,

3. Non-Payment of Interest by Brazil and Argentina

Sovereign debtors do not "default," at least not in polite company. Amongst bankers, borrowers, and financial journalists the D-word is scrupulously avoided and left only for the likes of the odd gauche academic.

Under most loan agreements, default is a technical state declared by the lender on the basis of the borrower's breach of a covenant. Default, in this sense, does not occur automatically upon the non-payment of interest or principal because lenders usually do not want such events to trigger cross-default clauses[115] in the debtor's other financial agreements.

In this technical sense only, Brazil was not in default on its loans in this period as its lenders were careful not to declare it in default. However, Brazil did not repay principal or interest on its commercial bank loans from July 1989 to April 1991.[116] In April, it agreed to pay one-quarter of its US$8 billion in interest arrears in 1991 and to capitalize the balance by converting it into ten-year bonds.[117] By mid-1990, Argentina owed US$6 billion in interest arrears[118] and was making nominal payments of US$40 million per month.[119] Argentina's non-payment galled bankers less than Brazil's. Argentina's foreign exchange reserves of around US$2 billion gave it little room to maneuver. However, Brazil's reserves of between US$8.5 billion and US$11 billion, were eyed avariciously by most bankers.[120]

4. Change in Role of IMF and World Bank

As we have seen, part of the impetus for the Brady Plan was the breakdown in creditor solidarity between the commercial banks.[121] Early 1990 witnessed another such breakdown but this time between official and commercial lenders. The IMF and World Bank cast aside part of their role as debt policemen and

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ECONOMIST, Feb. 3 1990, at 83. Standard Chartered and Barclays did not follow the lead this time.

115. Cross-default clauses provide that a default in any of a borrower's other financial agreements will constitute a default under this agreement.

116. *See Catching Up*, ECONOMIST, April 13, 1991, at 85.

117. *Id.*

118. Argentina's arrears were on a much smaller total indebtedness than Brazil's.

119. Fraga, *Banks in Informational Session*, 838 INT'L FIN. REV., Aug. 4, 1990, at 28.

120. *Brazil's Debt Proposals: 'Ludicrous'*, 849 INT'L FIN. REV., Oct. 20, 1990, at 27.

121. Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships* U. ILL. L. REV. 493 (1988).

began, on a selective basis,[122] to advance funds to nations before they had reached a deal with their commercial banks and notwithstanding that the nation was in arrears on payments to those banks.[123] The non-payment of interest by two of the largest debtors, the increasing informal repurchase of debt in the secondary market by Brazilian state-owned companies, and this breakdown in creditor support by the official agencies all meant that 1990 was a particularly galling year for many bankers.

5. Return of the Major Debtors to the Voluntary Capital Markets

One of the most extraordinary aspects of the entire history of the 1982 debt crisis was, to this author, the incredibly early return of the debtors to the voluntary capital markets.

Mexico was the first debtor to return. In 1989, Mexican companies issued some junk bonds with high yields.[124] These were primarily vehicles for the repatriation of flight capital.[125] During 1990, however, Mexican companies were able to return to the mainstream voluntary markets with various offerings including one for DM 100 million by Pemex, the state-owned oil company.[126]

By February 1991, Mexico was able to issue the first Eurobond in its own name since 1982. The issue was so well received that the offering was increased from DM 200 million to

122. The official lenders did not discard their policing role entirely. For instance, the letter of intent for a US$2 billion IMF loan to Brazil in September 1990 made the loan conditional on Brazil resuming interest payments to its commercial bank creditors. *Payments Unlikely This Year*, 844 INT'L FIN. REV., Sept. 15, 1990, at 25.

123. *Brazil Debt Downgrade on Hold*, 831 INT'L FIN. REV., June 16, 1990, at 26. For instance, the IMF resumed disbursements on a standby credit to Argentina in late 1990 when it was in arrears to its bank creditors and only making nominal debt service payments, and well before it reached a Brady style restructuring agreement. *Argentina Gets IMF Money: 25% Set Aside for Buybacks*, 855 INT'L FIN. REV., Dec. 1, 1990, at 29.

124. Zellner, *Mexico Gets Back to Bonds*, 18 LATINFINANCE 24 (1990). For instance, Cemex issued US$150 million of two-year notes in November 1989 which were priced to yield 16%. *See* Peagram, *Brave New World*, EUROMONEY, Mar. 1991, at 59.

125. W. A. Orme, Jr., *Behind the Bond Rush*, 20 LATINFINANCE 4 (1990).

126. In November 1990, Pemex issued US$100 million of bonds in a U.S. private placement and US$150 million of eurobonds at coupons of 11.46% and 11.75%, respectively. Steven Bavaria, *Mexico Comes Back to Market; The Miracle Recovery*, INVESTMENT DEALERS DIGEST, Dec. 10, 1990, at 20. Another early offering was of US$100 million by a Mexican sovereign development bank, BNCE. Pettis Interview II, *supra* note 47.

DM 300 million.[127]

In April 1990, Venezuela returned to the private capital markets with a US$40 million Eurobond offering by Sivensa, a private sector company.[128] Brazil's return was by a US$200 million Eurobond issue by Petrobras, the state oil company, on July 10, 1991.[129] On the back of strong demand the issue was increased to US$250 million.[130] This early return to the international capital markets was remarkable as it would be over two and a half years before Brazil's Brady style restructuring was finalized. Argentina's return was announced on August 14, 1991, by way of an issue of eurobonds.[131] The issue was initially of US$100 million but demand was so high it was increased to US$300 million; quite incredible given that at the time Argentina was over US$7 billion in arrears on interest payments and its loans traded at thirty-five to thirty-nine percent of face value on the secondary market.[132]

The maturity and coupons of these early bonds differed from the loans. The bonds, unlike the loans, were being serviced. Nonetheless, to pay three times as much for Argentine bonds as for Argentine loans strikes this writer as extreme. Can the perceived "seniority" of bonds[133] be the only reason?[134] Lee Buchheit put it best, when he penned this dialogue of humour and insight:

> [F]or the love of Mike . . . who would ever buy unsecured

127. Peagram, *supra* note 124, at 59. The Eurobond carried a coupon of 10.5% and was issued at slightly over par to yield 10.37%.

128. Pettis Interview II, *supra* note 47.

129. Tracy Corrigan, *Banks Seek More Profitable Debts*, FIN. TIMES, July 10, 1991, at 31. The eurobond carried a 10% coupon and was discounted upon issue to yield 13.5%.

130. Hubbard, *Argentina's Return to Bond Market May Win Applause*, REUTERS, Aug. 14, 1991. At the time of the Eurobond issue by Petrobras, oil prices were high and the bond was for a relatively short two years. Both of these factors increased its attractiveness.

131. The two-year bonds were issued by the Republic and priced 5 points over U.S. Treasury bonds. *Two Very Different Latin American Issues*, 895 INT'L FIN. REV., Sept. 14, 1991, at 22.

132. *LDC Secondary Market Debt Opening of NY Trading on 13/9/91*, 895 INT'L FIN. REV., Sept. 14, 1991, at 23.

133. *See supra* note 76 and accompanying text.

134. The perceived seniority of bonds was given as the rationale for ignoring the low prices of a nation's bank loans when buying its bonds. *See Brazil's Problems Give Investors Cold Feet*, 898 INT'L FIN. REV., Oct. 5, 1991, at 29.

> bonds from a country that hadn't even finished sticking its creditors with substantial losses?
>
> Well, in the beginning — say 1991-92 — we suspected the investors were mostly . . . well-heeled expats . . . . You know, flight capital returning at a 14 percent coupon, that sort of thing. By 1992 however everybody wanted to lead Eurobond issues . . . and plenty of folks wanted to buy them. It was just like the syndicated loan frenzy of the late 1970s.[135]

In 1991, Latin American borrowers raised US$7.6 billion in bonds and US$4.9 billion in equity in the international capital markets.[136] The debt was mostly Eurobonds, issued in bearer form, predominantly to investors from Latin America.[137] The Eurobonds were able to be issued because they: (i) tapped a different market — individuals repatriating flight capital or simply seeking a high risk, high return investment; (ii) appealed to this market because they were issued in small denominations, for short terms, and were bearer bonds and thus attractive for tax and other purposes; and (iii) enjoyed "de facto seniority over bank debt . . . due in part to the fact that . . . bonds compose a relatively small portion of a nation's total oustanding debt."[138]

The first truly voluntary unsecured sovereign bank loan to the region after 1982 was, understandably, small and to the best sovereign credit south of Texas. Chile borrowed US$20 million from NMB in September 1990.[139]

6. Securitization of Brady Bonds

"Securitization" generally means the replacement of loans with bonds. In this case, it was Brady bonds that were securitized. Is that not a little like baptising the local vicar? Surely it has already happened. Well, yes and no.[140] For an interesting

135. Lee C. Buchheit, *Deja Vu All Over Again*, INT'L FIN. L. REV., Jan. 1992, at 6.

136. Voorhees, *Hope Springs Eternal*, 34 LATINFINANCE 21 (1992).

137. Clark, *supra* note 104, at 18.

138. Estabanez, *The View From Moody's*, 22 LATINFINANCE 47 (1990).

139. *Latin America's Return: Chile Gets Loan From NMB*, 843 INT'L FIN. REV., Sept. 8, 1990, at 22.

140. It should be noted that while the transformation of loans into bonds pursuant to the Brady Plan is generally referred to as securitization,

> it has not contained the characteristics of securitised markets as these have unfolded in the developed world. Specifically, while certain LDC debt has been repackaged into a securitised form and credit enhanced at least in part . . . the process has not involved the degree of transformation associated with the securitisation of mortgages, or other assets, in which obligations from a

example of such a development, and of the lengths banks were prepared to go to make Brady bonds attractive to private and corporate investors, consider the September 1991 private placement by Citicorp of US$50 million of securities collateralized by Mexican Brady bonds. Citicorp structured the issue in two tranches. The senior tranche was rated AA and consisted of bonds with an eighteen month term priced to yield 7.85%. This tranche represented forty-one percent of the issue. The junior tranche, which represented the balance of the issue, was unrated and yielded thirteen percent.[141] Citicorp had collected all the collateral of a Brady bond in the one instrument—the interest on the senior tranche was guaranteed by the rolling interest guarantee and the principal repaid at the end of the eighteen month term by selling the stripped out zero coupon bond.[142] Accordingly, the senior tranche was an investment grade security. The junior tranche was uncollateralized Mexican indebtedness paying a substantial premium to regular Brady bonds in the marketplace. This bond could therefore trade on something the market readily understood, its high coupon, rather than the difficult-to-value partial collateral attached to Brady bonds.[143]

7. The Advent of LDC Derivatives

Derivatives were initially limited to put and call options.[144] Small numbers of these options were written throughout this period. In early 1991, the growing liquidity of the Brady bond market and the rally in Mexican par bonds led to a demand for options from investors seeking to lock in their gains.[145] The pri-

> large number of borrowers are pooled, placed in separate vehicles, credit enhanced and funded through the issuance of rated securities.

Graffam, *Introducing Securitisation to the Developing World* at 3 (paper on file with the *Fordham International Law Review*).

141. *Citicorp LDC Debt Issue First of Kind on Market*, 4 LDC DEBT REPORT, Sept. 2, 1991, at 1.

142. This was a way to strip out the collateral and realize a certain value for the rolling interest guarantee which was otherwise impossible to value accurately.

143. Bradies were then priced at about 60 cents on the dollar and yielded about 11%. *Citicorp LDC Debt Issue First of Kind on Market*, *supra* note 141, at 1.

144. An option confers the right (but not the duty) to buy or sell a security at a fixed price within a specified time limit. A put option gives the right to sell, a call option the right to buy. *See* Gurmendi, *Options in the LDC Debt Market*, 27 LATINFINANCE 39 (1991).

145. *New Wrinkle in LDC Debt Market: Options on Bonds, Loans*, XV BANK LETTER, Mar. 4, 1991, at 2; Gurmendi, *supra* note 144, at 40-41.

mary market in derivatives began to grow.[146] Initially, there was no secondary market in derivatives—all option contracts were non-assignable.[147] As well as being useful for securing profits made in the bull run of 1991, options facilitated debt-equity conversions and privatizations. Potential investors could buy call options on the debt which would be required if their bid was successful, thus insulating their proposed investment from price increases in the debt without having to outlay the capital and take the risks involved in acquiring the actual debt.[148]

This market was pioneered by Chase Manhattan and Banco Santander in 1990.[149] Banks engaged in issuing put and call options in 1991 included Bankers Trust, Chase, Chemical, First Boston, First Interstate, NMB, Nomura, Manufacturers Hanover, Morgan, Santander, and Swiss Bank.[150] The pricing of LDC debt options was as much art as science and prices varied significantly between traders.[151] The pricing of options on these assets, which were heavily affected by political and other developments in the debtor country, was not amenable to the usual precise option pricing/hedging models[152] and was not for the faint hearted.[153]

B. *Impetus for the Market*

The principal impetus for the market in this period was provided by debt buy-backs and privatization schemes. These and other factors will be considered.

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146. Voorhees, *Putting the Call Before the Horse?*, 31 LATINFINANCE 1 (1991). It was estimated that including options being rolled over, options were being written on US$100 million to US$200 million of assets every month around September 1991. *Id.; see* Gurmendi, *supra* note 144.

147. *Putting the Call Before the Horse?*, *supra* note 146, at 21 (quoting Kathy Galbraith).

148. Gurmendi, *supra* note 144, at 41.

149. *NMB Postbank - Leading the Field*, INT'L FIN. REV. REVIEW OF THE YEAR — 1990, at 81.

150. *Id.*

151. Voorhees, *Doses of Reality*, 40 LATINFINANCE 19, 32 (1992).

152. *Id.; see* Ephraim Clark, *Briefing*, EUROMONEY, Feb. 1991, at 73; Ephraim Clark, *Briefing*, EUROMONEY, April 1991, at 79.

153. *LDC Derivatives Gather Momentum*, 867 INT'L FIN. REV., Mar. 2, 1991, at 20. Another factor was that the background of LDC debt traders was in loans, not bonds, and so very few understood option pricing parameters. Many wrote options as a way of placing directional bets on future price movements.

1. Debt Buy-Backs

The major impetus for the market throughout this period were formal and informal debt buy-backs by debtor nations.[154] In formal schemes, the Philippines repurchased US$1.3 billion of debt in January 1990 for 50 cents on the dollar,[155] Chile repurchased some US$330 million of its commercial bank debt,[156] and Costa Rica bought US$990 million of its US$1.5 billion of debt for sixteen cents on the dollar.[157] Furthermore, formal buy-back schemes were dwarfed in size by informal arrangements which promoted much activity in the secondary market.

The precise extent of the informal debt buy-backs will never be known. In 1989 and early 1990, Brazil reportedly encouraged state-owned companies to buy rescheduled Brazilian government loans in the secondary market and use it to pay their maturing local currency debt to the state[158] at a time when the loans traded between twenty-seven and thirty-one cents on the dollar.[159] *The Economist* estimated that in 1989 alone LDCs purchased some US$30 billion of their own debt informally through the secondary market.[160] A large sovereign debtor re-

154. Michael Pettis lists three principal sources of net demand in the market in this period: buy-backs, bicicletas and debt-equity swaps. *See* Michael Pettis, *Using Mexican Debt Prices as a Proxy for the Economy*, COLUM. J. WORLD. BUS. 116, 118 (1991).

155. *Brady's Bazaar, supra* note 55, at 81; *Philippines Buyback Completed*, 808 INT'L FIN. REV., Jan. 6, 1990, at 43. An investor who acquired Filipino debt upon the announcement of debt buy-backs as one limb of the Brady proposal in March 1989 would have turned a handy profit when the debt acquired for 36 cents on the dollar was repurchased by the debtor nation at 50 cents one year later.

156. *Looking for 'Aggressive' Bids in Buyback*, 800 INT'L FIN. REV., Nov. 4, 1989, at 35.

157. *Costa Rica: Buyback Details*, 807 INT'L FIN. REV., Dec. 23, 1989, at 29; *Costa Rica's Buyback at 16 Cents*, 817 INT'L FIN. REV., Mar. 10, 1990, at 31; *Costa Rican Financing Closes*, 828 INT'L FIN. REV., May 26, 1990, at 37. Furthermore, Yugoslavia had a "qualified dinars payment plan" under which certain domestic companies were permitted to convert debt acquired in the secondary market into local currency to pre-pay their own loans. *Secondary Market Report*, 777 INT'L FIN. REV., May 27, 1989, at 24; *LDC Finance — Yugoslavia Bright*, 779 INT'L FIN. REV., June 10, 1989, at 23-24. US$350 million of debt was exchanged in the first half of 1989 through this debt buy-back program. *Yugoslavia Tries to Drive Debt Price Down*, 781 INT'L FIN. REV., June 24, 1989, at 26.

158. *LDC Finance — Buying Debt to Pay Off Debt*, 815 INT'L FIN. REV., Feb. 24, 1990, at 32; *LDC Finance*, 824 INT'L FIN. REV., April 28, 1990, at 37 (reporting that "there are debt cancellations being approved, in which local currency obligations are cancelled in exchange for [Brazilian government rescheduled loans], mostly for public sector companies.").

159. *Price Indications for Value Impaired Debt*, 810 INT'L FIN. REV., Jan. 20, 1990, at 32; *Price Indications for Value Impaired Debt*, 815 INT'L FIN. REV., Feb. 24, 1990, at 35.

160. *Brady's Bazaar, supra* note 55, at 81.

putedly purchased a further US$17 billion of its own debt informally in mid-1990 partly with funds saved from the interest payments it had been refusing to make.[161]

These buy-backs were mainly by parastatals. Commercially there is no difference between this and the debtor nation repurchasing its own debt directly in the market. The crucial legal difference is that the debtor would require waivers from its creditors to repurchase its debt whereas state-owned companies, as separate legal entities, do not.

Defeasing debt for twenty to thirty percent of face value is highly attractive. The Brazilian government reportedly considered not resuming regular debt-equity auctions because their buy-backs (i) allowed them to recapture the entire discount on the debt and not share it with an investor as in a debt-equity, and (ii) avoided much of the inflationary impact of the debt-equity swaps.[162] The opportunity for these informal buy-backs is perhaps the greatest service the secondary market rendered the debtor nations.

A fascinating, secret informal buy-back was put together in 1989 between Mexico and JP Morgan.[163] The scheme was named "Moby Dick," presumably because of its size. Morgan lent Mexico US$500 million, which Morgan used on Mexico's behalf to buy Mexican par bonds. At the time, par bonds were

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161. Lee C. Buchheit, *Moral Hazards and Other Delights*, INT'L FIN. L. REV., April 1991, at 11. The unnamed borrower referred to by Buchheit can only be Argentina or Brazil, and is probably the latter. In October 1990, the Brazilian state oil company, Petrobras, reportedly bought back some US$600 million of Brazilian debt when it was trading at around 22% of face value. *Indicative Prices for Developing Country Credits*, 847 INT'L FIN. REV., Oct. 6, 1990, at 29; *Secondary Market Report*, 848 INT'L FIN. REV., Oct. 13, 1990, at 33 (reporting amount at US$300 million initially, but later made public that it was US$600 million). The head of Petrobras resigned over the matter as the government had previously issued a decree banning such buybacks. *New Petrobras Head Named*, 850 INT'L FIN. REV., Oct. 27, 1990, at 28. On one estimate Brazil and its parastatals retired between US$2 billion and US$3 billion by this means in the first four and a half months of 1990 alone. *Zelia Brings No Comfort for Banks on Interest*, 828 INT'L FIN. REV., May 26, 1990, at 41. On another estimate Brazil retired between US$13 billion and US$15 billion in the preceding few years through buy-backs. *Brazil Ddebt Downgrade on Hold*, 831 INT'L FIN. REV., June 16, 1990, at 26.

162. *Zelia Brings No Comfort for Banks on Interest*, 828 INT'L FIN. REV., May 26, 1990, at 41.

163. There is only one source of information for this scheme but it is highly reliable. Interview with XX (name withheld on request) formerly a trader with JP Morgan and other trading houses, New York City, April 19, 1993 (XX was an LDC debt trader in Morgan's employ at this time).

trading at less than fifty cents on the dollar,[164] so Morgan was able to purchase over US$1 billion face value of bonds. Mexico continued to pay the 6.25% coupon each year to Morgan as the registered owner of the bonds. However, as Mexico enjoyed beneficial title to the bonds it received a credit for these interest payments, and as they were substantially greater than the interest on its US$500 million loan[165] some of the interest Mexico paid each year on its bonds was refunded to it. It is not known whether Mexico ultimately defeased the debt by paying off its loan to Morgan and taking full title to the bonds or whether it later sold the bonds back into the secondary market at a healthy profit.[166] In either event, such a scheme amounted to substantial debt relief for Mexico. Because Mexico's Brady bonds did not prohibit buy-backs, the scheme was not in contravention of any covenants, but the scheme was nevertheless kept secret. The scheme worked so well Mexico extended it, with Morgan's assistance, to cover US$2 billion face value of par bonds. Morgan allegedly completed similar arrangements with the Philippines, Uruguay, and Venezuela.[167]

Bankers and commentators like to discuss 'moral hazards'. The phrase has a certain ring to it, an attractively illicit ring. In sovereign debt terms, 'moral hazard' describes any situation that rewards the sovereign debtor for financial misbehavior.[168] Informal debt buy-backs are a classic example of moral hazards because the secondary market price of the debt is acutely sensitive to the actions of the debtor nation.[169] Institute a moratorium on interest payments and the price of one's debt falls through the floor, as Brazil's did between July 1989 and early 1991 when Bra-

164. Throughout 1990, Mexican par bonds traded in the 42-46 cents on the dollar range. See "LDC secondary market debt price" columns in various issues of INT'L FIN. REV..

165. This was a floating rate loan, with interest at a premium over LIBOR.

166. Perhaps three years later when the bonds were trading at around 82 cents on the dollar. *Indicative Prices for Developing Country Credits as of 10/12/93*, 1009 INT'L FIN. REV., Dec. 11, 1993, at 48.

167. XX Interview, *supra* note 163.

168. Buchheit, *supra* note 161, at 10. In mid-1990, bankers were reportedly "growing increasingly frustrated at the fact that there is not much they can do to Brazil, which has well over US$8bn in foreign reserves, and has made no attempt to start talks or to even make a token payment on more than US$5bn of overdue interest." *Brazil Debt Downgrade On Hold*, 831 INT'L FIN. REV., June 16, 1990, at 26.

169. Buchheit, *supra* note 161, at 11; Anayiotos & De Pinies, *The Secondary Market and the International Debt Problem*, 18 WORLD DEVELOPMENT 1655, 1657 (1990).

zilian debt could be acquired for as little as twenty-two cents on the dollar.[170] In such a situation two years of unpaid interest not only deflates the price of one's debt, it also liberates the funds to purchase it.[171]

Formal debt buy-backs usually require the consent of the creditors as such conduct is generally considered to be in breach of the typical mandatory prepayments clause and sharing clause in the loan agreement.[172] Consents are only required, however, if the debtor repurchases its debt itself. In the typical informal buy-back, the debtor either uses a state-owned company or incorporates a financial institution to acquire the debts or appoints a third party to buy the debts and acquires beneficial ownership of the debts through a participation.[173] In neither case is the typical mandatory pre-payment or sharing clause infringed. Indeed, in neither case will the banks even know the debtor has effectively extinguished its own debts. The math, if not the morals, of interest moratoria and debt buy-backs are highly attractive.[174]

Interestingly, Mexico is not prohibited by the terms of its Brady bonds from repurchasing them on the open market.[175] There are four possible explanations for this: (i) the banks and

170. For instance, Brazilian debt traded at 22 cents in March 1990. *LDC Secondary Market Prices*, 819 INT'L FIN. REV., Mar. 24, 1990, at 35; 24 cents in July 1990. *LDC Secondary Market Prices*, 835 INT'L FIN. REV., July 14, 1990, at 29; 22 cents again in October. *LDC Secondary Market Prices*, 847 INT'L FIN. REV., Oct. 6, 1990, at 29; and 24 cents in January 1991. *LDC Secondary Market Prices*, 861 INT'L FIN. REV., Jan. 19, 1991, at 23.

171. A further example of moral hazard arose in mid-1989 when Yugoslavia was accused of attempting to sell US$50 million of its debt on the secondary market to drive down the price. *Yugoslavia Tries to Drive Debt Price Down*, 781 INT'L FIN. REV., June 24, 1989, at 26. Yugoslavia's debt buy-back scheme was particularly active at the time and a lower price would have resulted in less Yugoslavian foreign exchange reserves being used in the buy-backs.

172. Buchheit, *supra* note 161, at 11.

173. *Id.*

174. For instance, consider the hypothetical case in which a debtor declares a two-year moratorium on repayments of principal or interest. After twelve months or so, in the case of both Argentina and Brazil, such a moratorium drove the secondary market price of their debt below 20 cents on the dollar. In our hypothetical, if the price of the nation's debts falls below 20% and the nation saves all the funds it would have paid out in interest at, say, 9% p.a., after a year it can begin repurchasing its debt progressively on the secondary market and over the two years will have saved enough money by not making repayments to retire effectively all of its outstanding debt. A neat and highly tempting alternative to the indefinite repayment of interest on the full face value of the debt. (Of course, not all of a nation's debts will be available for repurchase on the secondary market as many lenders will not part with their portfolios at that price, but with respect to the debt which is available the point is made).

175. *'Junk' of the 1990s?*, 823 INT'L FIN. REV., April 21, 1990, at 29.

their advisors did not appreciate the moral hazard being demonstrated at the time in the secondary market; (ii) the banks and their advisers believed the Brady bonds would be immune to non-payment of interest and price manipulation by the debtor; (iii) the banks agreed with Dornbusch that there is no moral hazard as the burden of repaying these loans is not carried by those who benefited from them, but is carried rather by the poor;[176] or (iv) the banks gave ground on this point in the negotiations because Mexico was prepared to trade off other issues for it. Only the fourth explanation is plausible.[177] It is supported by the six weeks spent negotiating, exhaustively, this one issue.[178]

In addition to buy-backs, the major impetus for the market, particularly as this period drew to a close, was privatizations, which are discussed in the next section.

2. Privatizations

There was little foreign investment in equity in Latin America in the 1970s. Development by way of foreign debt rather than foreign equity ownership of local companies had appealed to Latin American governments in the 1970s as it appeared to offer the countries control over their economic destiny. However, paradoxically, equity investment would have led to less loss of economic sovereignty than did the IMF structural adjustment programs of the rescheduling years. A majority foreign equity stake in a local company means the loss of do-

176. Dornbusch, *Our LDC Debts*, NBER WORKING PAPER SERIES NO 2138, at 53 (1987) .

177. Consider this statement in 1990, "A direct purchase of debt by a government has a moral hazard problem embedded in it and would, in general, be refused by banks": Anayiotos & De Pinies, *supra* note 169, at 1666. In the late 1980s few commentators noted that the Bradyization of a nation's loans into bonds did not protect them against non-payment and rescheduling. It was more popular and politically correct to take the "party" line that the Brady schemes were resolving the debt crisis. There were, however, voices to the contrary and most market participants were aware that a Brady restructuring was no guarantee against credit risk. As Scott MacDonald said with respect to the securitisation of bank loans under the Brady scheme: "is the foundation being established for a new debt crisis, one that involves bonds instead of commercial bank loans?" Scott MacDonald, *A Word to the Wise*, 27 LATINFINANCE 43, 44 (1991); *see* Martin Schubert, The Risks and Rewards of Investment in the High Yield Latin American Debt Market, a speech delivered at the Latin American High Yield Conference, New York City, May 30-31, 1990, at 22 [herinafter Schubert Speech I].

178. *'Junk' of the 1990s?*, 823 INT'L FIN. REV., April 21, 1990, at 28.

mestic control of that company. The 1970s lending boom, on the other hand, resulted in economic policy for most of Latin America in the 1980s being dictated from Washington, DC. In the early 1990s, Latin America decided to turn back the clock by replacing debt with equity. Privatization programs were the means to this end[179] and Latin American debt was the principal currency.[180]

Privatizations provided significant impetus for the market especially in the latter part of this period.[181] Most of the consideration for the privatized assets was debt[182] so these privatizations were, in effect, massive one-off debt-equity swaps.

In Argentina, the first major privatization was of the national telecommunications authority, ENTel. The prospect of this privatization, and the "huge amount of paper"[183] it would require underpinned the secondary market in Argentine debt for months. The southern division of ENTel was sold for US$114 million cash and US$2.7 billion in debt to Citicorp and Telefonica de Espana.[184] The northern division was sold to a consortium[185] for US$100 million cash and US$2.2 billion in debt.[186] The next major Argentine privatization[187] was of Aero-

179. By Citibank's calculations, there were more than 150 privatizations completed in Latin America in the three years up to April 1992, which raised revenues of some US$50 billion in either cash or debt. *See* William Rhodes, *The Sea Change in Latin America*, a speech delivered at the Bankers' Association for Foreign Trade, 70th Annual Meeting, Naples, Florida, April 29, 1992 (on file with the *Fordham International Law Journal*).

180. Debt was the principal currency in the Argentine and Brazilian privatizations. In Mexico, whose economy was generally considered to be more healthy and whose debt was trading at about twice the price of Argentina's and Brazil's (because it was being serviced) the buyers in privatizations were more often domestic companies and the currency more commonly cash. For instance, Compania Minera Cananea was acquired by Mexicana de Cobre for US$468 million in cash. *Privatisation Double Take — Morgan's Mexican Deal*, 842 INT'L FIN. REV., Sept. 1, 1990, at 19.

181. *See generally Privatisation in Latin America*, a Supplement to LATINFINANCE, March 1992.

182. Sometimes debt represented the entire purchase price, as in the privatization of Usiminas considered subsequently.

183. *LDC Market Rallies Strongly on 'Euphoric' Sentiment*, 829 INT'L FIN. REV., June 2, 1990, at 25.

184. Froman, *Creditor Review — Citibank*, 20 LATINFINANCE 65 (1990).

185. The consortium was headed by JP Morgan together with the Italian state telephone company, and Cables and Radio of France.

186. W. A. Orme, Jr., *The Deal of the Year: Selling Entel*, 20 LATINFINANCE 9 (1990); *Entel Again*, 22 LATINFINANCE 9 (1990).

187. In 1990 alone privatisations reduced Argentina's debts to commercial banks from US$35.3 billion to US$31 billion.

lineas Argentinas, the national carrier. The buyer of the largest stake, thirty percent, was Iberia of Spain[188] for US$683 million in cash and $2 billion in debt.[189]

Mexico's privatization push began with an aggressive plan to privatize its eighteen state-owned banks.[190] Mexico earned US$3.1 billion from the sale of state-owned enterprises in 1990 and US$10.7 billion in 1991 as privatizations proceeded on a massive scale.[191]

The first major privatization in Brazil was of the country's largest steel maker, Usiminas,[192] on October 24, 1991.[193] Few foreign interests submitted bids.[194] In the end, foreigners acquired only six percent of the steel group. Usiminas was sold[195] for US$1.17 billion in Brazilian government bonds, obligations, and loans.[196] While the entire price for the steel group was paid with debt, almost none of Brazil's restructured debt was used, buyers preferring to use privatization certificates denominated

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188. Iberia also acquired controlling stakes in Viasa, the largest of Venezuela's three airlines, and in Ladeco, a Chilean airline. *See Privatisation Update*, 30 LATINFINANCE 77 (1991).

189. *Out of the Gate*, 23 LATINFINANCE 12 (1990); *Aerolineas Finally Gets Off the Ground*, 854 INT'L FIN. REV., Nov. 24, 1990, at 25. There is a disparity in reports of how much cash Iberia paid for its stake. The former source gives the figure in the text, the latter source, gives a figure of US$260 million. The sources agree on the amount of the debt. The US$2 billion was comprised of US$1.6 billion in loans and US$400 million of unpaid interest. Latin American privatizations were full of paradox. Argentina's first two major privatizations resulted in the telephone monopoly being "privatized" to, among others, the state telecommunications companies of Spain and Italy and the national airline being "privatized" to the national airline of Spain.

190. Not all privatized corporations were sold to foreigners for debt. The first three of Mexico's banks to be privatized, Multibanco Mercantil, BancPais and Banca Cremi, as well as Mexico's largest bank, Banamex, were sold to Mexican interests for cash. *See Mercantil Sets the Pace for Bank Privatisations*, 882 INT'L FIN. REV., June 15, 1991, at 29. This trend was encouraged by regulations which prevented any one foreign bank from holding more than 10% of a Mexican bank and limited the non-Mexican shareholding in any Mexican bank to 30%. *See* Recio, *Setting a Standard*, 29 LATINFINANCE, at 60-61 (1991).

191. *The Privatisation Process in Mexico*, 1 MEXICO - ON THE RECORD 3 (1992).

192. The full name is Usinas Siderugicas de Minas Gerais.

193. Griffith, *Epic Sale*, 33 LATINFINANCE 63 (1991).

194. Potential foreign shareholders were put off by dramatic falls in the price of Brazilian debt in the weeks preceding the auction and by violent protests outside the Rio de Janeiro stock exchange and other domestic opposition to the sale of the state steel-maker to foreign interests. *Id.*

195. That is, the 75% of Usiminas that was put up for sale, was sold.

196. For a breakdown of the "currencies" used in the acquisition, see Griffith, *supra* note 193, at 64. The one currency not used in the acquisition was cash.

in local currency.[197] The Brazilian privatization program was important in the reduction of public debt, which was a precondition to the IMF approval needed for a Brady style restructuring.[198] If selling national assets for national debt strikes you as strange, consider the sale of Babeto, a Brazilian footballer. An Italian businessman paid Babeto's Brazilian club US$4.2 million in cash and US$1.5 million in Brazilian debt for him with the intention of on-selling him to an Italian club.[199]

3. Debt-Equity Swaps

With virtually the only active debt-equity program in 1989 being Chile's, debt-equity swaps certainly did not drive the market in 1989 as they did in 1988.[200] Chile's program provided some impetus to market activity but, in the words of a report in September 1989, "a dearth of [the] debt-equity conversion programmes that helped fuel last year's record volume has had a dramatic effect on the market".[201] In 1990 demand was created for Mexican debt by two debt auctions which Mexico had agreed to hold as part of its Brady restructuring. In July banks bid for the right to convert US$851 million into equity in Mexican companies.[202] Bankers were unhappy with the first auction because Mexico managed to recapture fifty-two percent of the discount for par bonds.[203] At the time, par bonds were selling for around

197. The privatization certificates had been issued early in the Collor administration in return for confiscated deposits. *See Usiminas Sale: The Winners and the Losers*, 901 INT'L FIN. REV., Oct. 26, 1991, at 20.

198. *Brazil's Privatisation Delays Widen Credibility Gap*, 897 INT'L FIN. REV., Sept. 28, 1991, at 20.

199. *On the Ball*, 812 INT'L FIN. REV., Feb. 3, 1990, at 25.

200. *Secondary Market Gets Bullish*, 768 INT'L FIN. REV., Mar. 25, 1989, at 21.

201. *Secondary Market Report*, 791 INT'L FIN. REV., Sept. 2, 1989, at 22. Having said this, one study puts dollar inflows from debt-equity conversions into Latin America at US$3 billion in 1987, US$5 billion in 1988, and US$3.7 billion in 1989. *Back to the Future*, 16 LATINFINANCE 24, 26 (1990). Argentina, Brazil, Ecuador, and Mexico suspended their programs in late 1988 or 1989 while the Philippines, Nigeria, and Yugoslavia established new, relatively small, debt-equity programs. *See* Martin Schubert, *The Secondary Market in LDC Debt — 1990 and Beyond*, a speech delivered at the Third Annual Latin America Financial Forecast Conference, Miami, Sept 29-30, 1989 (on file with the *Fordham International Law Journal*) [hereinafter Schubert Speech II]. Venezuela also established a small program in November with an auction of US$150 million of debt for conversion into equity. *See Secondary Market Report*, 800 INT'L FIN. REV., Nov. 4, 1989, at 38.

202. *Mexico's First Debt Auction*, 20 LATINFINANCE 14 (1990).

203. The discount rate was 26.23% for discount bonds and 52.05% for par bonds. *See Mexico's First Debt Auction*, 20 LATINFINANCE 14 (1990).

43.5 cents on the dollar so the debt-equity process provided a premium of only ten percent, in return for which investors had to settle for restrictions on their investment. All of the successful bids were by Mexican entities, some with foreign partners, às no wholly foreign bids were prepared to accept such a high discount.[204] The second and final auction was in October. US$2.5 billion of debt was converted into equity at effectively the same discount as the earlier auction.[205] As earlier, debt-for-nature exchanges continued to contribute insignificantly to market demand for debt[206] and a few debt-for-development swaps were also implemented.[207]

4. Swaps Between Debtors

During this period, the secondary market made possible a new style of transaction—the mutual exchange of each other's debt between two debtor nations. In 1989, Brazil agreed that Paraguay could discharge its indebtedness to it through the

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204. *Mexico Gets 52% on Swap,* 836 INT'L FIN. REV., July 21, 1990, at 25.

205. The discount rates were 26.15% and 52% for discount and par bonds respectively. *Mexico's Swap Program is Over,* 22 LATINFINANCE 14 (1990); *see Mexico Auctions $2.5billion of Debt,* 848 INT'L FIN. REV., Oct. 13, 1990, at 33. Interestingly, 65% of the successfully tendered debt in the first auction was par bonds, whereas in the second auction par bonds accounted for only 21% of the successfully tendered debt, the balance being discount bonds. Of course, all the tendered debt had to be Brady bonds as there were no longer any outstanding eligible loans.

206. W. A. Orme, Jr., *The Greening of Latin Debt,* 16 LATINFINANCE 52 (1990). Debt-for-nature swaps were typically implemented in countries the debt of which traded at very large discounts for this made such swaps more worthwhile. The typical price paid for debt used in these swaps from 1987 to early 1990 was 12 to 16 cents on the dollar. The largest swap in this period was funded by Sweden and saw the retirement of US$24.5 million of Costa Rican debt. Mexico had its first debt-for-nature swap in early 1991 — Conservation International Foundation paid US$1.8 million to acquire US$4 million in debt. This was retired in return for Mexico's promise to spend US$2.6 million on protecting the Lacandon Rain Forest in Chiapas. *See Mexico's Nature Swap,* 25 LATINFINANCE 8 (1991). In Ecuador environmentalists acquired US$9 million of debt for about 12 cents on the dollar and converted it into local currency to use protecting Ecuador's rain forests. Madagascar also arranged the first African debt-for-nature swap. *See Debt-For-Nature Swaps in Ecuador and Africa,* 787 INT'L FIN. REV., Aug. 5, 1989, at 24; *see also Debt-For-Nature Swaps,* 840 INT'L FIN. REV., Aug. 18, 1990, at 26; *BankAmerica Donating $6m for LDC Debt for Nature Projects,* 882 INT'L FIN. REV., June 15, 1991, at 34.

207. In one deal, US$30.3 million of Ecuadorian debt was acquired by a Roman Catholic priest with funds raised in Scotland and swapped into local currency. Of the proceeds, the equivalent of US$28 million was used for a nutrition program in Quito and US$2.3 million to provide running water to 60,000 people in the shanty town where the priest lived and worked. *Ecuador: We're Going to Heaven on This Deal,* 849 INT'L FIN. REV., Oct. 20, 1990, at 29.

tender of an equal face value of Brazilian debt acquired on the secondary market.[208] In May 1990, Brazil agreed to accept its own indebtedness in exchange for US$300 million owed to it by Bolivia. Bolivia acquired the Brazilian paper on the secondary market at its then price of 25.5 to 27.5 cents on the dollar. This enabled Bolivia to discharge US$300 million of indebtedness for about US$80 million.[209] Mexico and Venezuela also used similar arrangements to facilitate payment of oil debts by poorer Central American states.[210]

5. Portfolio Adjustment

Portfolio adjustment by way of swaps was only a minor stimulus to market activity.[211] As the period progressed, many banks for the first time since 1982 had full provisions against their LDC loans.[212] As a result, sales for cash were the usual form of market transaction.[213]

6. The Revision of Japan's Tax Rules

Japan provided funds to Mexico to facilitate its acquisition of the collateral for its Brady bonds.[214] Its other principal contribution to the Brady plan was to begin the relaxation of its remarkably tight tax rules for LDC debt. In early 1990, the Japanese Ministry of Finance increased the maximum loan-loss provisions which Japanese banks could take on their US$30 billion of LDC debt from fifteen percent to twenty-five percent, thereby laying the groundwork for the participation, to albeit a limited extent, of the Japanese banks in selling their LDC credits.[215]

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208. Schubert Speech II, *supra* note 201, at 19.

209. *Bolivia and Brazil Reach Accord on Plan to Cut $300 Million of Each Other's Debt*, *supra* note 89.

210. Schubert Speech II, *supra* note 201, at 19.

211. Banks did from time to time swap equal face amounts of one nation's debt for that of another in 1989 and 1990 with a cash fee to compensate for different values. Hence a bank might have given Brazilian debt plus 6 percent cash for Venezuelan debt. *See* Martin Schubert, *The Secondary Market for LDC Debt — The Expected Impact of a Brady Type Initiative*, an address delivered at the Latin American Financial Strategies Conference, New York City, June 20-21, 1989, at 14 [hereinafter Schubert Speech III].

212. In the sense that their loan loss reserves equalled the difference between the book value and secondary market price of their LDC debt portfolios.

213. Corrigan, *supra* note 129, at 31.

214. *See* Buckley, *supra* note 1.

215. *Brady's Bazaar*, *supra* note 55, at 81. This 25% limit on reserves was lifted in early 1991.

7. The Supply of Debt

Throughout this period there was an abundant supply of debt as a result of the selling programs of most U.S. regional banks and some major U.S. and U.K. banks.[216] For instance, Chase-Manhattan reduced its portfolio in 1990 by US$2.5 billion, principally through sales.[217]

C. *Market Characteristics*

The principal characteristics of the market in the previous period were the hand-crafted nature of the transactions, the absence of a formal market structure and confidentiality. The principal characteristics in this period were as follows:

a. The change to the new, and current, name for the market;
b. The greater efficiency of the market;
c. The advent of quotation screens;
d. The introduction of Brady bonds;
e. The longest sustained rally in the market's history; and
f. Price volatility.

The effect in this period of the three characteristics that were previously most significant will be considered first and followed by a consideration of the above six factors.

1. Nature of Transactions

During this period, transactions became simpler in two ways. First, the usual form of loan transaction was a cash sale which is far easier to price, negotiate, and document than a swap of assets. Second, as Brady bonds progressively replaced bank loans, trading and transfer procedures were further simplified.[218] While the market would have to await the implementation of Brady schemes for Brazil and Argentina before it began

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216. For instance, from the end of 1988 to late 1991 Natwest reduced its LDC debt exposure from US$4.4 billion to around US$600 million. *See* Westlake, *Bulls Buoyed by Brady Bonanza*, BANKER, Oct. 1991, at 50, 54.

217. *LDC Reserve Hike Mooted for Japanese Banks*, 862 INT'L FIN. REV., Jan. 26, 1991, at 19. Citibank reduced its portfolio by about US$1 billion per annum but mostly through conversions into equity, not secondary market sales. *US Banks Continue to Reduce LDC Portfolios*, 861 INT'L FIN. REV., Jan. 19, 1991, at 23.

218. The advent of Brady bonds also reduced the number of different credits issued by a debtor and thus further simplified trading.

to resemble other security markets in its day-to-day operation, the trend in that direction was now clear.

2. The Formal Market Structure

One of the first steps of the new LDC Debt Traders Association was to promulgate a series of market practices.[219] As the Association had no supervisory power, these were merely recommended practices. Nonetheless, they were a welcome move towards more orderly market conduct. The practices were promulgated in June 1991 and dealt with matters such as preparation and execution of confirmations, retroactive interest rate adjustments, the passing on of interest payments on transferred credits, and a standard settlement period of three weeks for standard loan assets.[220]

3. Confidentiality

Confidentiality became a dead letter during this period. The old niceties of not wishing to be seen to be selling a customer's loans were irrelevant in an environment in which more and more banks were finding new money requests to be "perfectly resistible invitations."[221] Furthermore, the secondary market prices of loans and bonds were now public and were published in each edition of *International Financing Review, LDC Debt Report* and *LatinFinance,* as well as in newspaper and journal articles.

4. A New Name for the Market

One of the more obvious changes to the market in this period was its name. The units within banks which traded LDC debt had traditionally had names like the "Loan Transactions Unit," "Asset Swap Group," or "LDC Debt Trading Group." In 1990, along with Brady bonds, came the birth of a new name, "Emerging Markets:" a name more positive, more suggestive of growth and development, more pro-active[222] than any used

219. Memorandum from Nicolas S. Rohatyn, Chairman, to the Members of the LDC Debt Traders Association, June 27, 1991 (copy on file with the *Fordham International Law Journal*). *Debt Traders Association Adopts Market Practices,* 4 LDC DEBT REPORT, July 15 1991, at 3 (discussing practices).

220. Rohatyn, *supra* note 219.

221. Buchheit, *supra* note 161, at 14.

222. That quality close to the heart of all investment bankers.

before, and a name which stuck.[223] In May 1992, the *International Financing Review* changed the title of its regular weekly feature from "LDC finance" to "Emerging markets"[224] and in June 1992 the LDC Debt Traders Association became the Emerging Markets Trading Association.[225]

5. Greater Market Efficiency

One measure of a market's efficiency is the narrowness of the spread between bid and offer prices. By late 1991, the spreads for the most heavily traded debts, such as those of Mexico and Venezuela, were as narrow as 1/4th to 3/8ths of a point.[226] Only five years earlier, spreads of two to three percent had been common.[227]

6. Advent of Quotation Screens

In 1991, three inter-bank brokerage firms began to post buy and sell prices for LDC debt on Reuters' screens.[228] Tullett & Tokyo had offices in both New York and London, Tradition was based in New York, and InterCapital Brokers in London. The prices on their screens were indicative only—the actual transactions were still negotiated over the telephone and there was no sanction for resiling from posted prices except one's reputation in the market.[229] This softness of posted prices allowed traders to try to deliberately push prices one way or the other.[230] Nonetheless the advent of screens was an important step in the maturation of the market.

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223. *See* David Gillen, *Prices Adrift in Featureless Trading; Morgan Stanley Forms LDC Debt Unit,* THE BOND BUYER, Sept. 21, 1990, at 3 ("At the top end of this group are countries that are getting everything right — we don't even call it LDC, we call it 'emerging markets'" (statement of Jay Newman of Morgan Stanley)).

224. *See, e.g.*, 930 INT'L FIN. REV., May 23, 1992, at 26.

225. *Traders Group Prepares Rules of Conduct,* 934 INT'L FIN. REV., June 20, 1992, at 30. This association is universally known as EMTA.

226. *More Bad News for Junk: LDC Market Grows Efficient,* 1 JUNK BOND REPORTER, Feb. 25, 1991, at 4.

227. Schubert Speech I, *supra* note 177, at 23.

228. *Talking Screens,* 30 LATINFINANCE 8 (1991).

229. *Id.*

230. Michael Scharfenberger of Euro Brokers Capital Markets cited this as the major reason that this fourth inter-bank broker declined to introduce screens. *Id.*

7. Sustained Rally in Prices

The Brady Plan had a fundamental effect on prices of LDC debt in the secondary market. Secondary market prices had consistently moved in only one direction, downwards, from the market's inception until March 1989. The announcement of the Brady proposal in March 1989 appears to have halted that trend.[231] The prices of some nation's debts declined after that date. But overall, the Brady Plan appears to have effected a structural change within the market since which the general price trend has been either flat or positive.[232]

The trend reversal is shown by the Lehman Brothers price index of secondary market LDC debt, which between mid-January and early August 1991 rose by over thirty percent.[233] The Brady bond rally is likewise reflected in the Salomon Brothers' Brady Bond Index which recorded a sixty-six percent return from April 1990 to September 1991.[234] The sustained rally in prices persisted into October 1991. In the words of *The Banker* in October 1991, "even the optimists could not have expected this year's bull run in LDC debt."[235]

Prices were further buoyed from June onwards by the prospect that the Brady scheme for the biggest debtor, Brazil, would be passed[236] and by the glowing reports some of the major Latin American countries were receiving from the economic analysts.[237] However, all bull runs turn bearish. As we shall see, the

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231. In June 1990, it was reported that "overall, there is a sense that the secondary market's long decline is at an end." *LDC Market Rallies Strongly on 'Euphoric' Sentiment*, 829 INT'L FIN. REV., June 2, 1990, at 25. For the first time since 1983, most banks' reserves equalled the discount on the debt in the secondary market and speculative investors were entering the market in significant numbers and a 'senior participant' noted that "we now have a realistic market and that the bottom may have been reached for the time being." *Id.*

232. Lee & Sung, *supra* note 72, at 17-18.

233. Westlake, *supra* note 216, at 50. In this period, Argentine debt increased in value by 56%, Brazilian debt by 62%, and Mexican debt by 32%.

234. Peter Truell, *Latin American Debt Holders Scored Big Gains, Index Shows*, WALL ST. J., Oct. 2, 1991; KLAFFKY, ET AL., Introducing the Salomon Brothers Brady Bond Index — A Performance Benchmark for Developing Country Bonds (1991) (Salomon Brothers) (copy on file with the *Fordham International Law Journal*).

235. Westlake, *supra* note 216.

236. Previous Brady schemes had resulted in large increases in the price of the debt. *See Brazil Rises On Optimism That Term Sheet Will Pass*, 4 LDC DEBT REPORT, June 17, 1991, at 2.

237. *See, e.g*, Robert S. Gay, SPECIAL ECONOMIC STUDY — MEXICO: ON THE MEND, (Morgan Stanley 1991).

extraordinary bull run of 1991 was to end in a mauling for investors.

8. Price Volatility

One of the standout characteristics of this period of the market's development was extreme price volatility.[238] In 1989, the market was periodically illiquid and volatile. In March 1990, Brazilian debt fell by over fifteen percent on one day, from thirty-three to twenty-eight cents on the dollar.[239] The fall was attributed to a story in *Gazeta Mercantil* that the new head of the central bank had some reservations about debt-equity swaps and debt buy-backs.[240] Brazil was not paying interest at the time, so these deals were the primary source of demand for the debt. Within two weeks Brazilian debt had fallen a further thirty percent to as low as 19.75 cents on the dollar,[241] and the worst was still to come. In October 1991, Brazilian debt went into a breathtaking freefall.

This volatility was a product of a number of factors. In the preceding years the secondary market had permitted many of the U.S. regional, Canadian, and continental European banks to divest their LDC debt holdings. Accordingly, the remaining debt was more concentrated in the hands of the U.S. money center banks[242] and two of the large U.K. banks.[243] As a result, the market was thinner and volatile.[244]

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238. For instance, in two days in mid-June, 1989 the price of Argentine debt rose from 11.5% to over 15.5% — an increase of over 35% in 48 hours. *See* Schubert Speech III, *supra* note 211, at 12.

239. *Brazil Prices Crash 5 Points Ahead of Inauguration*, 817 INT'L FIN. REV., Mar. 10, 1990, at 35.

240. *Id.*

241. *Secondary Market Report*, 819 INT'L FIN. REV., Mar. 24, 1990, at 37.

242. UNITED NATIONS ECONOMIC COMMISSION FOR LATIN AMERICA AND THE CARRIBEAN & UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, TRANSNATIONAL BANK BEHAVIOUR AND THE INTERNATIONAL DEBT CRISIS 17, (1989) [hereinafter ECLAC/CTC].

243. Lloyds and Midland Banks. Barclays Bank had pursued a strategy in 1989 of selling off much of its LDC portfolio in the secondary market and Natwest, from the end of 1988 to late 1991, had reduced its LDC debt exposure by some 86%. *See* Westlake, *supra* note 216.

244. Schubert Speech III, *supra* note 211, at 11. For instance, the nine largest U.S. banks held 63% of U.S. exposure to troubled LDCs at year-end 1982 and 70% by mid-1988. *See* Statement of Robert L Clarke, Comptroller of the Currency, before the House Committee on Banking, Finance and Urban Affairs, Washington DC, January 5, 1989, 8 OCCQJ 63 at 64. As one example of the flight from LDC lending of the less-

As Martin Schubert said,

> prices oftentimes move on a small amount of tangible deal demand and lots of anticipation of real purchase demand . . . or, inversely, on anticipation of no demand stemming from political shut-downs of the debt/equity window . . . . A tiny trend may produce an avalanche one way or the other, which makes for volatile conditions. Economics and intrinsic value play less of a role than politics and expectations of demand, or rumours that a bank is preparing to move an asset or a government authority change [a] regulation.[245]

That all securities implicitly include option positions is a major recent development in finance theory which offers an explanation for this volatility. The "delta" of an option measures the sensitivity of the value of the option to changes in the price of the underlying asset.[246] Applying this concept to debt, researchers have concluded that the delta of the debt of a credit-impaired corporation can have a value approaching or even exceeding the delta of the equity of that corporation.[247] The value of equity is usually thought to be highly sensitive to the earnings of the issuer. In this situation, when the debt of a credit-impaired issuer is as sensitive as equity to the issuer's earnings, it makes sense to say that the debt has "equity-like" characteristics.

9. Market Volume and Debt Traded

As the market became ever larger, so did the disparity between estimates of its volume. Estimates of volume for 1989 were consistently between US$60 billion and US$75 billion.[248] Most

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exposed banks consider the case of Royal Bank of Scotland. Between October 1989 and March 1990, it sold most of its LDC debt reducing its portfolio from US$404 million to US$71 million. *See Royal Bank of Scotland Sharply Reduces LDC Debt,* REUTERS, May 2, 1990.

245. Schubert Speech III, *supra* note 211, at 13.

246. Pettis & Gross, *What Does It Mean To Say That Debt Can Have Equity-like Returns?*, CAPITAL MARKET STRATEGIES, June 1995, at 6.

247. *Id.*

248. *See Brady's Bazaar, supra* note 55, at 81; *Back to the Future,* 16 LATINFINANCE 24 (1990) (estimating US$60-70 billion given for 1989). Lee & Sung cite 1989 volume at US$108.1 billion, but they have calculated that figure by adding together the individual reported trading volume figures for the top 16 traders. While this ignores the contribution of the smaller traders, it nonetheless almost certainly overstates the market's volume as most trades would be counted twice in two traders' figures and it makes no allowance for the incentives for individual trading houses to inflate their figures. *See* Lee & Sung, *supra* note 72, at 29. Martin Schubert initially estimated trading volume

commentators put the total volume of the market for 1990 at around US$100 billion,[249] although some put it as low as US$75 billion.[250] By way of comparison, the turnover through Euroclear and CEDEL of the secondary market in eurobonds in 1990 was some US$6 billion.[251]

The market continued to expand dramatically in 1991 and estimates of total trading volume varied widely, ranging from US$150 billion[252] to a wildly optimistic US$500 billion.[253] The consensus seems to be that volume for the year was between US$200 billion and US$250 billion.[254] The major reason for the increase in market activity was the securitization of Mexico's debt into easily traded bonds and the price support afforded LDC loans by negotiations for Brady-style restructurings for other debtors.[255] In February 1991, the transfers of almost US$13 billion of Mexican and Venezuelan Brady bonds[256] were processed through Euroclear.[257] The market in Brady bonds was proving itself much broader and deeper than virtually anyone had anticipated.[258]

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for 1989 at US$60 billion, but then, one week later, revised his estimate to US$75 billion. *See* Martin Schubert, a speech delivered at the Hospitality Industry Investment Conference, New York City, June 3-5, 1990, at 1 (copy on file with the *Fordham International Law Journal*) (hereinafter Schubert Speech IV).

249. Brian O'Reilly, *Cooling Down the World Debt Bomb*, Fortune, May 20, 1991, at 124; Voorhees, *supra* note 151, at 26. Lee & Sung's estimate of 1990 trading volume is US$137.5 billion, but this is subject to the caveats identified above.

250. NMB POSTBANK - LEADING THE FIELD, INT'L FIN. REV. Review of the Year — 1990, at 78 (spec. supp).

251. SCOTT &WELLONS, INTERNATIONAL FINANCE - TRANSACTIONS, POLICY AND REGULATION 653 (1995).

252. Voorhees, *supra* note 151, at 26.

253. *See* Clark, *supra* note 32 (estimating US$300 billion); Evans, *Brazilian Debt Takes a Pounding; Price Hits 20 Cents as Hope Fades for Mexico-Style Pact*, AM. BANKER, Nov. 5, 1991, at 10 (estimating US$500 billion).

254. *Fast Growing Debt Market Tries Some Self Regulation*, 4 LDC DEBT REPORT, Nov. 11, 1991, at 1 (estimating $200 billion); Tracy Corrigan, *Debt — Big rise in Turnover*, FIN. TIMES, April 6, 1992.

255. *Brady's Bazaar*, *supra* note 55, at 81.

256. *A Trading High*, LATINFINANCE 20 (1991).

257. Euroclear is a Brussels based clearer, owned by the JP Morgan group, which, along with CEDEL, serves as the clearing house for most Euro issues of debt and equity.

258. *A Trading High*, *supra* note 256. Some traders would, I am sure, prefer not to be reminded of their predictions upon the inception of Brady bonds. For a small sample, consider "the market will be almost totally illiquid" (Stephen Dizard, Salomon Brothers), "I doubt if more than 10% of the new bonds will be traded over the next three years" (John Purcell, Salomon Brothers), "When they do trade they'll probably trade in the capital markets divisions of banks" (Martin Schubert). That the expecta-

In the earlier part of this period most loan trades were of amounts between US$5 million and US$20 million.[259] As Brady bonds began to trade heavily in 1990, the average size of each transaction fell significantly at the same time as total volume increased dramatically.[260]

In 1990, the debt of a new obligor came on to the market in small amounts. Borrowers from the Soviet Union were falling behind in payments—past due Soviet loans totalled around US$2 billion in mid-1990.[261] As Soviet payments arrears approached 90 to 120 days, some banks, rather than wait and hope, sold the loans and trade credits into the secondary market at discounts between five and fifteen percent.[262] Buyers included Soviet state banks and investors interested in converting the loans into local currency.[263] By September 1991, Soviet loans with three to four year maturities were trading at discounts around forty-five cents on the dollar.[264] It is highly unlikely many of these transactions would have occurred without a developed secondary market. During this period a broad range of credits began to be traded more regularly including loans to Morocco, Nigeria, Poland, and Yugoslavia.[265] By the end of this period the debt of some twenty-six nations was traded regularly in this market.[266]

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tions of such experienced, senior traders could have been so totally inaccurate emphasizes the whole new era that Brady bonds brought to the market. Peter Geraghty, of NMB, was prescient: "the new bonds, and a host of derivative instruments spun off the bonds . . . will trade actively. They should add depth to the market and attract a whole new class of investor." Ioannou, *Banking on a Better Future*, EUROMONEY, Sept. 1989, at 251.

259. Peter Truell, *New Clues Surface to Security Pacific's Closing of Debt Unit — Credit-Trading Operation Was Shut Down in 1989, Puzzling Many Traders*, WALL ST. J., June 19, 1990, at A22.

260. Kelash, *LDC Debt Traders Vie for Top 1990 Ranking*, 4 LDC DEBT REPORT, Feb. 4, 1991, at 1.

261. Siegel, *Soviet Trade Finance Woes Spark Debt Trading By Banks*, XIV BANK LETTER, July 30, 1990, at 1.

262. *Id.*; *see* MORGAN, SECONDARY MARKET FOR SOVEREIGN DEBT 12 (1991)(on file with the *Fordham International Law Journal*).

263. Siegel, *supra* note 261.

264. *LDC Sovietology*, 31 LATINFINANCE 12 (1991).

265. Morgan, *supra* note 262. Bulgarian debt was also traded, to a significantly lesser extent. *See Shortened Week Keeps Trading Activity Light*, 4 LDC DEBT REPORT, April 1, 1991, at 2.

266. The 26 nations include Algeria, Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, Honduras, Ivory Coast, Jamaica, Mexico, Morocco, Nicaragua, Nigeria, Panama, Peru, Philippines, Poland, South Africa, Senegal, Sudan, Uruguay, Ven-

10. Brady Bonds in the Secondary Market

Debt traders were initially disappointed with the Brady bonds because they had been crafted without reference to those who would have to make markets in them.[267] Investors like simple investments for which yield calculations can be made accurately and easily. "Brady bonds" met neither of these criteria[268] and tended to trade at an under-value due to pricing difficulties.[269] The market convention in the early years at least was to value the interest guarantee as if it were only in place for the first eighteen months of the bond's life;[270] thereby understating the true value of the bond by ignoring the rolling nature of the guarantee.[271]

Brady bonds benefited from, and traded upon, the perceived "seniority" of bonds over bank loans. The broad range of bond holders may make a debtor less likely to default as one or two bond holders are more likely to sue than a homogeneous group of banks[272] subject to pressure from each other and their respective central banks. Furthermore, a successful bondholder is entitled to retain the proceeds of its litigation whereas the sharing clause in loan agreements means a successful bank plaintiff has to share the proceeds of litigation ratably with the other

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ezuela, Yugoslavia, and Zaire. *See LDC Secondary Market Debt Prices 19/9/91*, 896 INT'L FIN. REV., Sept. 21, 1991, at 30.

267. Ioannou, *supra* note 258, at 252.

268. *Id.*; *Mexico terms are out,* 794 INT'L FIN. REV., Sept. 23, 1989, at 24 ("bonds should be simple and clear and these are neither. They will suffer from illiquidity and difficult pricing."). Many traders believed the deal had been over-designed.

269. Because it is impossible to predict when a debtor may default, it is impossible to determine the precise value of the rolling interest guarantee. *See* Ioannou, *supra* note 258, at 252.

270. Orlanski, *Valuing Credit Enhancements*, 27 LATINFINANCE 37-38 (1991). A guarantee for the first eighteen months would have cost the debtor only half as much as a rolling guarantee. The extra cost would appear, at least in the early years of the trading of these bonds, to have been totally wasted. *See* Ioannou, *supra* note 258, at 252.

271. The guarantee was a rolling guarantee in that it was available until called upon, that is, the bondholders had the benefit of the guaranteed payment of 18 months of interest if, at any time during the life of the bond, the debtor should default on interest payments and the guarantee had not previously been called upon. It is thought that the need for the guarantee was driven by accounting considerations. Once interest repayments were over ninety days in arrears banks were required to put the loan on a non-accrual basis and make provisions for it. The rolling interest guarantee effectively converted this ninety day grace period (from the bank's perspective) into 21 months and removed the bargaining power the debtor's gained from not having paid interest for, say, 60 or 70 days. Pettis' Interview II, *supra* note 47.

272. Schubert Speech I, *supra* note 201, at 9.

banks in the syndicate. The major disincentive to solo litigation by banks is absent.[273] These factors, however, are hardly a guarantee. In the 1980s, otherwise recalcitrant debtors like Argentina and Brazil had an excellent record servicing their bonds.[274] From this record arose the supposed "seniority" of bonds over loans. The record, however, was a mere accident of history. Argentina, Brazil, and other debtors stayed current on their bond debt in the 1980s because there was so little of it—it simply was not worth going into arrears on interest payments.[275] A less myopic view of history would have revealed a consistent default on bonds by Latin American borrowers between the 1820s and the 1940s when bonds were the principal source of foreign finance.[276]

Nonetheless, at the end of this period, while Brady bonds

273. MacMillan, *supra* note 7, at 346-49.

274. "Developing countries have an excellent record for servicing [sovereign bonds], in stark contrast to their dire efforts to pay off bank debt." *The Acceptable Face of Junk*, ECONOMIST, Feb. 17, 1990, at 94.

275. Lee C. Buchheit, *Deja Vu All Over Again*, INT'L FIN. L. REV., Jan. 1992, at 7. For the four largest Latin debtors, Argentina, Brazil, Mexico, and Venezuela, the costs of servicing their bonds in 1989 was only about 5.5% of the their total debt-service burden. In 1989, Argentina owed private bondholders US$13.8 billion, Brazil US$2.2 billion, Mexico US$3.9 billion, and Venezuela US$2.2 billion. MacDonald, *A Word to the Wise*, 27 LATINFINANCE 43 (1991). As Estabanez wrote, "bond debt has de facto seniority over bank debt . . . due in part to the fact that, currently, bonds compose a relatively small portion of nations' total outstanding debt." Estabanez, *The View from Moody's*, 22 LATINFINANCE 47 (1990).

276. In the words of Martin Schubert: "From the private investor perspective, the new sovereign bond instruments are senior to other bank held indebtedness since borrowers are supposed to hold their bonds in greater esteem and are under more pressure to service bond issues than commercial bank debt . . . this has proven to be a historical fallacy." Martin Schubert, *The Latin American High Yield Debt Market — A Vehicle for the Long Term Investor, the Short Term Speculator, or the Buyer of Cheap Assets — A Provocative Analysis*, a speech delivered at the Fourth Annual Latin America Financial Forecast Conference, Miami, Sept 28-29, 1990, at 17 [hereinafter Schubert Speech V]. Latin American nations (except Brazil) issued £19 million of bonds in London in the 1820s. By 1828 all were in default. *See* MARICHAL, A CENTURY OF DEBT CRISES IN LATIN AMERICA 43 (1989). The next lending boom was in the 1860s which culminated in the first three years of the 1870s with close to 75 million pounds of bonds issued. The bubble burst in 1873 as the European stock markets crashed and worldwide trade declined precipitously. DELAMAIDE, DEBT SHOCK 94-99 (1984). The next major payment interruption on Latin America's foreign obligations was in the 1930s in the aftermath of the Great Depression. By the mid-1930s, almost 70% of national Latin American government dollar denominated bonds and almost 90% of municipal, provincial and corporate bonds were in default. *See* Skiles, *Latin American International Loan Defaults in the 1930s: Lessons for the 1980s?*, Federal Reserve Bank of New York, Research Paper No 8812, April 1988, at 1, 15 & 17; and Marichal, *supra* at 212-13.

represented only twenty percent of total LDC debt, they accounted for a majority of market trading.[277] The most actively traded debt in late 1990 and 1991 was the Brady bonds of Mexico and Venezuela.[278]

D. *Participants*

1. Traders

At the beginning of this period, in early 1989, there were perhaps a total of sixty trading units engaged in this market.[279] The three most active traders in the market at this time were Citicorp, NMB, and Morgan Guaranty, in that order.[280] Citicorp's trading volumes were aided by its own active program of reducing its exposure to the region, principally by conversions into equity.

By year-end 1989, the ranking had changed somewhat. A survey placed Morgan first with a volume of US$14 billion, NMB next with US$13.6 billion, and Libra Bank third with US$11.5 billion.[281] Libra Bank was a consortium bank established by ten other banks[282] and based in London where it was the most active trader.[283]

In 1990, Morgan continued to lead in the volume stakes by trading US$16 billion, face value, of debt. Manufacturers Hanover was second with US$14.5 billion and Chase Manhattan third with US$14.3 billion.[284] The next three most active traders were Bankers Trust with US$12.5 billion, Citibank with US$10.7 billion, and NMB with US$10.5 billion.[285] The other major traders in 1990, in descending order, were Chartered West LB, First Chicago, Samuel Montagu, Salomon Brothers, and Chemical

277. *Latin American Debt Holders Scored Big Gains, Index Shows, supra* note 234.

278. Corrigan, *supra* note 129, at 31.

279. Schubert Speech II, *supra* note 201.

280. Peter Truell, *Treasury Plan Should Benefit Some Banks,* WALL ST. J., Mar. 16, 1989.

281. Evans, *LDC Debt Market Facing Oversupply of Latin Paper,* AMERICAN BANKER, Mar. 14, 1990, at 1.

282. The banks include Chase Manhattan, National Westminster, Royal Bank of Canada, Swiss Bank Corp, Westdeutsche Landesbank, Mitsubishi Bank, Bancomer, Banco Itau, Credito Italiano, and Banco Espirito Santo e Commercial de Lisboa. *Id.*

283. London accounted for perhaps 20% of trading in the market at this time.

284. Murphy, *Moving Up,* 25 LATINFINANCE 55, 56 (1991).

285. *Id.* at 56.

Bank.[286]

In 1991, Chemical led in the trading stakes, benefiting from its merger with Manufacturers Hanover, with a trading volume of US$31 billion.[287] JP Morgan was next, followed by Chase Manhattan, Citibank, Morgan Grenfell,[288] NMB, Merrill Lynch, Salomon Brothers, Bankers Trust, and Banco Santander, in that order.[289]

All of the above trading volume figures are from each bank's own reported volumes.[290] The absence of any central exchange or recording facility for trades rendered independent verification impossible.[291] Accordingly, all figures have to be accepted with the proviso that self-interest may have figured in their compilation and competition amongst traders for prominence in these market rankings was fierce. For instance, in the 1990 survey in which traders were asked for their trading volumes, they were also asked to rank the five market leaders in terms of trading volume. Positions one to three and five were occupied by the same banks as in the self-reporting survey. However, as judged by their peers, NMB bank jumped from sixth place to fourth, and Bankers Trust fell from fourth place out of the top ten.[292]

There are many ways to inflate trading figures. Counting both sides of the debt exchanged in a swap is an easy way of increasing trading volume and somewhat justifiable if a trader wishes to classify its trades by volume of debt traded, i.e., a swap of Brazilian for Polish obligations appears under the amount of Brazilian debt traded and also under the amount of Polish debt traded. Some brokers included trading into and out of their own portfolios.[293] Others included new issues in the primary

286. *Id.*; *see* Kelash, *supra* note 260.

287. Voorhees, *Fasten Your Seatbelts*, 35 LATINFINANCE 57, 58 (1992).

288. Morgan Grenfell hired the entire Libra Bank trading team upon Libra being disbanded and thus rapidly acquired a substantial market presence. Pettis Interview II, *supra* note 47.

289. *Id.* This order is the one determined by peer assessment of each other's performance and has been preferred on the grounds of likely accuracy over the order based on the traders' own reported volume figures from which it differs slightly.

290. Murphy, *supra* note 284, at 55.

291. *Ten Market Leaders*, 20 LATINFINANCE 37 (1990) ("There is no neutral, factual source, for secondary market LDC debt trading volume or profits.").

292. Murphy, *supra* note 284, at 56. Chartered West LB, ranked seventh on its own figures, was also not placed by its peers in the top ten.

293. Voorhees, *Documentation Concerns — Mas o Menos*, 30 LATINFINANCE 42 (1991).

market or trades in securities in local Latin American stock exchanges.[294] Indeed, in the words of Kathy Galbraith, "It is very questionable. People inflate their numbers. They include everything but the kitchen sink. Some figures are grossly, ridiculously exaggerated."[295]

The LDC Debt Traders Association considered the issue and concluded there were no widely observed guidelines to be applied in determining volume. The Association chose not to implement its own survey in 1991 considering hard figures too scarce.[296] This in-built bias towards inflation presumably had a similar impact on the volume figures for the market given above, which must be read subject to the same qualifications.

The explosive growth in the market attracted many new traders: Dillon Read, First Boston, and Bank of Tokyo in 1989,[297] Goldman Sachs and Morgan Stanley in 1990,[298] and an Austrian bank, Osterreichische Landerbank, in 1991.[299] Some were however leaving the business. Libra's closure in 1990 surprised many in the market.[300] The new reserve levels set by the Bank of England required a 450 million pound capital contribution from shareholders. Dissolution of the bank and transfer back to the shareholders of their respective proportions of its loan book was seen as the more palatable option.[301]

As new traders joined the market, established trading units

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294. *Id.*

295. *Id.*

296. *Id.*

297. *Third World Debt*, XIII BANK LETTER, Dec. 25, 1989, at 4.

298. *Goldman Set to Launch LDC Trading Desk*, XIV BANK LETTER, Aug. 6, 1990, at 4; David Gillen, *Prices Adrift in Featureless Trading; Morgan Stanley Forms LDC Debt Unit*, BOND BUYER, Sept. 21, 1990, at 3.

299. *LDC Debt Trading Unit Formed By Austrian Bank*, 4 LDC DEBT REPORT, April 1, 1991, at 6.

300. *Libra's Disappearance*, 16 LATINFINANCE 6 (1990); *Shareholders Wind Down Libra*, 818 INT'L FIN. REV., Mar. 17, 1990, at 32. Of far less significance, Scandinavian Bank Group shut down its LDC debt trading units in New York & London in 1989. *Third World Debt — Watch out securitisation is on its way*, 703 INT'L FIN. REV., Dec. 12, 1987, at 3876. It had been in the business for less than two years and was also a consortium bank owned by banks in Sweden, Denmark, Norway, Finland and Iceland. *See Scandinavia Bank Pulls Out of LDC Trading*, XIII BANK LETTER, Oct. 30, 1989, at 4.

301. *Shareholders wind down Libra*, 818 INT'L FIN. REV., March 17, 1990, at 32. Libra was also closed because the era of consortium banks was coming to an end. Libra had been formed to spearhead the member's international expansion and by 1990 most banks were ready to expand internationally themselves. Pettis Interview II, *supra* note 47.

grew larger. For instance, in 1986, Salomon Brothers had only a few people in its LDC debt trading unit. By the end of 1990, Salomon had fifteen traders supported by a research and sales team.[302]

The advent of Brady bonds began to shift the balance of power among traders. In this period, the major commercial banks, such as JP Morgan, Chase, and Chemical, had the advantage of trading their own bank's portfolio of LDC credits and commercial banks were more comfortable in the world of loans, not securities. Brady bonds traded as conventional debt securities—a field in which the investment banks such as Salomon and Merrill Lynch were traditionally expert. Brady bonds presented the investment banks with an opportunity to take market share from their commercial banking brethren.[303]

The history of NMB tempts the pen. Until 1989, as Nederlandsche Middenstandsbank, NMB was a minnow among whales trading with the likes of Morgan, Citibank, and Salomon. In 1989, it merged with Postbank, Europe's largest postal savings bank, which more than doubled its assets and made it the third largest bank in The Netherlands.[304] In 1991, another merger, this time with The Netherlands' largest insurer, Nationale-Nederlanden, again almost doubled its assets.[305] This time the merger came with an entirely new name — the Internationale Nederlanden Groep, and the group became universally known as ING.[306] Whether in its current or earlier incarnations NMB/ING exhibited a commitment to innovation and a willingness to back its judgments. Its early, critical judgment was that there were profits to be earned in Latin America. Nothing innovative in that one could say, the international financial community believed it almost en masse in the 1970s. NMB, however, took this view in 1983. Unburdened by a portfolio of loans to the region, NMB moved into Latin America.[307] In 1983, it was the first non-Latin American bank to begin trading LDC loans in New York.

302. Steven Bavaria, *Mexico Comes Back to Market; The Miracle Recovery*, INVESTMENT DEALERS DIGEST, Dec. 10, 1990, at 17.

303. *Brady's Bazaar*, *supra* note 55, at 81.

304. *NMB Postbank - Leading the Field*, INT'L FIN. REV. REVIEW OF THE YEAR — 1990, AT 78 (spec. supp.).

305. *Nat-Ned NMB Postbank Merger Approved*, 864 INT'L FIN. REV., Feb. 9, 1991, at 22.

306. *NMB Postbank - Leading the Field*, *supra* note 304.

307. *Id.*

Subsequently, it acquired offices, branches and brokerages in Latin America at bargain basement prices from banks fleeing the region.[308]

Two men guided NMB in these years. By the late 1980s, Gerrit Tammes was vice-chairman of the bank. By background he was a trader who knew Latin America, having spent eight years in Surinam and Brazil. Tammes was prepared to back his judgments and go against the tide. His man on the ground in this market was Peter Geraghty, head of LDC trading in New York, and widely recognized as one of the market's most astute traders. The Dutchman and American made a strong team. In 1990, the *International Financing Review* appointed NMB its "LDC Debt Trading House of the Year."[309]

The year 1989 was highly profitable for most traders notwithstanding a severe price slide towards year-end[310] partly in response to provisioning by major U.S. and U.K. banks. Many of the major traders reportedly made massive profits in the first half of 1990 as the market went through a long rally in prices and trading volume increased dramatically.[311] In 1991, the trend of record profits continued with the longest bull run in the market's history. The trading of LDC debt was proving to be a much better business than the lending of it had been.

2. Brokers

A major new form of participant entered the market in 1988 as Tullet in New York established a LDC debt brokerage opera-

308. NMB bought the Chilean operation of JP Morgan, the Argentine branch of Barclays, a large brokerage house in Brazil, and a branch and joint venture to serve the Venezuelan market. The only other major bank to increase its presence in Latin America in the 1980s was Citibank and they didn't begin their build up as early as did NMB. *US Banks Continue to Reduce LDC Portfolios,* 861 INT'L FIN. REV. Jan. 19, 1991, at 23.

309. *NMB Postbank - Leading the Field, supra* note 304. However, change is the only constant in this market and in February 1988, ING Barings (as it then was) stopped all dedicated equities research, sales and trading for Latin America. Shortly thereafter, Peter Geraghty resigned. *See* Weever & Newton, *Barings to Suffer Massive Cutbacks,* SUNDAY TELEGRAPH, Mar, 8, 1988, at 1.

310. *Market Softens with Start of End-of-year Selling,* XIII BANK LETTER, Nov. 6, 1989; *Market Slips Further as Year-End Selloff Continues,* XIII BANK LETTER, Nov. 13, 1995. The price softness continued into 1990. *See The Next Secondary Market,* INT'L REPORTS, Jan. 15, 1990.

311. Siegel, *Money Centers Make Big Bucks Trading Distressed Country Paper,* XIV BANK Letter, June 25, 1990, at 1.

tion headed by Michael Scharfenberger.[312] In January 1990, Scharfenberger and his team left Tullet to set up an LDC broking unit within Eurobrokers Capital Markets[313] and, in July, Martin Quintin-Archard joined Intercapital Brokers Ltd to head the independent brokerage service they were establishing.[314] These were the first operations set up specifically to act as brokerages, as middlemen with no loan portfolios and without taking positions.[315] Scharfenberger said customers principally used brokers for two reasons: "They want to remain anonymous to the market at large and they want an overview as to where the market actually is."[316] Confidentiality was maintained by the identities of counterparties being disclosed only when a deal had been done. Brokers charged much lower fees than the traders.[317] In 1990, Intercapital charged three basis points on each side of a transaction for Brazilian or Mexican debt and four basis points on other trades.[318] The lowest regular fee of traders at the time was 1/8th percent, or 12.5 basis points.[319] After 1990, the increasing role of brokerages contributed significantly to the reductions in traders' margins.

This innovation by Quintin-Archard at Intercapital was to have profound implications for the market. Over time, the dramatic reduction in the cost of trading increased liquidity in the market markedly and the brokerages came to serve as clearing houses.[320] Although few realized it at the time, Martin Quintin-Archard in characteristically flamboyant style, had ushered in a new era in the market's growth.[321]

3. Sellers

The major sellers early in this period were the regional U.S. banks. Most of these banks continued the policy begun in 1988

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312. *LDC Players: the Broker,* 825 INT'L FIN. REV., May 5, 1990, at 36.

313. Eurobrokers were well known for their worldwide operation in Eurodollar time deposits, and interest rate and currency swaps.

314. *Intercapital in LDC Broking,* 834 INT'L FIN. REV., July 7, 1990, at 29.

315. *LDC Players: the Broker,* 825 INT'L FIN. REV., May 5, 1990, at 36.

316. *Id.*

317. *Id.*

318. *Attracting Attention,* 852 INT'L FIN. REV., Nov. 10, 1990, at 34.

319. Pettis Interview II, *supra* note 47.

320. *Id.*

321. *Id.*

of liquidating their LDC loan portfolios.[322] As one commentator wrote in September 1990, "The big U.S. regional banks uniformly followed the same strategy for dealing with LDC debt during the past 18 months. They kept running like hell."[323] Furthermore, the major U.S. banks, for the first time, began to sell loans and Brady bonds, once issued, into the secondary market. For instance, Bank of America swapped or sold some US$1.16 billion of LDC loans in 1989.[324] JP Morgan, likewise, reduced its exposure by US$1 billion in 1989.[325] In this period, Japanese banks started to sell significant amounts of debt for the first time in the market's history.[326] As had been the case with the U.S. banks, the larger Japanese banks were much slower to get involved in selling their portfolios.[327] The early sales activity from Japan involved smaller Japanese banks that saw asset sales as a relatively painless way to meet the new capital adequacy standards.[328]

In summary, in this period, the sellers fell into two categories. The first were the U.S. regionals most of whom were following a 'sell at all costs' policy. The second came into prominence as the period progressed and consisted of the major U.S., European, and Japanese banks. Their approach was to reduce exposure gradually through considered sales.[329]

4. Buyers

In 1990, the market began to see more high-yield inves-

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322. By August 1990, Wells Fargo, Security Pacific and First Interstate had disposed of virtually their entire exposures to Latin America and many other regional banks, such as Mellon, First Chicago and Bank of New York, had aggressively reduced their exposures. Froman, *Creditor Review — Color Me Gone*, 20 LATINFINANCE 58 (1990).

323. *Id.*

324. Froman, *Creditor Review — Bank of America*, 20 LATINFINANCE 66 (1990).

325. Froman, *Creditor Review —JP Morgan*, 20 LATINFINANCE 69 (1990); *see* Froman, *Creditor Review — Citibank*, 20 LATINFINANCE 65 (1990).

326. *Brazil, Argentina Loans Offered By Japan Bank*, 4 LDC DEBT REPORT, June 3, 1991, at 2 (reporting the offering for sale of US$80 million of Brazilian loans and US$36 million of Argentine loans by "major Japanese bank"); *Japanese Selling Mexican Exposure*, 4 LDC DEBT Report, Feb. 18, 1991, at 12. Japanese banks wrote their Mexican debt down to market value shortly after the issuance of Mexico's Brady bonds in March 1990. Siegel, *Are the Japanese Ready to Sell?*, XIV BANK LETTER, April 9, 1990, at 1; *Japanese Selling Mexican Exposure*, *supra* at 12.

327. *Id.* at 12.

328. *Id.* Sales of LDC loans realised cash which could be used to boost capital as well as removing an asset for which capital would have to be held.

329. Pettis, *supra* note 154, at 118.

tors.[330] The decline in the U.S. domestic junk bond market in 1989 had left a body of investors with an unsatisfied appetite for high yields.[331] LDC debt, particularly the debt of oil-producing LDCs, was seen as an attractive high-yield investment.[332] The Brady bonds of Mexico and Venezuela gave traders a salable security and many were active in seeking private investor buyers. Salomon Brothers, for instance, produced a bound, twenty page report promoting the benefits of investing in LDC sovereign bonds.[333] The report mentioned the "seniority" of bonds over bank debt and the excellent record of debt service on bonds seven times in the first eight pages.[334] The fact that the recent historical advantages of bonds were disappearing as Brady and other[335] bonds replaced bank loans was mentioned once, on page nine, and against this were arrayed three countervailing factors.[336] Banks were particularly interested in marketing sovereign bonds to Latin American private investors who knew the debtor nations and were interested in investments for flight capital.[337]

Numerous high-yield LDC debt funds were also beginning to appear which offered investors a share in a portfolio of LDC bonds or loans.[338] As Salomon Brothers wrote in a promotional

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330. *Id.* at 117.

331. *Junk' of the 1990s?*, 823 INT'L FIN. REV., April 21, 1990, at 28; Lee C. Buchheit, *Return of the Living Debt*, INT'L FIN. L. REV., May 1990, at 28.

332. Kelash, *supra* note 260.

333. JOHN PURCELL ET AL., DAMRAU & FRANKLIN, DEVELOPING COUNTRY SOVEREIGN BONDS: OPPORTUNITY IN A NEW ASSET CLASS (April 1990) (on file with the *Fordham International Law Journal*).

334. *Id.* at 1-2, 5-8.

335. The return of these borrowers to the voluntary capital markets has almost invariably been through the issuance of either eurobonds or bonds in the domestic U.S. market usually by way of a private placement.

336. The countervailing factors mentioned in the report were that (i) bondholders could take legal enforcement action more easily than bank lenders, (ii) rescheduling of bonds would harm debtors' reputations more than the rescheduling of bank debt, and (iii) banks appeared ready to grant explicit seniority to Brady bonds over loans. PURCELL, DAMRAU, ET AL., *supra* note 333, at 9.

337. Schubert Speech V, *supra* note 276, at 16; PURCELL, CHANG, ET AL., DEVELOPING COUNTRY SOVEREIGN BONDS: RECENT DEVELOPMENTS IN A NEW ASSET CLASS 8 (1991)(24 pg booklet produced by Salomon Brothers)(copy on file with the *Fordham International Law Journal*).

338. Schubert Speech V, *supra* note 276. One of the first funds designed to invest in Latin American government bonds was entitled *The Sovereign High-Yield Investment Company*. It was formed in November 1989 to invest in U.S. dollar denominated bonds of countries such as Mexico, Brazil, Argentina, and Venezuela. As such, the fund aimed

booklet, "During the latter part of 1990 and early 1991, nonbank institutional investors entered the market in a serious way."[339] The uptick in prices in Mexican bonds in mid-December 1990 was significant because it was caused by demand from institutional investors. As Pettis said, "In the past, prices have moved largely because of demand for debt-equity . . . it is significant in that we have never seen institutional investors move prices in this market."[340]

In 1991, an entirely new group of high-yield buyers entered the market in significant numbers, a group of buyers with implications for the degree of regulation required for this market. U.S. pension funds and insurance companies and European non-bank institutions and retail buyers began acquiring LDC debt, principally the Brady bonds of Mexico and Venezuela.[341]

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to benefit from the superior repayment record of bonds over loans. It was managed by Scudder, Stevens & Clark and underwritten by Merrill Lynch and was the precursor to many such funds which were formed after the issuance of the first Brady bonds. *See Foreign Investment Funds — Directory*, 18 LATINFINANCE 49, 50 (1990); Hughes, *The Current Stage of the Overall Debt Situation*, TENTH ANNUAL REVIEW OF BANKING LAW 335, 342-43 (1991); A. C. Quale Jr., *Tapping the International Capital Markets Using Sophisticated Asset Securitization Techniques*, a paper delivered at the Latin High Yield Conference, May 30-31, 1991, New York City, 9-10. Other examples of early investment fund arrangements were the private placement in December 1989 of shares in five special purpose companies incorporated in Guernsey to acquire and hold LDC debt and benefit from the exceptional yields of this debt, and the trust structure created by Merrill Lynch which issued fixed-rate securities backed by floating-rate Venezuelan debt conversion bonds. These synthetic securities were targeted at retail and institutional investors. *See Secondary Market for Venezuelan Bond Swaps Gets Underway*, XV BANK LETTER, Sept. 2 1991, at 4. Some funds formed to invest primarily in equities in Latin America would also put a slice of their capital into debt. *See Funds are the way to go in Latin America*, 834 INT'L FIN. REV., July 7, 1990, at 33. For a general analysis of the securitization of LDC loans. *See* Quale, *supra*.

339. PURCELL, CHANG, ET AL., *supra* note 333, at 8.

340. *Secondary Market Report: Mexican Bonds Up Sharply*, 857 INT'L FIN. REV., Dec. 15, 1990, at 29. Martin Schubert described the market in 1990 as "now being aimed at non-bank and private individual investors solely on the basis that the credit at its huge discount after being repackaged, is now fully priced." Schubert Speech V, *supra* note 276, at 8.

341. Richard Waters, *Brazilian Debt Back On The Defensive*, FIN. TIMES, Oct. 31, 1991, at 29; Michael Pettis, *The Emergence of the Latin American Debt Market*, *in* THE NEW HIGH YIELD BOND MARKET - INVESTMENT OPPORTUNITIES STRATEGIES AND ANALYSIS (Lederman & Sullivan, eds.). This move into LDC debt investment was part of the marked trend of U.S. pension funds to invest abroad — from 1980 to 1990 overseas investments by U.S. pension funds grew from US$21 billion to US$250 billion. *See* Welles & Roman, *The Future of Wall Street: Why Our Financial System Will Never Be the Same*, BUS. WEEK, Nov. 5, 1990, at 122.

E. *Impact of the Market*

The principal impact of the market in this period was that it facilitated the Brady plan. The essence of the Brady plan, the securitization of loans into discounted bonds, could have been developed and implemented without a developed secondary market.[342] It would have been far more difficult, however, and less likely.[343] The secondary market afforded the prototype for these loans being traded as bonds. The market proved there was a market for, and investors to buy, more liquid instruments.[344] The secondary market laid the groundwork without which the Brady plan would have been a far greater step into the unknown. Indeed, this greater degree of risk probably would have mitigated against the involvement of the U.S. government in advocating the plan in this form.

Whether the Brady plan was a positive or negative development is open to debate. Many bankers and some other commentators believe that debt relief was unnecessary for the major Latin American borrowers. Many others believe that the debt relief afforded by the plan was far too limited and that the daily suffering caused by servicing the Brady bonds is intolerable. What is clear is that the Brady plan owes a real debt to the secondary market and the plan allowed the granting of limited debt relief in a politically palatable form. A straight reduction in principal outstanding or interest rates owing would have provoked far more of a political backlash in North America than did the same steps undertaken within the context of the securitization of the loans.[345]

The next most significant impact of the secondary market in this and the preceding period was the manner in which it assisted the collapse of creditor solidarity.[346] As we have seen, the market permitted the smaller, less burdened U.S. and European

342. Schubert Interview I, *supra* note 177.

343. Interview with Michael Chamberlin, Executive Director of EMTA, New York City, December 8, 1994.

344. *Id.*

345. There was strong popular opinion against any use of taxpayer funds to "bail out" the banks from the debt crisis and the use of IMF and World Bank funds to assist with the acquisition of the bonds' collateral can be seen as such a use of taxpayer funds. Furthermore, there were strong voices raised against debt relief for these "profligate" debtor nations, voices which were strangely quiet in opposition to the entire Brady plan package.

346. MacMillan, *supra* note 7, at 328-29.

banks to liquidate their holdings of LDC debts. No longer were the interests of all creditors alike. Creditors with smaller exposures now had an alternative to advancing new money as part of debt restructurings and took it. This collapse of creditor solidarity and involuntary lending made debt relief essential and heralded the Brady Plan.[347]

Another principal impact of the secondary market during this period was in facilitating informal debt buy-backs by debtors. Formal debt buy-back schemes can proceed independently of a secondary market as repurchases are made from the original lenders, although without a market there is no objective pricing mechanism.[348] Informal schemes require a secondary market as the purchaser of the debt is an entity separate from the borrower. Informal schemes appear to have retired far more debt than formal schemes in this period and at substantially greater discounts[349] than were part of the securitization of these loans under the Brady plan. Informal buy-backs were a major source of debt-relief for debtor nations such as Argentina and Brazil. Indeed, over a number of years, the amount of debt relief afforded by informal buy-backs may have exceeded the relief granted as part of the eventual Brady-style securitization of those nations' loans.[350]

The advent of LDC derivatives owes a debt to this market. The options themselves could have been issued without a market but the purposes for which they were typically issued would have been absent and the banks and brokers which issued the options would not have had the expertise in these assets to do so. Like-

347. David C Mulford, as Treasury Undersecretary, is generally credited as being one of the architects of the Brady Plan. In his words, "It was not only becoming harder to get the banks to put up new money, they were beginning to withdraw from the region. Banks were beginning to sell their positions in the market, take losses, it was clear that [the Baker] plan would have to be substantially revised." Tobin, *Reaping the Benefits*, INT'L FIN. REV. INTER-AMERICAN DEVELOPMENT BANK REPORT, Mar. 1993, at 18.

348. Pettis Interview II, *supra* note 47.

349. The discounts ranged from 50% to 80% depending upon the price of the debt in the secondary market.

350. The actual volume of debt retired by informal buy-backs is not known but would appear substantial. As is the norm in this field, there are those who believe debt buy-backs do not benefit the debtors and are an inappropriate use of their reserves. The popularity of buy-backs mitigates against this view and this writer does not subscribe to it. Debt-equity swaps attracted both proponents and opponents in the literature and this was eventually reflected in their declining popularity with debtor governments. Such has not been the pattern with debtors' attitudes to buy-backs.

wise, the reciprocal exchanges of debt between debtor nations, which proved a simple and cost-effective way for the poorer Latin American countries to satisfy their obligations, to their better-off neighbors would have been impossible without the secondary market.

In this period, for the first time, the market began to fulfill its clearing function. In theory, this is one of a market's more important roles for investors will avoid a market with a perceived overhang of sellers. Once the market was able to absorb the supply of debt the greater involvement of institutional investors was predictable. A persuasive case can be made that the main reason the crisis lasted throughout the 1980s and the prices of the debt eventually fell so low was the absence of a large, active secondary market in the first five years of the debt crisis. The market had to become large enough to fulfill its clearing function before it could play its significant role in the resolution of the crisis from the bank's perspective.[351]

The two principal impacts of the secondary market identified in the previous period continued in this one. Debt-equity swaps were made possible for investors who had not been lenders[352] and, in this period, exchanges of debt for equity facilitated privatizations throughout Latin America. Banks with smaller LDC exposures were able to liquidate their portfolios and banks with major exposures were able to reduce them.

Finally, the first few days of the next period were to witness the market having a broader impact than ever before. Pension funds in Massachusetts, the rainforest in the Amazon basin, and bank shareholders in Peoria, Illinois, all were to be affected by the developments to follow.

II. *THE MARKET'S YOUNG ADULTHOOD: OCTOBER 1991 TO DECEMBER 1993*

A. *The Major Events in This Period*

1. The Brazilian Collapse of 1991

The price of Brazilian debt increased throughout the bull

351. Pettis' Interview II, *supra* note 47.

352. Creditors are able to participate in debt-equity conversions without recourse to a secondary market as Citicorp, Bankers Trust, and Manufacturers Hanover did extensively in the Late 1980s. Other investors, however, require a secondary market from which to acquire the debt for conversion.

run of 1991. In early January it traded at 26.5 cents on the dollar[353] and by September had reached 40 cents.[354] Throughout October the market for Brazilian debt was jittery and in the last week of October plunged to 20 cents before steadying at around 24 cents.[355] Argentina was the other major debtor awaiting a Brady style restructuring and its loans fell from 41 cents to 27 cents before stablilising at around 34 cents.[356] The debts of countries as diverse as Morocco, Poland, and the Philippines were also affected.[357] The only debts to withstand the initial fall were those of nations with a Brady style restructuring in place, such as Mexico and Venezuela[358] — and Venezuela's debt was, in any event, affected by the subsequent general market skittishness.[359]

On Monday October 28, 1991, the price of Brazilian loans plummeted 22.2%.[360] This compares to the twenty-three percent fall in the value of the Dow Jones Industrial Average[361] on 'Black Monday,' October 19, 1987.[362] The 1987 New York stock market crash was studied in great detail and depth[363] and no single cause has emerged. In its report to Congress, the SEC noted that "we may never know what precise combination of investor psychology, economic developments and trading technol-

353. *LDC Secondary Market Debt Prices*, 859 INT'L FIN. REV., Jan. 5, 1991, at 31.

354. *Brazilian Debt Takes a Pounding; Price Hits 20 Cents as Hope Fades for Mexico-Style Pact*, *supra* note 253.

355. *Id.*

356. *Id.*

357. Richard Waters, *Brazilian Debt Back on the Defensive*, FIN. TIMES, Oct. 31, 1991, at 29; *see Bears Hold LDC Debt Market As Uncertainty Prevails*, 4 LDC DEBT REPORT, Nov. 11, 1991, at 2.

358. Waters, *supra* note 357.

359. *Venezuelan Coup Rumours Upset Market Briefly*, 4 LDC DEBT REPORT, Nov. 25, 1991, at 2; *Contrary to Rumor*, 33 LATINFINANCE 11 (1991).

360. The price dropped from 27 cents on the dollar to 21 cents. This followed a fall of 18% on Friday, October 25 (from 33 cents on the dollar to 27 cents). *See* Voorhees, *Brazilian Meltdown*, 32 LATINFINANCE 12 (1991).

361. The Dow Jones Industrial Average measures the movements in the 30 major industrial stocks listed on the New York Stock Exchange.

362. The Dow fell some 508 points on this day of the "Crash." *See Regulation for the Securities Markets?*, 10 ANN. REV. BANKING L. 379 (1991).

363. *See* James V. Feinerman, *Internationalizing U.S. Capital Markets in Global Context: Problems and Prospects*, 28 L. AND POL'Y IN INT'L BUS. 605, 607 (1997) (discussing causes of New York stock market crash and declines occurring on London, Tokyo, and Hong Kong exchanges); Jerry W. Markham, *Federal Regulation of Margin in the Commodities Futures Industry—History and Theory*, 64 TEMP. L. REV. 59, 140 (1991) (detailing possible causes of stock market crash of 1987).

ogies caused the events of October."[364]

October seems a bad month for financial markets. No detailed study of the October 1991 collapse in the LDC debt market has been done, yet it appears that its causes are more readily indentifiable than was the case for the 1987 Crash.

Causes of the October 1991 Collapse

As with the 1987 Crash there were a multitude of causes of the 1991 LDC debt collapse, with the following four the most commonly cited:

> 1. A gathering economic storm broke in Brazil in October: fears of hyper-inflation and growing antagonism between the government and business drove the currency down on the black market,[365] official exchange rates were devalued by fifteen percent, and adverse export figures were released for September.[366] Furthermore, Brazil's economic fundamentals were not good[367] and it had flooded the new issues market by issuing over US$1 billion of debt in the preceding two months.[368]
> 2. The Usiminas privatization was postponed in September until October 15, 1991, after a court held that rescheduled Brazilian foreign loans could not be used in the privatization.[369] This decision was then reversed two days later by a higher court.[370] Nonetheless, the market softened with the postponement of the privatization auction; investor interest cooled and some large positions, taken in anticipation of the loans being used to acquire a stake in the steel group, were liquidated.[371] There was another extension before the priva-

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364. The Division of Market Regulation of the Securities and Exchange Commission ("SEC"), The October 1987 Market Break, *reprinted in* Fed Sec L Rep (CCH), Special Rep No 1271 (Feb 9, 1988) at xi.

365. Waters, *supra* note 357; Voorhees, *Brazilian Meltdown*, 32 LATINFINANCE 12 (1991).

366. *Subdued Secondary Market Takes a Breather*, 903 INT'L FIN. REV., Nov. 9, 1991. Brazil's exports fell 25% between August and September and the US$35 million balance of trade for September was the smallest of 1991.

367. *Id.*

368. *Brazil's Problems Give Investors Cold Feet*, 898 INT'L FIN. REV., Oct. 5, 1991, at 29. The principal issuers of the debt had been parastatals like Petrobras and Telebras. *Brazil: A Long Way to Go*, 900 INT'L FIN. REV., Oct. 19, 1991, at 21.

369. *Brazil's Privatisation Delays Widen Credibility Gap*, 897 INT'L FIN. REV., Sept. 28, 1991, at 20.

370. *Id.*

371. Belgo-Minera, a Belgian metals group, withdrew from the bidding to acquire

tization eventually went ahead on October 24. Even then, the low participation rate of foreign investors[372] reduced confidence in foreign investment in Brazil's proposed privatization programme[373] and thus in the sustained demand for Brazilian debt.

3. As with the Crash of 1987, technical factors contributed to the fall. Early in the sell-off, some traders were simply realizing year-end gains. During the long bull run, put options had been sold at out-of-the-money strike prices to banks for exposure limitation purposes and were now exercised.[374] Furthermore, margin calls played their usual significant role in a sell-off and forced sales by those who had acquired loans on margin.[375]

4. The major cause of the collapse was probably that most traders were long[376] on Brazilian loans in August and September in expectation of price rises on the long-awaited Brady style restructuring for Brazil.[377] This strategy had proven

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Usiminas, and sold a large holding of Brazilian debt acquired in anticipation of the debt-equity auction. James Krause, *Fed Probes Third World Debt Trades At Top Banks*, AM. BANKER, Jan. 17, 1992, at 1.

372. Foreign investors accounted for only 6 to 7% of successful bids in the privatization auction. One of the reasons for this was that very little Brazilian foreign debt was tendered in the auction. Investors were prepared to bid higher prices using privatization certificates. These certificates, held principally by domestic companies, had been issued earlier in return for confiscated bank deposits and would have begun to decline in value if not used reasonably quickly. *Usiminas Sale: The Winners and the Losers*, 901 INT'L FIN. REV., Oct. 26, 1991, at 20.

373. Waters, *supra* note 357; Voorheés, *Put Out*, 32 LATINFINANCE 12 (1991). Little foreign participation in Brazil's privatization program would mean a major reduction in anticipated demand for Brazil's debt and consequently lower longer-term prices.

374. *Banks Study Debt Market in Brazil Led Crash's Wake*, 4 LDC DEBT REPORT, Nov. 11, 1991, at 1.

375. *Id.* With respect to the realization of end of year gains, Michael Pettis has a theory that there is a regular annual sell-off in this market as traders prepare for the calendar year end and bank management calculates the amount of profits it is willing to forgo in the name of reducing exposure to LDC debts. Interview with Michael Pettis, now a Managing Director at Bear Stearns & Co., New York City, April 24, 1993 [hereinafter Pettis Interview I]; Pettis, *supra* note 154, at 118. The theory is borne out by events in 1989. *Market Slips Further as Year-end Selloff Continues*, XIII BANK LETTER, Nov. 13, 1989, at 3. And, to a much lesser extent, 1993. In 1993 a major price slump in the first week of November accompanied a selling spree in which many assets fell in value 5-6 points. *See Savage Secondary Selling Spree*, 1004 INT'L FIN. REV., Nov. 6, 1993, at 41. But overall the institutional investors sustained the demand for debt through a jittery October and year-end and there was not a repeat of earlier end-of-year crashes. *See The Making of a Market*, INSTITUTIONAL INVESTOR, April 1994, at 66.

376. Waters, *supra* note 357.

377. Corrigan, *supra* note 254.

highly profitable in the case of Mexico and Venezuela.[378] Once it became clear Brazil and the banks could not agree on terms and the restructuring would not occur soon, traders sold these positions.

2. Brady Restructuring Agreement with Argentina

Argentina and its bank advisory committee announced their agreement in principle on this long-awaited restructuring on April 7, 1992.[379] The terms were close to the Mexican model with the banks being given the choice between thirty-year fixed interest par bonds,[380] thirty-year discount bonds,[381] and new money loans.[382]

Interest rates decreased after this preliminary agreement with the result that the overwhelming majority of creditors chose par bonds.[383] The restructuring was then delayed while Argentina tried to persuade its creditors to take thirty-five percent of their debt in discount bonds.[384] Because par bonds leave princi-

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378. *Id.*

379. Voorhees, *Betting on Brady*, 37 LATINFINANCE 14 (1992); *Argentina: Lots of Work Remains on Agreement*, 924 INT'L FIN. REV., April 11, 1992, at 30. In January 1992, before Argentina's restructuring, Nigeria had implemented a simplified Brady scheme under which it repurchased a portion of its loans and transformed the balance into par bonds. *The Salomon Brothers Brady Bond Index: Impact of Recent Events and Return Prospects*, Mar. 26, 1992, at 2 (copy on file with the *Fordham International Law Journal*). The Nigerian Brady restructuring was unusual in that it did not result in a perceived improvement in Nigeria's economic prospects (as reflected in secondary market prices for its debt) and the country did not subsequently return to the voluntary international capital markets. Clark, *supra* note 32, at 53.

380. The par bonds paid interest at 4% in year one rising progressively to 6% in year seven and thereafter. There was full collateral for principal and a 12 month rolling interest guarantee.

381. The discount bonds had the standard 35% discount of principal, paid Libor plus 13/16% and had the same collateral as the par bonds.

382. Voorhees, *Betting on Brady*, 37 LATINFINANCE 14 (1992). Argentina remained some US$8 billion in arrears on its interest payments. Under this restructuring proposal the great majority of these arrears would be converted into past-due interest bonds. These unsecured bonds pay a floating interest rate above Libor and have a term of twelve years. Earlier versions of the proposed Argentine restructuring were far more complex and unconventional but these were discarded in favor of simplicity. *See Evaluating the Argentina Brady Exchange Proposal*, Mar. 2, 1992 (copy on file with the *Fordham International Law Journal*).

383. Argentina's creditors initially opted about 80% for par bonds and 20% for discount bonds. *Argentine Brady Deal*, 942 INT'L FIN. REV., Aug. 15, 1992, at 24. Other reports put the ratio at 90:10 in favour of par bonds. *Banks Get Behind Argentina*, 948 INT'L FIN. REV., Sept. 26, 1992, at 22.

384. *Argentinean Debt Negotiations*, 944 INT'L FIN. REV., Aug. 29, 1992, at 30.

pal unreduced, they require more funds for the acquisition of the zero coupon bonds as collateral for the principal than do discount bonds and Argentina could only afford the collateral if at least thirty-five percent of the bonds had discounted principal.[385] Argentina was eventually able to persuade its creditors to take thirty-five percent of their exposure in discount bonds in time for a December 1992 signing of the restructuring.[386] The restructuring was finally completed in April 1993 with the issuance of the Brady bonds.[387] The bonds were held in escrow until reconciliation of the ownership and consequential interest entitlements of the loans could be completed. Reconciliation required recreating the ownership history of each piece of debt, some of which had been traded hundreds of times.[388] This was particularly important because, for a number of years, Argentina had either made no or only partial payments of interest.[389] To further complicate matters Argentine loans had traded both with and without past due interest for about three years before the issuance of the Brady bonds. The last interest to be reconciled was the overdue interest on Argentina's bank loans. Some US$6.6 billion of bonds were issued and US$636 million of cash paid for eighty-five percent of this interest in October 1993.[390] In December, a further US$1.2 billion of bonds and cash were distributed leaving less than four percent of past due interest still to be reconciled in 1994.[391]

3. Preliminary Brady Restructuring Agreement with Brazil

Brazil and its creditors reached agreement on the terms of the long-awaited Brady style restructuring in mid-1992.[392] At the

385. Argentina received around US$2 billion in loans from the IMF, the World Bank, and the Inter-American Development Bank to purchase the collateral for the Brady bonds. *Emerging Markets — Argentina Gets Brady Money*, 961 INT'L FIN. REV., Jan. 9 1993, at 42.

386. *Banks Get Behind Argentina*, 948 INT'L FIN. REV., Sept. 26, 1992, at 22; *Argentina: 'Went as Expected'*, 950 INT'L FIN. REV., Oct. 10, 1992, at 31; *Argentina's Brady Signed*, 959 INT'L FIN. REV., Dec. 12, 1992, at 29.

387. *Argentina Issues its Bradys*, 974 INT'L FIN. REV., April 10, 1993, at 25.

388. *Id.*

389. *Argentina FRBs Issued*, 1003 INT'L FIN. REV., Oct. 30, 1993, at 41.

390. *Id.*; *Argentina — FRBs Near*, 999 INT'L FIN. REV., Oct. 2, 1993, at 50.

391. *Argentine — US$1.1bn FRBs Released*, 1011 INT'L FIN. REV., Dec. 31, 1993, at 30.

392. *Q&A: William Rhodes*, 39 LATINFINANCE 87 (1992); *Brazil Signs $44bn Brady deal*, 937 INT'L FIN. REV., July 11, 1992, at 28. The menu brazil agreed with its creditor banks included: 30-year discount bonds at LIBOR plus 13/16th%, with collateral for

time, leading bankers were optimistic of a relatively rapid completion of the restructuring[393] — an optimism which was utterly misplaced. Again, as with Argentina, interest rates declined after the terms of the restructuring were set and before the banks were required to select their options from the menu. As a result, the selections were heavily biased in favor of par bonds and the acquisition of collateral required more funds than Brazil had available.[394] Brazil sought to have creditors rebalance their selections of restructuring instruments; a process which proved to be very time-consuming: agreement on new options was not reached until July 1993.[395] Even then, the process was not over as Brazil was unable to obtain an IMF accord and funding by the November 30 deadline.[396] A new deadline of April 15 was set for the completion of the rescheduling. Unlike other debtors, Brazil did not need the IMF funds to be able to acquire the collateral for the Brady bonds.[397] The U.S. Treasury was not willing to sell the zero coupon bonds needed as collateral to Brazil, how-

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the principal and a 12-month rolling interest guarantee; 30-year par bonds paying 4% in year one rising progressively to 6% for years 7 to 30 and with the same collateral as the discount bonds; 15-year front-loaded interest reduction bonds ("FLIRBs") paying 4% for years one and two, 4.5% for years three and four, 5% for years five and six, and LIBOR plus 13/16% thereafter, and collateral only for a 12-month rolling interest guarantee for the first six years; 18-year new money bonds equal to 18.18% of a bank's exposure and paying Libor plus 7/8%; new money loans with a tenor of 20 years, the same interest rate as the FLIRBs, and progressively higher repayments of principal; and 20-year capitalisation bonds with the same interest rates as FLIRBs except that for years seven on the rate is 8% fixed, not a floating rate, and the difference between the lower interest rates for years 1 to 6 and 8% will be capitalised (these bonds have no collateral).

393. *Q&A: William Rhodes*, 39 LATINFINANCE 87 (1992).

394. The commercial banks elected for almost 60% of the debt to be converted into the two available classes of par bonds, and for almost 20% to be converted into discount bonds. Brazil sought a maximum of 40% of par bonds and a minimum of 35% of discount bonds. *See Brazil Asks to Extend Deal Closing to Nov 30*, LDC DEBT REPORT, May 31, 1993, at 1.

395. *Brazil Brady on the Way*, 988 INT'L FIN. REV., July 17, 1993, at 45. Brazil had requested creditors to take no more than 40% of their debt in par bonds and no less than 35% in discount bonds. *Brazil: Rebalancing Update*, 981 INT'L FIN. REV., May 29, 1993, at 60.

396. *Brazil Requests Brady Extension*, 997 INT'L FIN. REV., Sept. 18, 1993, at 47.

397. *Id.*; *Brazil — Under Pressure*, 998 INT'L FIN. REV., Sept. 25, 1993, at 47; *Brazil — Collateral at Issue*, 991 INT'L FIN. REV., Aug. 7, 1993, at 40. By the end of October, 1993, Brazil's foreign exchange reserves were about US$29 billion. *Brazil — Critical Mass Reached*, 1010 INT'L FIN. REV., Dec. 18, 1993, at 48. This was up from US$7 billion in November 1991. *Market Down on Thin Volume*, 905 INT'L FIN. REV., Nov. 23, 1991, at 22. IMF funds were needed only for the vote of confidence they represented.

ever, without an IMF deal and the restructuring agreement had been made conditional upon an IMF accord being in place.[398] Cross-conditionality of official and commercial bank lending was alive and well. At the eleventh hour in March 1994, however, when the IMF would still not commit its funds,[399] Brazil revealed it had purchased the necessary U.S. Treasury zero-coupon bonds in the open market and intended to proceed with the rescheduling anyway.[400] Brazil then promplty obtained waivers of the term which made the IMF agreement a condition of the closing[401] and Brazil's Brady restructuring was the first to proceed without the formal support of the IMF.[402]

After the completion of Brazil's Brady scheme, Brazil's bonds represented thirty-seven percent of the total, Mexico's twenty-five percent, Argentina's twenty-four percent, and Venezuela's fourteen percent.[403]

4. Debtor Nations Sued

In 1990, Paraguay instituted a program to repurchase, on a confidential basis, its debt in the secondary market through Finance Consult[404] and First Boston & MG Emerging Markets[405] and had reduced its outstanding commercial bank debt to only US$230 million. At the time, Paraguay was refusing to meet payments on interest or principal, despite relatively healthy foreign exchange reserves. This classic instance of moral hazard[406] galled bankers.[407] Banque de Gestion Privee, a part of the Credit Agricole group of France, acquired some US$20 million of Paraguayan debt in the secondary market and sued to enforce

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398. *Id.*; *Brazil — Under Pressure*, 998 INT'L FIN. REV., Sept. 25, 1993, at 47.

399. The IMF said no "in the nicest possible way" by taking notice of Brazil's "significant record of progress" in addressing its inflation problem. *No IMF Letter for Brazil*, 1022 INT'L FIN. REV., Mar. 19, 1994, at 49.

400. *Id.*

401. *Brazil — Waiver Approved*, 1023 INT'L FIN. REV., Mar. 26, 1994, at 46.

402. *No IMF Letter for Brazil*, 1022 INT'L FIN. REV., Mar. 19, 1994, at 49.

403. Krengel, *Brady Bonds and Their Message for Equity Markets*, LATIN AMERICAN BI-WEEKLY BULLETIN 3 (1994).

404. *Banque de Gestion Privee — SIB v Republica de Paraguay and Banco Central del Paraguay*, 787 F. Supp 53.

405. Interview with YY (name witheld on request) formerly a senior trader with one of the major trading houses, New York City, April 1993 [hereinafter YY Interview].

406. For further consideration of such moral hazards, see text accompanying note 168.

407. *Attaching Paraguay*, 34 LATINFINANCE 14 (1992).

the terms of the loan agreements.[408] In 1992, it received summary judgment and a court order attaching assets of the Central Bank of Paraguay held by Swiss Bank Corporation in New York to satisfy the debt.[409]

In September 1993, a small trading house, Pravin Banker Associates, received summary judgment against Peru for non-payment of its debts.[410] The boutique had sued Peru for the full face value of US$1.4 million of Peruvian loans it had acquired in the secondary market in December 1990 for 27 cents on the dollar.[411] At the same time, a Swiss emerging markets boutique sued Ecuador for US$30 million based on the face value of loans and unpaid interest. This suit was settled for an undisclosed amount. The proceeds of the settlement were for the Swiss boutique alone and did not accrue to other creditors.[412]

The final law suit against a debtor nation in this period warrants special consideration.[413] In 1993, the Dart family were Brazil's fourth largest creditor with an exposure of US$1.4 billion under the Multi-Year Deposit Facility Agreement dated as of September 22, 1988 ("MYDFA").[414] In March 1993, as part of the restructuring, the Darts elected to have all of their MYDFA debt converted into capitalization bonds, so-called C-bonds, which had a tenor of twenty years, and paid reduced interest rates for the first six years and eight percent thereafter, with the difference between the lower interest rates and eight percent to be

408. *Banque de Gestion Privee — SIB v Republica de Paraguay and Banco Central del Paraguay,* 787 F Supp 53.

409. *Attaching Paraguay,* 34 LATINFINANCE 14 (1992).

410. *Pravin Banker Associates Ltd v Banco Popular del Peru and The Republic of Peru,* 895 F. Supp 660 (S.D.N.Y. 1995); *Pravin Banker Associates Ltd v Banco Popular del Peru and The Republic of Peru,* 1995 U.S. Dist. LEXIS 2730 (93 Civ 0094 (RWS) (March, 1995 per Sweet, DJ).

411. *Suits Against Ecuador, Peru Could Shake Up Debt Market,* 6 LDC DEBT REPORT, Aug. 2, 1993, at 1; *Pravin Banker Presses Suit to Recover Peruvian Debt,* 6 LDC DEBT REPORT, Sept. 7, 1993, at 5; *Pravin Banker Associates v. Banco Popular del Peru,* 93 Civ. 0094, 165 Banker 379, 1994 U.S. Dist. LEXIS 2003, decided Feb 24, 1994.

412. *Suits Against Ecuador, Peru Could Shake Up Debt Market,* 6 LDC DEBT REPORT, Aug. 2, 1993, at 1.

413. *CIBC Bank and Trust Co (Cayman) Ltd v Banco Central do Brasil,* 886 F. Supp 1105 (SDNY 1995).

414. *See* Preliminary Offering Memorandum dated September 30, 1996 for US$1,281,699,755.40, The MYDFA Trust, Trust Certificates due September 15, 2007 at A-1 (copy on file with the *Fordham International Law Journal); and A pointed issue* 1001 INT'L FIN. REV. Oct 16, 1993, 45.

capitalized.[415] As with par bonds, C-bonds involved no discount of principal. Unlike par bonds, C-bonds were not collateralized and therefore didn't require the expenditure of foreign exchange on zero coupon bonds. Nonetheless, Brazil wanted to rebalance the Darts' selection to achieve a balance among the options. Under the terms of the refinancing, the Darts were entitled to make the election they had made, and refused to resile from it,[416] i.e., they elected to hold Brazil to its agreement. As the Dart debt represented only four percent of Brazil's total debt and all other creditors had consented to the restructuring, Brazil was able to proceed with its Brady restructuring without the Dart's consent.[417] The loans held by the Darts in the MYDFA remained as loans, while the balance were converted into Brady bonds. On June 28, 1990, the Darts instituted proceedings against Banco Central do Brasil and others for failure to pay some US$60 million of interest when due and other claims. These proceedings were eventually settled on March 18, 1996, by Brazil giving to the Darts some US$52.3 million of bonds and US$25.3 million in cash on account of past due interest.[418]

In summary, these sporadic law suits by minor lenders, investment boutiques, and the Dart family had no effect on the broader market — no wave of litigation followed the efforts of these pioneers.

5. Return to Voluntary Markets

The vigorous return of the major debtors as borrowers on the international capital markets continued strongly in this period. Most of these capital flows were through direct and portfolio investment in the equity and securities markets, and were

415. The C-bonds paid 4% for years one and two, 4.5% for years three and four, and 5% for years five and six.

416. Interview with Lee C Buchheit, of Cleary, Gottlieb, Steen & Hamilton, New York City, December 6, 1994.

417. *Brazil — US$160m payment made,* 1011 INT'L FIN. REV., Dec. 31, 1993, at 33.

418. Power, *Sovereign Debt: The Rise of the Secondary Market and Its Implications for Future Restructurings,* 64 FORDHAM. L. REV. 2701, 2745-54 (1996); Preliminary Offering Memorandum dated September 30, 1996 for $1,281,699,755.40, The MYDFA Trust, Trust Certificates due September 15, 2007, at A-5. As the MYDFA loans remained as relatively illiquid loans, the Darts transferred them to a trust, The MYDFA Trust, which issued Trust Certificates due September 15, 2007, which were then offered to qualified institutional buyers under Rule 144A of the Securities Acts of 1933 by the above Preliminary Offering Memorandum.

principally funded, at least initially, by the repatriation of flight capital. Commercial bank syndicated lending did not resume on a significant scale.[419] In words which this author endorses, Clark said, "one of the more remarkable recent developments in the international financial arena has been the explosion of private capital flows to borrowers, especially Brady countries, that were once credit constrained."[420]

As early as March 1992, Moody's was warning that "debt is rising rapidly again."[421] The rating agency continued,

> The old boom-bust model seems still prevalent, judging by the rapid increase in credit, the steep rise in current account deficits, and the return to reliance on external indebtedness. Heavy external capital flow . . . could magnify the size of the eventual reversal. If the fight for redistribution [of wealth] remains the fundamental factor of Latin America's political economy, the current improvement could prove fragile indeed.[422]

This return to the capital markets was aided by the low interest rate environment in the United States and Japan in the early 1990s. Higher yields were available in LDC bonds, a fact of which Latin American borrowers were quick to take advantage.[423]

B. *Impetus for the Market*

Debt-for-nature swaps, as before, continued on a scale of little significance to the market but of real significance to environ-

419. Clark, *supra* note 32, at 52. The first loan to Mexico since the inception of the debt crisis was made in February, 1992 by Chase Manhattan. Lee C. Buchheit, *You'll Never Eat Lunch In This Conference Room Again,* INT'L FIN. L. REV., April 1992, 11, at 12.

420. Clark, *supra* note 32, at 52. Much of the demand for Brazilian eurobonds as late as mid-1993 came from flight capital. In contrast, by that time the principal demand for Mexican eurobonds was from industrial country investors, particularly from the United States. The difference reflects Mexico's earlier return to the international capital markets and the size of the enormous pool of Brazilian flight capital.

421. Ongoing Risks of Latin American Sovereign Debt, Moody's Special Comment — Industry Group: Sovereign, Mar. 26, 1992, at 1 (Moody's Investor Services) (copy on file with the *Fordham International Law Journal*).

422. *Id.* at 5.

423. *Financial Market Developments,* BANK OF ENG. Q. BULL. 469, 471 (1993), *reproduced in* SCOTT & WELLONS, INTERNATIONAL FINANCE - TRANSACTIONS, POLICY AND REGULATION 659-60 (1995). For instance, Mexican entities issued US$4 billion of bonds in the international markets in 1992 and US$7 billion in the first ten months of 1993. *Id.* at 660.

mental protection efforts in the relevant debtor countries.[424] Debt-equity swaps, particularly in the form of privatization auctions, provided substantial impetus to the secondary market, especially early in this period. Debt buy-backs likewise were a substantial impetus to the market.[425] However, the principal impetus for the market in this period was the activity of the trading houses and institutional investors.[426] The sustained bull runs of 1991 and 1993 made debt trading a highly lucrative business and, as we shall see, trading houses began to take large positions in the debt and were a major source of demand throughout this period.

This represented a sea change in the market. For the first time in the market's history, its principal impetus was no longer the use of the debt in buy-backs, privatizations, or debt-equity swaps but was the demand from plain, old-fashioned investors, albeit mainly wealthy Latin American individuals and institutional investors such as mutual funds. The Brady process was seen to have improved the quality of the credits by coupling debt relief to partial collateral for the bonds. By mid-1993, institutional investors were reported to be coming into the market "in droves" and to be holding "assets to maturity rather than trade."[427] Options aided this process — whereas before participants might have sold into a rising market to take their profits, now more participants were buying put options to secure their profits and retaining the asset.[428] Furthermore, as LDC funds were now being offered with minimum investments as low as US$1,000 to US$1,500, a whole new class of investor was being

424. *BankAmerica Donates LDC Loans*, REUTERS, July 29, 1993. The World Wildlife Fund completed a US$19 million debt-for-nature swap in the Philippines in August 1993 with funds provided by the U.S. Agency for International Development. *Philippines — Debt-for-Nature Swap*, 992 INT'L FIN. REV., Aug. 14, 1993, at 40.

425. In August 1993, Brazil requested that the amount of collateral for its Brady bonds be reduced from US$3.2 billion to US$2.8 billion because the stock of debt for conversion was US$5 billion less than had been estimated. This unanticipated reduction in debt almost certainly resulted from informal debt buy-backs and this figure suggests buy-backs had been popular in 1992 and 1993. Brazil's total debt for its Brady-style restructuring was US$35 billion rather than the US$40 billion widely expected.

426. Interview with Martin Benegas-Lynch, International Treasurer, Banco Santander, New York City, April 22, 1993 [hereinafter Benegas-Lynch Interview].

427. *Secondary Market — Prices to Remain Stable*, 983 INT'L FIN. REV., June 12, 1993, at 55.

428. *Id.*

brought into the market.[429]

There was evidence that towards the end of this period the role of the institutional investors was beginning to have a greater impact on the market than that of the trading houses.[430] Furthermore, Mexican par bonds had been tracking U.S. Treasury bonds since 1992 and by late 1993 the Brady bonds of Venezuela and Argentina were also tracking U.S. Treasuries.[431] In short, the market was beginning, finally, to behave like a mature securities market.

C. *Market Characteristics*

1. Market Structure

The market in this period had an unusual three part structure. The most actively traded part of the market were the Brady bonds — a large pool of highly liquid securities.[432] The largest part in terms of total debt remained the bank loans but these were substantially less liquid than the bonds. The third part of the market were the new issues: eurobonds, Yankee bonds, and Rule 144A offerings.[433] Unlike the other two parts of the market,[434] the new issues were not discounted, and are beyond the scope of this work.

429. *Id.* For instance, the Emerging Markets Income Fund II launched by Oppenheimer in June 1993 raised US$285 million to be invested primarily in dollar-denominated Brady bonds and emerging markets loans of Latin American countries. *Funds — All the Rage,* 985 INT'L FIN. REV., June 26, 1993, at 48.

430. *Market Charges to New Highs,* 994 INT'L FIN. REV., Aug. 29, 1993, at 36; *Bradys Rally,* 995 INT'L FIN. REV., Sept. 4, 1993, at 38 (reporting investor saying that "the market no longer is controlled by dealers, it is a customer driven market . . . All during the summer the traders begin to bid it down and then the investors would come in and buy.").

431. *Secondary Market — Quiet and Mixed,* 999 INT'L FIN. REV., Oct. 2, 1993, at 53; *Secondary Market — Treasury-driven,* 998 INT'L FIN. REV., Sept. 25, 1993, at 47.

432. JOHN CLARK, THE STRUCTURE, GROWTH AND RECENT PERFORMANCE OF THE LATIN AMERICAN BOND MARKET, Federal Reserve Bank of New York Research Paper Number 9416, Oct. 1994, at 2 [hereinafter Clark paper no. 9416].

433. Yankee bonds are bonds issued in the U.S. domestic market and therefore must satisfy the SEC rules. Because such compliance is onerous, the majority of the bonds issued in the United States were placed with Qualified Institutional Buyers under the provisions of Rule 144A. This rule allows such buyers, which have met minimum net worth and other tests designed to insure their size and sophistication, to trade privately placed securities freely without meeting the onerous SEC requirements. *See* Clark paper no 9416, *supra* note 454, at 19-21.

434. The bank loans, of course, traded at substantial discounts and the Brady bonds traded at a discount to face value which was in addition to the discount involved in their creation from bank loans.

2. The Growth in Bond Trading

After Brazil's Brady restructuring was completed in April 1994, there were about US$200 billion of LDC bonds outstanding. These consisted of about US$150 billion of Brady bonds and US$50 billion of new issues, principally eurobonds.[435] The secondary market turnover of the most active of these bonds "rival[led] that of all but the most liquid industrial country government bond markets and exceed[ed] that of the U.S. corporate and junk bond markets"[436] and the stock of LDC bonds at US$200 billion was comparable to the U.S. junk bond market at US$290 billion.[437]

Meanwhile, between 1989 and mid-1994, Latin American debtors placed some US$60 billion of new-issue bonds on the international capital markets of which some US$50 billion were still outstanding at the time of Brazil's Brady scheme in April 1994.[438] There are many differences between the Brady and new-issue bonds. Most Brady bonds issuances were in massive amounts exceeding US$10 billion[439] with 30-year bullet maturities and the repayment of principal secured by zero-coupon bonds held in escrow.[440] And Brady bonds were, of course, issued to the debtor's existing creditors. In contrast, new issue bonds were typically placed in amounts between US$100 million and US$250 million and their average maturity at the end of the 1993 was five and a half years.[441]

The high liquidity of Brady bonds is the result of the size of the issues, their duration, and the nature of the underlying risk.[442] Their long duration means the prices of Bradies are particularly responsive to changes in perceptions of country risk and

435. *Id.* at 4-7.

436. *Id.* at 7.

437. *Id.* at 4.

438. *Id.* at 6. The leading underwriters of these bond issues, in order, were: Credit Suisse First Boston, JP Morgan, and Chase. Other major underwriters, in no particular order, were: Merrill Lynch, Salomon Brothers, Swiss Bankcorp, Goldman, Citibank and Bear Stearns. See YY Interview, *supra* note 405.

439. For instance, as part of their restructurings, Argentina, Brazil, and Mexico issued US$12.6 billion, US$10.5 billion, and US$22.4 billion of par bonds respectively. Clark paper no. 9416, *supra* note 432, at 7.

440. *Id.*

441. *Id.*

442. *Id.* at 10.

of interest rates.[443] The nature of the underlying risk means the bonds are subject to the continual stream of political and economic developments in Latin America,[444] each of which may give grounds for the sale or purchase of bonds. This high liquidity and volatility is precisely what contemporary finance theory would predict.[445] Notwithstanding this high liquidity, it appears that the majority of Brady bonds were still held by the commercial banks in their loan portfolios at the end of 1993.[446]

The market appears to regard new issue bonds as having a de facto senior status over Brady bonds — a view with which the ratings agencies concur.[447] The reasons generally given for this supposed seniority are the large share of total indebtedness represented by Brady bonds together with their long maturities and connection with previously distressed credits. In addition, Brady bonds were generally registered bonds and thus more readily restructured than the new issues which were usually in bearer form.[448] Brady bonds in turn were perceived as enjoying de

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443. *Id.*

444. *Id.* These events occur far more frequently than do changes in the affairs of a major corporate bond issuer, for instance.

445. *See supra* note 246 and accompanying text.

446. This is a testament in part to the massive amount of Bradys issued. *See* Clark paper no. 9416, *supra* note 432, at 21. Peagram, writing in September 1994, said that, "it's generally believed that banks in some countries such as Italy and Canada have not yet sold any of their Brady bonds and that banks in general remain the largest holders of these instruments." Peagram, *How Safe Are Those Bradys?*, Euromoney 50 (1994). Lehman Brothers wrote that "although the investor base has diversified over the past five years, commercial banks as a group still appear to be large holders of Brady Bonds. Through mid-year 1994, the Brady plan closure had not led to a significant drop in asset exposure of banks . . . to individual Brady countries. In the absence of new syndicated lending, this would seem to indicate a fair amount of Brady Bond retention." *See* LEHMAN BROTHERS, OVERVIEW OF THE BRADY MARKET - BRADY BOND HANDBOOK 5 (Lehman Brothers 1995) (copy on file with the *Fordham International Law Journal*).

447. Several types of Argentine, Mexican, and Venezuelan Brady bonds were, in this period, rated a one half letter grade below the countries' respective sovereign bond issues. The rating agencies perceived these bonds as more likely to be rescheduled for the reasons given in the text. *See* Clark paper no. 9416, *supra* note 432, at 28.

448. *Id.* at 12. As the holders of registered bonds can be contacted by a financially troubled debtor regarding rescheduling, such bonds are often considered more likely to suffer that fate than bearer bonds. However, bearer bonds are not immune from rescheduling or restructuring. A debtor does not need to know its creditors to be able to defer or rearrange payment. In the words of MacMillan, "the sovereign debtor could either unilaterally reschedule its debt by simply announcing the new terms to bondholders, or it could negotiate with them. Although a unilateral rescheduling is an undesirable policy choice for a sovereign debtor, it may become necessary if a negotiated rescheduling is not forthcoming." MacMillan, *supra* note 7, at 334.

facto seniority over bank loans, although, in this writer's opinion, this is more problematic.[449]

3. Profitability of Brady Bonds for Investors

This period is the first in the market's history when being consistently long was a good strategy. The appreciation in Mexican bonds between their issuance in March 1990 and 1993 was exceptional. Mexican par bonds traded at 42 cents on the dollar shortly after issuance and discount bonds at 63 cents. By year-end 1993 the par bonds were trading at around 84.5 cents and the discount bonds at around 96 cents[450] — a 100% capital appreciation on the par bonds, which had paid 6.25% interest in the meantime, and a 50% capital appreciation for discount bonds which had paid Libor plus 13/16th%.

4. Location of Market

The market had began in New York City and traditionally had operated out of New York and London. With increasing maturity it also spread its geographic and time zone coverage with a number of traders operating also out of Frankfurt, Tokyo, Mexico City, Rio de Janeiro, and Buenos Aires.[451] Not all market makers and traders felt obliged to service, or limit their operations to, these centres. In 1993, ING Bank (formerly NMB) had five units trading emerging markets debt and these were in New York, London, Tokyo, Sao Paulo, and Manila.[452] While banks found it profitable to service the investors in a range of centers,

449. There appears to be a clear perception in the market that Brady bonds are more secure than the loans of a country yet to have a Brady style restructuring. To the extent that being granted a Brady scheme is a mark of approval from the IMF and the international financial community (and to the extent one accepts that IMF policies lead to sustainable economic growth) then there may be some substance to such a perception. However, the substance derives only from this factor, not the form of the debt as either bonds or loans. Against this, countries which have undergone a Brady style restructuring have very few medium and long-term bank loans which almost certainly confers some seniority upon the loans. It is the situation of the 1980s reversed. In the 1980s bond exposures were so small it was not worth alienating a source of funds to save the relatively small amounts due on them. In the 1990s it is the loan exposures which are so small as to make default not worthwhile. In the 1990s, ironically, LDC bank loans are probably more secure than the Brady bonds.

450. *Ldc Secondary Market Debt Opening Of Ny Trading On 29/12/93*, 1011 INT'L FIN. REV., Dec. 31, 1993, at 30.

451. *Fast-Growing Debt Market Tries Some Self-Regulation*, LDC DEBT REPORT, Nov. 11, 1991, at 1.

452. Voorhees, *The Bull Run of 93*, 50 LATINFINANCE 28 (1993).

the great bulk of the trading, and all the market making,[453] still occurred in New York and London. In 1993, market participants and commentators estimated that about 80-85% of trades were done in New York and the balance of 15-20% in London.[454] New York tended to dominate trading in Latin American debt whereas London was stronger in the trading of Polish and other Eastern European, and Morrocan debt.[455]

5. Screen Trading

In 1992, the trading screens remained indicative only.[456] The prices did not have to be honored by the traders posting them and trades could only be concluded over the telephone. This facilitated the making of bogus quotes for the purpose of moving the market rather than effecting a transaction. During 1993, there was a marked trend towards 'live' screens.[457] These screens indicated by a symbol which quotes were live, and capable of acceptance, and which were only indicative. Live quotes first became common in the heavily traded instruments such as the Brady bonds of Argentina, Mexico, and Venezuela.[458]

The move towards live screens was significant, both for the reduction it brought in the opportunities for abuse and as a sign of the final stages of maturation of the market into adulthood.

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453. Interview with Felix Robyns, Managing Director, Emerging Markets, Bankers Trust, London, May 5, 1993 [hereinafter Robyns Interview].

454. Martin Benegas-Lynch estimated that 80% of market activity was in New York with the balance in London. Benegas-Lynch Interview, *supra* note 426. Mary Tobin estimated that 85% of market activity occurred in New York with the balance in London. Interview with Mary Tobin, Senior Staff Writer, *International Financing Review*, New York City, April 21, 1993.

455. Interview with Martin W. Schubert, Chairman European InterAmerican Finance Corporation, New York City, April 22, 1993 [hereinafter Schubert Interview I]. Michael Pettis estimated that in New York up to 90% of Latin American trading and only about one-third of Eastern European trading occurred. Pettis Interview II, *supra* note 47.

456. Voorhees, *Doses of Reality*, 40 LATINFINANCE 19, 22 (1992).

457. Voorhees, *Shooting the Bull; Debt Markets*, 55 LATINFINANCE 30 (1994); *Secondary Market — Still Worth Preserving*, 980 INT'L FIN. REV., May 22, 1993, at 31.

458. Interview with Giacomo de Filippis, Chairman of Giadefi, Inc., New York City, April 22, 1993 [hereinafter De Filippis Interview]. The fact that a price is firm is usually signaled by an asterisk next to it on the screen. By 1993, however, prices without the asterisk for debt of the principal debtors posted by reputable traders were far more often than not honoured by the traders, i.e. when another trader called on that quote the trader who had posted it would sell at the price indicated.

6. Derivatives

The growth in the debt market in this period was outstripped by the growth in options on the debt. In 1992, according to EMTA's survey, options were sold on US$15 billion face value of debt.[459] In 1993, this figure increased dramatically to between US$80 billion[460] and US$100 billion of debt.[461] Apart from risk management and speculation, options continued to provide a real service to potential investors in privatizations who, for the price of the option, could secure the right to acquire debt at a certain price should it be required to exchange for equity in the privatized corporation.[462] In 1992 warrants were created on the debt of Brazil and Poland, among others, and afforded investors the opportunity to speculate on these assets.[463] The leading issuers of options in 1992 were Merrill Lynch, Chase Manhattan, and JP Morgan. First Boston, ING, and Chemical were also active.[464]

An active secondary market in options developed in this period. EMTA assisted this development with the adoption in May 1993 of six market practices for the trading of options.[465] Mar-

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459. Clark paper no. 9416, *supra* note 432, at 23.

460. *Id.* In 1992, call options reportedly outnumbered put options by five to one. In 1993, calls remained more popular but the demand for each type of option was far more balanced.

461. John Clark put the volume of options trading in 1993 at US$60 billion with a further US$20 billion of 'structured transactions' such as those in which fully collateralised investment-grade securities are created out of Brady bonds. Michael Fuhrman estimated the annual volume for 1993 as between US$80 and US$100 billion. *See* Voorhees, *Shooting the Bull: Debt Markets*, 55 LATINFINANCE 30 (1994).

462. Richard Waters, *Risk and Reward: Derivatives Rush to Catch Up with Emerging markets*, FIN. TIMES, Dec. 29, 1992, at 18. These options tended to be expensive, up to 3 or 4 cents on the dollar, because they were extremely difficult for the bank issuer to hedge. Pettis Interview II, *supra* note 47.

463. *Id.* It was reported in October 1992 that there were US$500 million of public warrants based on Latin American debt. *See* Schmerken, *Latin American OTC Derivatives: Made in the USA*, 10 WALL ST. & TECHNOLOGY 29 (1992).

464. Waters, *supra* note 462. Other commentators exclude ING and Chemical and include Bankers Trust, Salomons, Swiss Bank Corp, Paribas, and Banco Santander as active writers of options at this time.

465. EMTA, Vol 2 No 3 Bulletin, May/June 1993, 2 (on file with the *Fordham International Law Journal*). In 1994, EMTA further assisted this process by producing the Master Agreement for Options on Emerging Markets Instruments and a 15 page Market Practice Guide explaining the Master Agreement (also July 11, 1994). The Master Agreement was designed to allow parties to enter into one agreement covering all options transactions between them. Separate subsequent transactions then need only be evidenced by a relatively simple form of confirmation. Alternatively, parties could exe-

ket activity in options and warrants increased dramatically in 1993. The normal size of options was in the US$5 million range with trades of US$10 million becoming increasingly common.[466]

Forward contracts are another common type of derivative but were not written in the true sense in this market.[467] Some traders would engage in quasi-forwards with Latin American investors by agreeing to extend the settlement period for a Brady bond for more than the customary seven days.[468]

An interesting, related form of derivative in this market was the "when-and-if" trading of Brady bonds prior to their issuance. Argentine bonds traded on this basis for an extended period prior to their issuance.[469] Brazilian Brady bonds commenced trading on this basis in mid-1993 and continued until issuance in April 1994.[470] These trades were agreements for the purchase of bonds to be executed upon issuance of the bonds provided issuance occurred before a specified date.[471] In effect, these when-and-if trades were futures and the precipitous decline in LDC debt prices in early 1994 meant they were exceedingly expensive futures for many purchasers.[472] Other derivatives, as we have seen, divided Brady bonds into tranches of securities in so-called structured transactions. One tranche, with all of the stripped out collateral from the Bradies, would attract an investment-grade rating. The other tranche, with no collateral, traded purely on its higher yield.[473] In this, and other ways,[474] banks

cute a Stand-Alone Confirmation which incorporated the terms of the Master Agreement by reference and operated for that one transaction only.

466. *OTC Options Catching On,* 1000 INT'L FIN. REV., Oct. 9, 1993, at 44.

467. Clark paper no. 9416, *supra* note 432, at 24.

468. *Id.* For instance, if the settlement period is extended to 28 days for the sale of a Brady bond by a customer to a trading house, the customer can then acquire the bond in the market 21 days later and, with the usual seven day settlement, satisfy its obligation to provide the security. In effect, the customer has taken a 21-day forward contract on the Brady bond.

469. The Argentine bonds were issued on April 7, 1993 and EMTA helped facilitate the smooth trading of the when-and-if issued bonds by recommending an April 14 date for the settlement of when-and-if trades with real bonds. *See Argentine Debt Issues Rally On When-Issued Exchange,* LDC DEBT REPORT, April 12, 1993, at 1.

470. Clark paper no. 9416, *supra* note 432, at 44.

471. EMTA issued draft forms to facilitate the trading of when-and-if issued Brazilian Brady bonds and new market practices for Brazilian debt trading in August 1993. *See* EMTA, Vol 2 No. 4 Bulletin, July/August, 1993, at 1 (copy on file with the *Fordham International Law Journal*).

472. Clark paper no. 9416, *supra* note 432, at 44.

473. *See id.* at 25.

were able to reshape emerging markets debt to suit investors permitted to invest only in investment-grade securities.[475]

7. The Metamorphosis of LDC Trading Desks into Emerging Markets Desks

One interesting aspect of the heavy new issuances of bonds by LDCs is that the eurobonds typically traded in the Emerging Markets divisions of the trading houses side-by-side with the Brady bonds and bank loans of debtors which had not yet had a Brady style restructuring. As Eurobonds are securities under the U.S. securities laws, this hastened the movement of LDC trading units into the registered broker-dealer subsidiaries of the respective banks and thus under the regulation of the securities laws. These new bond issues also supported the name change from LDC debt to "Emerging Markets" as bankers sought to distance these new issues from the taint of the debt crisis.[476]

8. Efficiency of Market

Research into prices in the secondary market confirms that the market continued to grow more efficient over time.[477] The reasons for this trend were not identified in the research but the most likely reasons for this trend are higher trading volume and general market maturity.[478]

9. Market Volume and Debt Traded

The conversion of an ever increasing proportion of the outstanding loans into bonds continued to transform the market from a heavily negotiated one into something looking more like a standard securities market. The bonds settle on Euroclear with simple transfer documentation. This means bond trades are

474. *See Argentina — BIG Trust 1 Launched,* 990 INT'L FIN. REV., July 31, 1993, at 35.

475. Voorhees, *Shooting the Bull; Debt Markets,* 55 LATINFINANCE 30 (1994).

476. The term "emerging market" was coined in about 1984 by the International Finance Corporation (a part of the World Bank group) while in the process of seeking a title for a less developed country investment fund. The IFC had previously promoted the Third World Investment Trust, but its acronym, TWIT, was considererd unhelpful. The Emerging Markets Growth Fund, on the other hand, was a marketable name. *See* Alain Soulard, *The Role of Multilateral Financial Institutions in Bringing Developing Companies to U.S. Markets,* 17 FORDHAM INT'L L.J. S145, S147 (1994).

477. LEE, SUNG & URRUTIA, *supra* note 72.

478. *Id.* at 553.

both cheaper and quicker than loan trades.[479] Many institutional investors are proscribed from investing in loans so conversion into bonds made LDC debt accessible to a broader range of these major investors.[480] Interest rates in developed countries were low from mid-1990 until early 1992 which made Brady bonds, especially par bonds, appear relatively more attractive.[481] Furthermore, a Brady restructuring was seen as a stamp of approval for a nation's economic policies[482] and its Brady bonds typically benefited from the perceived improvements in creditworthiness.[483]

For all of these reasons, market volume continued to increase dramatically. In 1992, the Emerging Markets Traders Association ("EMTA") conducted its first survey of trading volumes. The total volume for emerging markets was US$773 billion.[484] This figure was somewhat in excess of other estimates which were in the US$500 billion[485] to US$600 billion[486] range. The Association's volume figure includes the double counting involved in the one transaction being recorded as a sale on one trader's books and as a buy on the counterpart trader's books and being counted in the trading volume of each.[487] Discounting the double counting and considering the estimates of others, this author's best estimate is that about US$500 billion face value of LDC debt in fact changed hands in 1992.[488] By way of com-

479. Voorhees, *Starting the Day Right*, 35 LATINFINANCE 73 (1992).

480. *Id.*

481. Interview with Felix Robyns, Managing Director, Emerging Markets, Bankers Trust, London, May 5, 1993.

482. The completion of a Brady restructuring was often perceived as a strong green light for foreign direct and portfolio investment. Interview with Professor Riordan Roette of the Johns Hopkins University, Washington, DC, April 29, 1993. The ability of Argentina and Brazil to reaccess the international capital markets well before their Brady restructurings casts some doubt on the accuracy of the perception.

483. Voorhees, *Starting the Day Right*, 35 LATINFINANCE 73 (1992).

484. Emerging Markets Traders Association ("EMTA"), Vol 2 No 5 "Bulletin", Sept/Oct 1993, at 1 (copy on file with the *Fordham International Law Journal*). The most actively traded debt was that of Brazil, with a volume of US$209 billion, followed by Mexico at US$189 billion. Latin American debt represented over 80% of trading volume and the volume of bonds traded exceeded that of loans.

485. Holland, *The LDC Debt Market: It's a Jungle Out There*, BUS. WEEK, Mar. 15, 1993, at 86.

486. Clark, *supra* note 32, at 11 (estimating just below US$600 billion).

487. Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

488. A reduction of about one-third of total volume traded would seem appropriate as only trades between traders would be counted twice. Transactions of traders with

parison, some US$1.7 trillion of stocks were traded on the New York Stock Exchange that year.[489] For the first time in 1992 the volume of bonds traded exceeded that of bank loans.[490]

The size of EMTA's membership also gives some idea of the scale of the market — in 1992, it exceeded 100 institutions for the first time.[491]

Market volume continued to accelerate. EMTA's annual volume survey estimated that US$1.978 trillion[492] of debt traded in 1993.[493] This figure is again higher than the other estimates which ranged from US$1 trillion[494] to US$1.5 trillion.[495] Once again, the best estimate after eliminating double counting is that perhaps US$1.3 trillion of debt in fact changed hands in 1993.

According to EMTA's survey, trading volume in Brady bonds in 1993 was US$1.02 trillion, some fifty-two percent of total market volume.[496] Typical trading sizes towards the end of this period were in the US$10 million to US$15 million range.[497]

In 1992, the most heavily traded debt was that of Brazil, which accounted for 29.8% of total debt traded.[498] It was followed by the debt of Argentina (23.6%), Venezuela (17.1%), and Mexico (16.2%).[499] The balance of the trading comprised some 3% of other Latin American debt and 10.2% of the debt of

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buyers, such as mutual funds, or with sellers, such as commercial banks without their own LDC debt trading desks, would not be counted twice.

489. Holland, *supra* note 485, at 86.

490. *Emerging Markets: A Trillion Dollars in 1993?*, 1002 INT'L FIN. REV., Oct. 23, 1993, at 40.

491. Nicolas Rohatyn, Remarks to the EMTA 1992 Annual Meeting, Dec. 14, 1992, at 7 (copy on file with the *Fordham International Law Journal*).

492. This is a trillion in the U.S. sense of 1,000 billion (i.e., 1,000,000,000,000).

493. *1993 Debt Trading Volume Near U.S.$2 Trillion*, EMTA Bulletin, 1994, No. 4, at 1 (copy on file with the *Fordham International Law Journal*); Fidler, *Washington Opposes Suit Over Brazil Debt*, FIN. TIMES, Sept. 20, 1994, at 9.

494. The annual LATINFINANCE survey showed a total self-reported volume of the traders surveyed of US$1.365 trillion and concluded that "the consensus was that US$1 trillion of emerging market debt changed hands." *See* Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

495. *See* Tracy Corrigan, *Picking up the pieces of an emerging market*, FIN. TIMES, April 5, 1994, at 17.

496. Peagram, *How safe are those Bradys?*, EUROMONEY, Sep. 1994, at 50.

497. *Survivors Tackle Unchartered Waters*, EUROMONEY, Sep. 1994, at 48.

498. Clark paper no. 9416, *supra* note 432, at 11.

499. *Id.* Different figures have been cited elsewhere: US$209 billion of Brazilian debt being traded in 1992, US$189 billion of Mexican, US$156 of Argentine and US$94 billion of Venezuelan debt. *See Emerging Markets: A Trillion Dollars in 1993?*, 1002 INT'L FIN. REV., Oct. 23, 1993, at 40.

other countries.[500] In 1993, the apportionment of debt traded was quite different. Argentine debt was by far the most heavily traded at 28.2% of the total volume,[501] reflecting the activity associated with its Brady restructuring in that year. It was followed by the debt of Mexico (20.1%), Venezuela (18.7%), and Brazil (15.1%).[502] The balance was comprised of 4.4% for other Latin American debt and 13.5% for the debt of other countries.[503] Among other countries the debt of Morocco, the Philippines, and Russia appears to have been the more heavily traded.

There was an extraordinary bull run in 1993. The Salomon Brothers Brady Bond index registered a total return for the year of nearly 44%[504] and the JP Morgan Emerging Market Bond Index posted its tenth consecutive monthly gain in September.[505] These healthy returns were however eclipsed by the returns from some of the exotics. From December 31, 1992, to December 31, 1993, Bulgarian debt rose from 13 cents on the dollar to 41 cents, Ecuadorian debt from 28 cents to 51.75, Panamanian debt from 29 cents to 61.75, Peruvian debt from 18.5 cents to 69.5, and Russian debt from 15 cents to 49.5 cents.[506] Those figures produce a return of 375% for the year on Peru's loans and 330% for Russia's loans.

The veritable explosion in market volume in this period, from perhaps US$250 billion in 1991 to US$1,300 billion in 1993 is principally attributable to the following factors.

1. The huge surge in international liquidity in 1992 and 1993 seen in the rapid growth of bond funds and mutual funds.[507]
2. The securitization of the loans into Brady bonds.
3. The stronger economic performance and policy reforms of the debtor nations improved the perceived quality of the credits.[508]

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500. Clark paper no. 9416, *supra* note 432, at 11.

501. *Id.*

502. *Id.* EMTA's volume survey for 1993 shows that the following amounts of debt (bonds and loans) were traded in 1993: Argentina, US$544 billion; Mexico, US$465 billion; Venezuela, US$287 billion and Brazil, US$259 billion. *See* Peagram, *supra* note 124, at 50.

503. *Id.*

504. Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

505. *Secondary Market — Trading up*, 1000 INT'L FIN. REV., Oct. 9, 1993, at 42.

506. Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

507. Pettis Interview II, *supra* note 47.

508. Clark paper no. 9416, *supra* note 432, at 46.

4. The exceptional bull runs in this period which made debt trading and investment extremely lucrative.
5. The rediscovery of Latin America by the international capital markets.[509]

Whether this rediscovery of Latin America proves to have been based on the sound economic prospects of the region or whether it is yet another case of the short-term memory of international finance markets, history will establish.[510]

D. *Participants*

1. Traders

In both 1992 and 1993, the market's highest volume trader, as identified by its peers, was JP Morgan. In 1993, the top eight traders and their self-reported trading volumes in billions were as follows: JP Morgan (US$225), Salomon Brothers (US$154), Lehman Brothers (US$150), Chemical (US$130),[511] Chase (US$123), Morgan Grenfell (US$118.5), Citibank (US$116), and Merrill Lynch (US$85). The next four were: Bankers Trust (US$54), Credit Suisse First Boston (US$52), Banque Paribas (US$47), and Samuel Montagu (US$30).

This list is instructive. A comparison with the trading volumes in the year in which Brady bonds were first issued, 1990, shows that the top eight traders in that year were all commercial banks.[512] In 1993, four of the top eight traders were commercial banks and the other four investment banks. This change is at-

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509. *Id.* Private sector debt and equity flows to Latin America trebled in 1991, up from US$13.4 billion in 1990 to over US$40 billion in 1991. *See* PURCELL, CHANG, ET AL., PRIVATE CAPITAL FLOWS TO LATIN AMERICA: VOLUME TRIPLES TO $US40 BILLION IN 1991 (Salomon Brothers 1992) (copy on file with the *Fordham International Law Journal*). In 1992, private-sector debt and equity finance to LDCs increased dramatically to $102 billion exceeding official loans and grants, at $54.6 billion, for the first time. In the words of the chief economist of the World Bank, Bruno, "There has been a remarkable turnaround in private capital flows to the middle-income countries." *See Third World Turns to Private Finance,* AUSTRALIAN, Dec. 17, 1993, at 25. In May 1993, the finance ministers of developing countries gathered together and called upon the leaders of the G-7 countries to "do all they can to encourage private capital flows, including foreign direct investment, portfolio investment and commercial bank lending." *See Emerging Countries to G-7: Let Money Flow More Freely,* LDC DEBT REPORT, May 17, 1993, at 5.

510. This author hopes it is the former and believes it will be the latter.

511. Early in this period two major traders, Chemical Bank and Manufacturers Hanover, merged, and retained the Chemical name. Voorhees, *Hope Springs Eternal,* 34 LATINFINANCE 21, 25 (1992); *Chemical's Team,* 34 LATINFINANCE, Jan/Feb 1992, at 6.

512. *See supra* note 285.

tributable to three factors. First, Brady restructurings transformed the loans into securities and thus from the types of instruments in which commercial banks had expertise to the type in which investment banks had expertise. Second, as the size of the market grew dramatically, the advantage for commercial banks in being able to sell from their own portfolios was greatly diminished. Third, and most significantly, as institutional investors became increasingly important buyers of the debt, investment banks took increasing shares of the business as selling securities to institutions is their traditional business.[513]

The market had become a substantial source of profits for some trading houses. For the twelve months from mid-1991 to mid-1992, Salomon Brothers reported profits of US$110 million on US$33 billion of trades and Chemical profits of US$80 million on US$40 billion of trades.[514] Traders began to promote LDC debt heavily as an attractive investment. Salomon Brothers, in particular, produced a great deal of literature promoting investment in Brady bonds.[515]

In an interesting move, Merrill Lynch and ING Bank announced at roughly the same time, but apparently quite independently, that they would stop making markets in LDC debt.[516] ING said the interbank market now had sufficient market makers and its energies were better directed to monitoring its own trading and creating investor flows. It stressed the market remained important to it. Merrill said it would make markets to clients but not to the street.[517] It seems making markets in this

513. Pettis Interview II, *supra* note 47. In this regard, while in form a commercial bank, JP Morgan functions more like an investment bank.

514. Voorhees, *Doses of Reality*, 40 LATINFINANCE 19, 24 (1992).

515. *See* LATIN AMERICA — THE PROBLEMS FADE, Feb. 12, 1992 (Salomon Brothers) (copy on file with the *Fordham International Law Journal*) (including statements such as "We believe that investors now need to focus on the opportunities for new revenue generation on this continent during the 1990s."); RELATIVE VALUE OF MEXICAN SOVEREIGN BONDS: NEW ISSUES VERSUS EXCHANGE BONDS, Mar. 3, 1992 (Salomon Brothers) (copy on file with the *Fordham International Law Journal*) (concluding that Brady bonds offered better value than newly issued bonds); NIGERIAN PAR BONDS: THE POWER OF ARITHMETIC, Mar. 1, 1993 (Salomon Brothers) (copy on file with the *Fordham International Law Journal*) (concluding that Nigerian Brady bonds offered "attractive investment opportunity."); EVALUATING SOVEREIGN CREDIT RISK: A HIGH-YIELD ANALYSTS GUIDE, Mar. 16, 1993 (Salomon Brothers) (copy on file with the *Fordham International Law Journal*).

516. *ING, Merrill stop market making*, 979 INT'L FIN. REV., May 15, 1993, at 29.

517. *Id.*

debt was not as profitable as other aspects of the business.

While the major trading desks were now powerhouses earning massive profits, the small trading houses which were there at the beginning continued to play a role. Let us revisit the three boutiques which pioneered this market: Eurinam, Giadefi, and Turan Corp. Martin Schubert at Eurinam continued to work hard to gain exposure for himself and his company. Jack de Filippis repositioned Giadefi to be principally a proprietary trader trading for its own account. Turan Corp. specialized in the debts of rarely traded countries and avoided the heavily traded credits. For the twelve months from mid-1991 to mid-1992 each had remarkably similar trading volumes. Based on their own reported figures, Eurinam traded US$1.5 billion of debt and Giadefi and Turan US$1.4 billion each.[518] Giadefi reported net profits of US$4 million on this trading[519] — a healthy return for an enterprise owned by its founder. The four largest traders each traded about US$40 billion of debt[520] in this period and these figures placed the boutiques between 20th and 25th in trading volume.

In the early years of the market, LDC debt trading was not regarded as a way to build a promising career in a bank.[521] Now the "emerging markets" divisions were major profit centers and many traders occupied senior positions in their respective banks. The market must have offered financial and/or personal rewards throughout its history because the traders who were there in the early days have in the main stayed the distance. The same names appear consistently in articles about the marker over the years: Stephen Dizard, Peter Drittel, Kathy Galbraith, Peter Geraghty, Michael Pettis, Alexis Rodzianko, Nicolas Rohatyn, and Susan Segal. As the market grew rapidly in the 1990s new names abounded, but the market rewarded those who were there early[522] and all the abovenamed traders were in senior administrative positions.[523] The people at the forefront of trading and

518. Voorhees, *Doses of Reality*, 40 LATINFINANCE 19, 20 (1992).

519. *Id.* at 24.

520. *Id.*

521. See text accompanying note 16 in Buckley, *supra* note 1.

522. For instance, two of Salomons' original traders, Mark Franklin and Stephen Dizard, are now managing directors and co-lead its highly respected global trading group, and Nicolas Rohatyn, whose entire career with JP Morgan has been in LDC debt trading and Emerging Markets, is a managing director.

523. For instance, Drittel was co-head of Bear Stearn's International Division, Gal-

research in this period include the following. In trading: Enrique Boilini (First Boston), Daniel Canel (JP Morgan), Americo da Corte (ING), Pierre Durand (Bankers Trust), Mark Franklin (Salomon Brothers), Con Egan (Lehman Brothers), Raoul Ponte (JP Morgan), and Miguel White (Manufacturers Hanover). In research: Joyce Chang (Salomon Brothers), Gary Evans (Barings Securities), Frank Fernandez (Merrill), and John Purcell (Salomon Brothers).[524]

2. Sellers

The principal suppliers of the debt in this period were, for the first time, the U.S. money-center banks as net sellers from their own books.[525] Japanese banks were also for the first time heavy sellers.[526] By the beginning of this period most major U.S. banks had substantial loan loss provisions for these assets which made cash sales relatively painless. Indeed during the bull run of 1991 it appeared that many banks had over-provisioned, as assets could be sold for substantially more than their book value less provisions. In addition, for the first time in the market's history, the trading desks had sufficiently large inventories of debt to be able to serve as sources of supply in periods of higher than usual demand.

3. Buyers

Early in this period mutual funds became significant buyers of LDC debt. In May 1992 Salomon Brothers estimated that non-bank institutions held about US$10 billion of LDC debt.[527] LDC debt represented about fifteen percent of the assets of most global mutual funds[528] which were attracted by its high yields.

braith was head of Chase's global trading operation, and Geraghty was head of ING's securities operation in London.

524. These trading and research personnel are listed as working for the party for which they worked predominantly in this period. For the record, although strictly beyond the scope of this work, the leading bankers in new bond issues in this period were: Maher Alhafer (Citibank), Emilio Camar (Merrill), Jorge Jasson (Chase), Michael Pettis (First Boston), and Gabriel Politzer (JP Morgan).

525. Clark paper no. 9416, *supra* note 432 at 14.

526. From March 1992 to March 1993, Japanese banks reduced their exposure to emerging markets by 30%, particularly to Argentina and Brazil, principally by debt sales. *Secondary Market*, 986 INT'L FIN. REV. 62, 63 (1993).

527. Pollock, *Funds Liven Performance with Latin Debt*, WALL ST. J., May 14, 1992.

528. *Id.*

The involvement of institutional and Latin American investors was "crucial to the growth and performance of the Latin American bond market."[529] By the end of this period, the major buyers of the debt were the LDC debt trading houses, Latin American investors, mutual funds, hedge funds, insurance companies, and pension funds.[530] The mutual and hedge funds and Latin American investors had aggressively increased their exposure in 1993. The involvement of all of these parties, except the traders, had been greatly facilitated by the securitization of the loans under the Brady Plan.[531]

In the late 1980s traders carried fairly small inventories of debt. Around US$40 million per trading desk was perhaps typical in 1988.[532] The securitization of loans under the Brady Plan and the resulting bull market changed that. Early in this period the market was described as one in which "a primary group of trading houses basically sell to each other all day for their own account and for account of an increasing [number] of private investors in Latin America."[533] In 1992, participants in the annual EMTA survey reported that proprietary trading by trading desks accounted for two-thirds of annual market turnover.[534] By 1993 traders, as a matter of course, would take major positions for speculative reasons and to cater to bond customers.[535] At the end of 1993 position limits typically ranged from US$500 million to well over US$1 billion and the 20 major traders held perhaps

529. Clark paper no. 9416, *supra* note 432, at 12.

530. *Id.*at 14. Participants in the EMTA survey in 1992 reported that 30% of their customer transactions involved investors from Latin America. Presumably the majority of this Latin American investment was former flight capital. This major role for private investors from the region reflects the investors' superior knowledge of policy reforms and economic and political conditions in the debtor countries.

531. *Id.* at 14.

532. *Id.*

533. Martin Schubert, The Debt Crash of October 91 — Lessons to be Learned, a speech delivered at the Argentina Investment Conference, New York, Nov. 25-26, 1991, at 15 (copy on file with the *Fordham International Law Journal*). In the same speech, Schubert also described the market thus: "the structure of the market can be described as . . . a giant fish bowl housing a handful of two way market makers nudging the price up or down, and investors on the outside placing bets, more based on how the market makers will react to a new condition, than fundamentals." In September 1993, Daniel Canel of JP Morgan was quoted as saying, "Three years ago, the secondary debt market was about 90% dealers and 10% clients. Now it is 65% dealers and 35% clients." *See* Voorhees, *The bull Run of 93*, 50 LATINFINANCE 28 (1993).

534. Clark paper no. 9416, *supra* note 432, at 16.

535. *Id.*at 14.

US$15 billion of debt.[536]

While pension funds and insurance companies entered the market as early as 1991, they only began to make significant purchases in the second half of 1993.[537] These investors were constrained[538] by the failure of most issuers[539] to attract an investment-grade rating for their bonds.[540] Mutual funds were not usually limited to investing in investment-grade bonds and by 1993 had "come to be viewed as the key players in the market."[541] The most significant mutual funds were those formed to invest entirely in Latin American debt followed by funds formed to invest in a range of international government securities. There were also substantial purchases by junk-bond funds.[542]

As a result of the heavy involvement of institutional investors the fundamental nature of the market shifted in 1993 from being a supply-driven trader's market to being somewhat of an investor's market that was, to at least a limited extent, demand driven.[543] In the words of one trader, "Since the summer of 1993 the [institutional investors] have been there, and it's changed the psychology of the market. When an asset drops three points, they're there to step in."[544]

The institutional investors were drawn to this market by the

536. *Id.* at 18.

537. *Id.* at 15. *See* Voorhees, *The Bull Run of 93*, 50 LATINFINANCE 28 (1993).

538. Insurance companies typically have strict limits on their holdings of speculative debt. Public pension funds are likewise constrained by state regulations. Private pension funds are less strictly regimented but are still required to exercise prudence. Many such companies and funds are further constrained by limitations in their constituent documents.

539. While Chile and Colombia did obtain investment-grade ratings, they never securitised their loans into Brady bonds. Pension funds and insurance companies were not usually permitted to purchase loans and there were only ever small amounts of Chilean and Colombian bonds on the market (at least until the new issues began to hit the market in the 1990s).

540. *Rating Agencies Stick to Guns on Latin Credit Assessment*, LDC Debt Report, April 12, 1993, at 5.

541. Clark, *supra* note 32, at 16.

542. *Id.*

543. Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

544. *Id.* The same trader, Jeremy Smith of Morgan Grenfell, said further, "a number of the sophisticated investors — hedge funds, pension funds, money managers, insurance companies — have $1 billion positions each . . . they have a lot of clout. It's not the traders moving the markets, it's the clients. What you see is a big New York dealer coming in and buying $100 million of debt — $60 million for clients and $40 million for themselves."

following factors:[545]

1. Low interest rates in the U.S. and Europe made the real returns on low-risk securities like U.S. Treasury bonds extremely slim.[546]
2. The economies of many Latin American countries, particularly Argentina and Mexico, had begun to improve dramatically.
3. Argentina completed its Brady restructuring and issued a massive amount of new Brady bonds.
4. Brazil's restructuring was likely to be put in place soon and many countries were beginning preliminary negotiations on Brady style restructurings.[547] The substantial capital gains made by debt holders after previous Brady restructurings were attractive.

The presence of these investors providing a sustained demand for the debt represented an important step in the evolution of the market. With this development the market may finally be able to move towards the relative stability of a mature securities market.

E. *Impact of the Market*

In this period, the market facilitated the wave of privatization programs which swept Latin America. Whether the sale of public assets in exchange principally for these debts was good for the debtor nations is highly contentious but, whether positive or negative, the privatizations would have been far less attractive to investors if debt could not have been used.

Somewhat paradoxically, however, in this period of explosive growth the market had very little effect on matters outside itself. In the prior period the market had had profound effects on the breakdown of creditor solidarity (which made the Brady Plan both achievable and necessary) and on the viability of the Brady Plan itself. In this period, the final one in the market's first decade, the market grew, and grew, and grew, but its external effects were limited.

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545. Voorhees, *Shooting the bull; debt markets*, 55 LATINFINANCE 30 (1994).

546. *See* Waters, *supra* note 358, at 18.

547. Countries such as Bulgaria, Ecuador, Jordan, Panama, Peru, Poland, and Russia.

CONCLUSION

In this period of the market's development, the face value of debt traded in the market increased twenty times from about US$65 billion to US$1,300 billion. This dramatic growth was supported by major changes in the nature of the market. Brady bonds meant ever increasing proportions of the trades closely resembled conventional securities trading — rapid transactions of readily transferable assets at fine margins. Brokers entered the market and screens bearing a mix of binding and indicative quotes appeared on trader's desks. Institutional investors brought a degree of depth and stability to what was still a volatile and unpredictable market. The nature of the top traders also changed. At the beginning of this period, all of the major traders were commercial banks. At the end, investment banks ranked equally with their commercial brethren in the trading stakes. The development of the market towards a conventional securities market had assisted those with expertise in trading securities.

In its first decade the market had five principal effects and consequences.[548] It forced banks to increase their loan loss provisions; facilitated the exit of certain banks from LDC lending and facilitated debt-equity swaps, privatizations, debt buy-backs and other debt exchanges. These effects of the market were considered in the predecessor Article.[549] The breakdown in creditor solidarity which flowed from the exit of certain banks from LDC lending made the Brady Plan necessary and the market's further facilitation of the Brady Plan is the fourth principal effect of the market. The final effect is the impact of the market on direct investment in the debtor nations. The latter two effects will now be considered.

The secondary market facilitated the Brady Plan in four ways:

(i) The market provided the prototype. As the relevant parties could see the loans trading like bonds each day, it was a small step to conceive of their securitization into bonds.
(ii) The market provided a secondary market for the bonds. The existing secondary market for sovereign loans could readily adapt to trade Brady bonds and so the existence of

548. These effects are listed in no particular order.
549. Buckley, *supra* note 1.

this market meant the banks knew there would be a market into which to sell their bonds.[550]

(iii) The market established there was investor appetite for such securities. The active trading of loans on the secondary market was a strong indication that there would be investors to purchase LDC loans which had been converted into bonds.[551]

(iv) The market discounts afforded a strong argument for debt relief. It was difficult for banks to resist the arguments for a degree of debt relief in the securitization process when most banks had been selling their loans at steep discounts in the secondary market.

The combined effect of these four factors was so significant that without the secondary market the Brady Plan may have been too large a step into the unknown to attract the support of the U.S. Treasury and without the support of, and persuasion of bankers by, the U.S. Treasury, the Brady Plan would not have come to pass. It is generally accepted that the securitization of the loans under the Brady Plan served the international banks. Securitization gave the banks liquid bonds, rather than relatively illiquid loans. It triggered a turnaround in secondary market prices that improved the values of the banks' portfolios dramatically. It opened the door for the debtors to return to the voluntary capital markets by bond issuances from which the banks, as underwriters, profited. And, above all, the Brady Plan, in permitting broader ownership of the debt, signalled the end of the 1982 debt crisis as a threat to the stability of the international financial system.[552]

However, the seeds of the next sovereign debt crisis may have been planted by the failure of the Brady Plan to reduce debt and debt service levels in a meaningful way. Furthermore, these seeds may have been watered and fertilized by the return

550. Interview with Michael Chamberlin, Executive Director of EMTA, New York City, December 8, 1994 [hereinafter Chamberlin Interview]. Martin Schubert believes the banks would not have agreed to the securitisation of the debt with debt relief without a sure market into which they could sell the resulting bonds. Schubert Interview, *supra* note 455.

551. Chamberlin Interview, *supra* note 550.

552. Securitization permitted banks to sell the debt to a broad cross-section of investors and not simply to each other. Thus, for the first time since the inception of the crisis, it was possible for the major U.S. money-centre banks to liquidate their entire portfolio of LDC debts, if they wished to do so.

to the voluntary credit markets that the Brady Plan made possible. The secondary market, in facilitating the Brady Plan, may have put the world on track for another debt crisis. Only history will be able to judge.[553] The securitization of the loans into Brady bonds and the use of bonds to raise most of the new money in the 1990s mean that the next debt crisis is unlikely to threaten the stability of the international financial system as did the 1982 crisis. However, because the debt of the 1990s has been piled on top of the Brady bonds, and because history suggests strongly the next debt crisis will be in the life of the Brady bonds, it will probably damage the debtor nations even more than did the 1982 crisis.[554]

In summary, the international banking community collectively, and its constituent banks individually, benefited from the transactions which the secondary market made possible[555] and will continue to do so provided the whole edifice does not collapse in another debt crisis.

Throughout the late 1980s and early 1990s the market's prices on LDC debt were regularly published and widely known. Especially in the 1980s, these prices were unrelated to the economic fundamentals of the countries.[556]

Upon one view, these large discounts throughout the late 1980s and early 1990s sent an overly negative message to potential investors in LDCs. On this view, the discounts were much larger than were warranted by the long-term prospects of repayment of the debt and reflected the thinness of the market and the lack of buyers rather than economic fundamentals.[557] If the prices were taken by many potential investors as an indicator of the economic health of the country, the size of the discounts may have kept potential investors away.[558] If investors inter-

553. On this topic generally, see MacMillan, *supra* note 7, at 305.

554. History certainly suggests that a debt crisis will grip Latin America, and thus the world, before todays' Brady bonds mature after 2020.

555. This is not surprising given the banks' influence over the early development of the secondary market and the banks' control over the resolution of the debt crisis.

556. It is generally accepted that the market did not price debt upon the basis of the economic fundamentals of the debtors: Interview with Professor Riordan Roette of Johns Hopkins University, Washington, DC, April 29, 1993.

557. *Id.*

558. Interview by telephone with Professor Manuel Pastor, Professor of Economics, Occidental College, Los Angeles, April 21, 1993 [hereinafter Pastor Interview]. This message, if sent, appeared to persist until the vote of confidence of the IMF and inter-

preted market prices in these terms, this was certainly a disservice the market rendered the debtors.[559]

The countervailing view is that the discounts in the market in the late 1980s were not large enough as the prices were propped up by the artificial accounting treatment of the loans on the books of the banks. Larger discounts would have enabled equilibrium to be reached between supply and demand and the market to fulfill its clearing function, as considered previously.[560] On this view, deeper discounts were desirable as they would have led to the earlier resolution of the crisis and benefited both banks and debtors.[561]

In summary, the money-center banks should be grateful their strong resistance to the market in the early years[562] did not stifle its growth severely for they have benefited from the market in numerous ways. Unlike the banks, the debtors did not enjoy multiple benefits from the market but overall they should also be grateful their initial mild resistance did not stifle the market's growth significantly[563] as they too have benefited from this market, principally because debt buy-backs were to provide their major source of debt relief and buy-backs would have been impossible without the market. The market was a generally positive development for all parties, in stark contrast to the uniformly negative effects of the debt crisis. Indeed, one could say the development of the secondary market turned the debt crisis from an unmitigated, into a mitigated, disaster.

national banking community implicit in a Brady style restructuring. A Brady style restructuring was invariably seen as a very positive sign by international investors: Roette Interview, *supra* and Pettis Interview I, *supra* note 375.

559. Pastor Interview, *supra* 558.

560. Pettis Interview I, *supra* note 375.

561. In debt-equity swaps, privatisations, formal and informal buy-backs and, presumably, in larger discounts on discount bonds and lower interest rates on par bonds in the Brady-style restructurings to come.

562. The bank's resistance was due to the fear the market would expose the true value of the loans held on their books at full face value.

563. The debtor's resistance was due to the fear that creditors who acquired loans in the secondary market would be less amenable to advancing new money than original creditors.