

RECENT AMENDMENTS TO REGULATION K: AN ANALYSIS

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1. INTRODUCTION: CURRENT SITUATION

At the end of 1988, the external debt of developing countries was approximately \$420 billion.¹ United States banks own about twenty percent of this debt.² As of 1986, the total projected interest service for these countries through 1991 is expected to be \$145.6 billion.³ A recent analysis indicates that developing countries now receive less in combined aid each year from the World Bank and the International Monetary Fund than they are paying in interest and principal on outstanding debt to the two organizations.⁴ Seven years after Mexico's finance minister announced its fiscal emergency, signaling the onset of the global debt crisis,⁵ the international financial crisis has hardly improved.⁶

This Comment will first look at the magnitude and implications of the debt crisis. It will then evaluate debt/equity swaps as a mechanism for reducing bank exposure in developing countries while encouraging

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¹ Riding, *Latins Want Bush to Help With Debts*, N.Y. Times, Nov. 29, 1988, at A14, col. 3; see generally *A Lesson From Chile*, THE ECONOMIST, Mar. 7, 1987, at 87-90 (discussing external debt and debt swapping). As of December 31, 1986, Brazil's debt was \$110.3 billion; Mexico's debt was \$100.3 billion; Argentina's debt was \$51.7 billion; Venezuela's debt was \$34.1 billion; Chile's debt was \$21.5 billion. Truell & Murray, *Debt Breakthrough*, Wall St. J., Dec. 30, 1987, at 1, col. 1.

² See generally Truell & Murray, *supra* note 1, at 4 (showing chart of ten biggest U.S. bank lenders to Mexico, with amounts outstanding in billions of dollars as of Sept. 30, 1987, and loan-loss reserves for developing countries).

³ *A Lesson From Chile*, *supra* note 1, at 87-90; Mellon Bank projections of Bank for International Settlements, World Bank, and country Central Bank data. These figures are based on the assumptions that between 1987 and 1991, OECD (Organization for Economic Cooperation and Development) real growth averages 2.6% per year, nominal oil prices average \$18/barrel, and LIBOR (London Interbank Offering Rate) averages 7.6% over the period. *Id.*

⁴ Lewis, *A Shift in Third World Funds' Flow*, N.Y. Times, Feb. 11, 1988, at D1, col. 3.

⁵ W. GREIDER, *SECRETS OF THE TEMPLE 517* (1987); see generally J. MAKIN, *THE GLOBAL DEBT CRISIS* 18 (1984); Broad, *How About a Real Solution to Third World Debt?*, N.Y. Times, Sept. 28, 1987, at A25, col. 2.

⁶ Alpern and Emerson, *Making Life Easier for Debtor Nations*, N.Y. Times, Feb. 7, 1987, at A27, col. 1; Riding, *Why Brazil Gave Up on Debt Moratorium*, N.Y. Times, Feb. 22, 1988, at D8, col. 5.

economic growth and privatization in these economies. Next, the Comment will consider the policies behind bank regulation in this area and the role of regulation as perceptions of international debt have changed. The August⁷ and February⁸ Amendments to Regulation K, which lib-

⁷ On August 18, 1987, 12 C.F.R. §211.5(f) was amended as follows:

(f) *Investment made through debt-for-equity conversions.*

(1) Permissible Investment. In addition to an investment that may be made under other provisions of this section, a bank holding company may acquire up to and including 100 percent of the shares of (or other ownership interest in) a foreign company if:

(i) The shares are acquired from the government of an eligible country or from its agencies or instrumentalities;

(ii) The shares are acquired by conversion of sovereign debt obligations of the eligible country either through a direct exchange of debt obligations or a payment for the debt in local currency, the proceeds of which are used to purchase the shares;

(iii) The shares are held by the bank holding company or its subsidiaries, provided however that such shares may not be held by a U.S. insured bank or its subsidiaries;

(iv) The shares are divested within five years of acquisition unless the Board extends such time period for good cause shown but no such extensions may in the aggregate exceed five years; and

(v) An investment shall be made under this paragraph in accordance with the investment procedures of paragraph (c) of this section and shall be subject to paragraph (b)(3)(i)(A) and (B) of this section.

(2) *Definitions.* For purposes of this paragraph:

(i) An "eligible country" means a country that, since 1980, has restructured its sovereign debt held by foreign creditors; and

(ii) "Investment" shall have the meaning set forth in §211.2(i) of this part and, for purposes of this paragraph, shall include loans or other extensions of credit by the bank holding company or its affiliates to a company acquired pursuant to this paragraph.

(3) *Conditions.*

(i) Any company acquired pursuant to this paragraph shall not bear a name similar to the name of the acquiring bank holding company or any of its affiliates; and

(ii) Neither the bank holding company nor its affiliates shall provide to any company acquired pursuant to this paragraph any confidential business or other information concerning customers that are engaged in the same or related lines of business as the company.

Amendments to Regulation K; 52 Fed. Reg. 30,914 (1987). For a general discussion of Regulation K, see, Mortimer and Slade, *Foreign Securities Activities of US Banks*, INT'L FIN. L. REV., June 1987, at 15.

⁸ On February 24, 1988, 12 C.F.R. §211.5(f) was again amended to read as follows:

(f) *Investments made through debt-for-equity conversions.*

(1) *Definitions.* For purposes of this paragraph:

(i) "Eligible country" means a country that, since 1980, has restructured its sovereign debt held by foreign creditors, and any other country the Board deems to be eligible;

(ii) "Equity" includes common stockholder's equity and minority interests in consolidated subsidiaries, less goodwill;

(iii) "Investment" has the meaning set forth in §211.2(i) of this regulation and, for purposes of the investment procedures of this paragraph only,

eralize the framework in which banks can engage in debt/equity swaps

shall include loans or other extensions of credit by the bank holding company or its affiliates to a company acquired pursuant to this paragraph; (iv) "Loans and extensions of credit" means all direct and indirect advances of funds to a person made on the basis of any obligation of that person to repay the funds.

(2) *Permissible investments.* In addition to investments that may be made under other provisions of this section, a bank holding company may make the following investments through the conversion of sovereign debt obligations of an eligible country, either through direct exchange of the debt obligations for the investment or by a payment for the debt in local currency, the proceeds of which are used to purchase the investment.

(i) *Public sector companies.* A bank holding company may acquire up to and including 100 percent of the shares of (or other ownership interests in) any foreign company located in an eligible country if the shares are acquired from the government of the eligible country or from its agencies or instrumentalities.

(ii) *Private sector companies.* A bank holding company may acquire up to and including 40 percent of the shares, including voting shares, of (or other ownership interests in) any other foreign company located in an eligible country subject to the following conditions:

(A) A bank holding company may acquire more than 25 percent of the voting shares of the foreign company only if another shareholder or control group of shareholders unaffiliated with the bank holding company holds a larger block of voting shares of the company;

(B) The bank holding company and its affiliates may not lend or otherwise extend credit to the foreign company in amounts greater than 50 percent of the total loans and extension of credit to the foreign company; and

(C) The bank holding company's representation on the board of directors or on management committees of the foreign company may be no more than proportional to its shareholding in the foreign company.

(3) *Investments by bank subsidiary of bank holding company.* Upon application, the Board may permit an investment to be made pursuant to this paragraph through an insured bank subsidiary of the bank holding company where the bank holding company demonstrates that such ownership is necessary due to special circumstances such as the requirements of local law. In granting its consent, the Board may impose such conditions as it deems necessary or appropriate to prevent adverse effects, including prohibiting loans from the bank to the company in which the investment is made.

(4) *Divestiture.*

(i) *Time limits for divestiture.* The bank holding company shall divest the shares of or other ownership interests in any company acquired pursuant to this paragraph (unless the retention of the shares or other ownership interest is otherwise permissible at the time required for divestiture) within two years of the date on which the bank holding company is permitted to repatriate in full the investment in the foreign company, but in any event within 15 years of the date of acquisition.

(ii) *Report to Board.* The bank holding company shall report to the Board on its plans for divesting an investment made under the paragraph no later than 10 years after the date the investment is made if the investment may be held for longer than 10 years and shall report to the Board again two years prior to the final date for divestiture, in a manner to be prescribed by the Board.

(iii) *Other conditions requiring divestiture.* All investments made pursu-

for their own accounts, will be examined as a reflection of this change in perception. Next, the Comment will analyze specific provisions of the Amendments in light of their goals and practical effect. The Comment will evaluate the effectiveness of the Amendments, balancing regulatory goals of safety and prudence with market realities.

2. BACKGROUND: THE EMERGENCE OF FINANCIAL TROUBLE

The debt of lesser-developed countries ("LDCs") is problematic for many reasons. First, the substantial amount of LDC debt held by U.S. banks presents great risk to the banking system.⁹ Data from 1982 revealed that claims on developing countries of the nine largest U.S. commercial banks¹⁰ totaled \$30.5 billion, 112.5% of their assets.¹¹ If

ant to this paragraph shall be subject to paragraphs (b)(3)(i)(A) and (B) of this section requiring prompt divestiture (unless the Board upon application authorizes retention) if the company invested in engages in impermissible business in the United States.

(5) *Investment procedures.*

(i) *General consent.* Subject to the other limitations of this paragraph, the Board grants its general consent for investments made under this paragraph if the total amount invested does not exceed the greater of \$15 million or one percent of the equity of the investor.

(ii) All other investment shall be made in accordance with the procedures of paragraph (c) of this section requiring prior notice or specific consent.

(6) *Conditions.*

(i) *Name.* Any company acquired pursuant to this paragraph shall not bear a name similar to the name of the acquiring bank holding company or any of its affiliates.

(ii) *Confidentiality.* Neither the bank holding company nor its affiliates shall provide to any company acquired pursuant to this paragraph any confidential business information or other information concerning customers that are engaged in the same or related lines of business as the company.

Amendments to Regulation K, 53 Fed. Reg. 5,363 (1988).

⁹ Meltzer, *International Debt Problems* 8 (July 1986) (unpublished abstract available from Department of Economics, Carnegie-Mellon University); Statement by Mellon Bank Corp. to the Subcommittee on International Finance and Monetary Policy of the U.S. Senate 2 (Apr. 2, 1987), [hereinafter Mellon Bank Senate Letter]. See also Truell & Murray, *supra* note 1, at 4, col. 2 (noting that "Moody's Investors Service has said it is considering downgrading the credit ratings of 11 major U.S. banks because of shaky foreign loans"); S. & P. *Cuts 5 Bank Ratings*, N.Y. Times, Feb. 2, 1988, at D5, col. 4 (reporting that the rating for some forms of credit was downgraded at Bank America, Chase Manhattan, Chemical (New York), First Chicago and Manufacturer's Hanover).

¹⁰ These banks are: Citicorp, Manufacturers Hanover Corp., Bank America Corp., Chase Manhattan Corp., Chemical New York Corp., J.P. Morgan & Co., Bankers Trust New York Corp., First Interstate, and Security Pacific. Nash, *Plan Could Stall Banking Mergers*, N.Y. Times, Feb. 1, 1988, at D8, col. 2; Berton, *Auditors Press Banks to Bite Bullet on Foreign Loans*, Wall St. J., June 8, 1987, at 6, col.1; see also Bennett, *Nation's Biggest Banks Had Worst Year in 1987 Since the Depression*, N.Y. Times, Feb. 16, 1988, at D5, col. 1.

these loans "went bad" through default on only half of their debt,¹² the six largest banks in the United States could go bankrupt.¹³ If even \$10 billion went bad (an amount less than that owed by Mexico alone), 36% of shareholders' equity in these banks would be in jeopardy.¹⁴ The banking system is thus vulnerable in two related areas: the exposure of bank assets and earnings to a major default or series of defaults;¹⁵ and the need for banks to continue substantial lending to debtor countries in order that the interest on the debts might be repaid.¹⁶

The debt imposes severe political, economic, and social hardships on debtor countries.¹⁷ The ability of debtor countries to pay debts depends upon government revenues, which in turn depend on the tax base.¹⁸ Debtor countries are compelled to devote most of their export

¹² J. MAKIN, *supra* note 5, at 19; cf. Feinberg, *Restoring Confidence in International Credit Markets*, UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD, 3, 5 (1984)(stating that exposure of these banks in only 6 major debtor nations averaged about 184% of their shareholders' equity.)

¹³ *Id.*; W. GREIDER, *supra* note 5, at 433.

¹⁴ J. MAKIN, *supra* note 5, at 18.

¹⁵ Meltzer, *supra* note 9, at 8.

A Mexican default would invite the collapse of the American banking system, starting at the top. Nervous investors and money managers would rush to pull their large deposits out of any banks with heavy exposure on foreign loans, and the panic would likely spread worldwide - a global run on the largest multinational banks. In theory, the Fed and other central banks of the industrial world could come to the rescue with massive loans to the Citibanks that were losing their liquidity - in effect, pumping up the money supply to save the banking system. This was not a theory anyone wished to test.

W. GREIDER, *supra* note 5, at 484.

Defaults are considered unlikely for several reasons. First, default would risk access to trade credits and additional international finance. Second, debtor countries are presently offered just enough new trade credits to make their economic situations bearable, while reminding them of the harsh penalty of default. Third, countries that are making debt-service payments maintain the hope of obtaining more favorable interest rates and maturity terms for rescheduled loans. Fourth, it might be possible for U.S. courts to obstruct a debtor nation's trade or international transactions should the debtor default. Finally, respect for the integrity of contracts, both internationally and as a precedent for the system within the debtor country, might deter default. Feinberg, *supra* note 12, at 11. See also Riding, *Brazil's Reversal of Debt Strategy*, N.Y. Times, Feb. 22, 1988, at D1, col. 3. (discussing the costs of Brazil's debt moratorium); Rohter, *Economy on Brink in Panama*, N.Y. Times, Feb. 22, 1988, at D8, col. 1 (discussing Panama's debt moratorium and its general political and economic environment).

¹⁶ Meltzer, *supra* note 9, at 8; McDougall, *Shifting Sands*, THE BANKER, Nov. 1987, at 121; Mellon Bank Senate Letter, *supra* note 9, at 2.

¹⁷ W. GREIDER, *supra* note 5, at 520; Farnsworth, *3d World's Prospects Called Poor*, N.Y. Times, Jan. 19, 1988, at D1, col. 6.

¹⁸ See J. MAKIN, *supra* note 5, at 251; see also Meltzer, *supra* note 9, at 2 (stating that a solution arises when debtor countries return to the marketplace, borrow and pay matured debt and service interest charges. To do this they must earn enough dollars (or other valuable exchange) from exports to pay for imports of goods and services to service the outstanding debt and to finance net capital flow. Net capital flow =

earnings to debt-servicing, leaving little for economic development.¹⁹ High interest rates and low growth rates²⁰ have made the burden of debt servicing increasingly heavy.²¹

Attempts to close the gap between interest rates and economic growth through heavier taxes (either directly or through inflation)²² place serious hardships on an already burdened population.²³ Austerity programs that aim to lower interest rates, decrease imports and expand exports may succeed in their immediate goals, boosting foreign exchange, but confront similar social and political opposition.²⁴

net new borrowing + net direct investment - net capital flight.)

¹⁹ W. GREIDER, *supra* note 5, at 550; see Bailey and Watkins, *Mexico's Dilemma*, N.Y. Times, Dec. 29, 1987, at 24, col. 2.

²⁰ J. MAKIN, *supra* note 5, at 252-53; From 1970 to 1979, interest rates on long-term private debt for debtor countries ranged from 5.1% to 8.2%. From 1980 to 1984, the interest rates ranged from 7.8% to 12.5% for these same countries. Although interest rates have since declined, domestic growth rates in debtor countries have also decreased. If interest rates remain moderate and real economic growth increases, the debt service burden will be less harsh. Layman & Kearney, *Debt for Equity: A Solution to the LDC Debt Crisis? (pt. I)*, J. COM. BANK LENDING, Jan. 1988, at 33, 40.

²¹ W. GREIDER, *supra* note 5, at 664. In 1983, Latin American countries owed about \$22 billion in interest on commercial bank debt, while receiving only about \$7 billion in net new bank loans. Feinberg, *supra* note 12, at 10: "[J]uxtaposing interest payments and credit flows reflects more accurately the immediate impact of international capital markets on a country's external payments"; if interest rates are high, this outflow will increase. *Id.* at 11. See also, e.g., Solarz, *One Way to Shore Up Filipino Democracy*, N.Y. Times, Feb. 22, 1988, at A19, col. 3. In the Philippines, the foreign debt is \$29 billion. This required the Philippines to pay over \$1 billion more in debt service payments to foreign creditors than it received in new assistance. With 70% of the people living below the poverty line, and per capita income below two dollars a day, this net loss of capital is a significant impediment to economic growth. *Id.*

²² J. MAKIN, *supra* note 5, at 253.

²³ *Id.* at 239-41, 253.

The social chaos that accompanies hyperinflation and unbearable tax burdens would result in political upheaval and, thereafter, new governments that almost by definition would be committed to repudiation of what would be termed 'illegitimate' debts of an 'oppressive' regime that had pressed too hard to wring the last peso, cruzeiro, or bolivar out of its citizens and, in doing so, made those currencies worthless.

Id. at 253. See also Feinberg, *supra* note 12, at 9, 10 (noting that many Latin American governments are under increasing political pressure to negotiate deals that force the banks to "share the burden of adjustment"); Colon, *Sharing the Burden of Latin Debt*, N.Y. Times, Apr. 16, 1987, at 23, col. 1 (stating that the U.S. must reduce debt service burdens while enhancing long-term growth).

²⁴ L. MALKIN, *THE NATIONAL DEBT 87* (1987) (discussing IMF riots); see also J. MAKIN, *supra* note 5, at 239-41 (discussing the international turmoil over the international debt crisis in debtor nations).

For poorer countries . . . [the debt] produced an era of domestic misery, a steady and unrelenting grinding down of economic aspirations . . . For the average citizens . . . economic life began to resemble a hopeless treadmill. They would see their real standard of living steadily decline as they worked to pay off their nation's old debts. Only the debts did not get smaller.

The debt crisis also distorts economic policies and trade patterns. In the early 1980's, Federal Reserve Chairman Paul Volcker strived to lower interest rates in the United States, pushing the domestic economy into a severe recession. The LDC export markets consequently dried up, and commodity prices began to fall dramatically as supply exceeded demand.²⁵ That meant a drastic fall in economic output and real income for LDCs.²⁶ Additionally, the strong dollar and the austerity programs that restricted imports in LDCs reduced the market for American goods abroad.²⁷

The debt has also had a substantial influence on U.S. monetary policy and bank regulation (which in turn affect the economy), as the Federal Reserve Board's goal of "managing the debt crisis"²⁸ and "saving the money-center banks"²⁹ has assumed top priority in U.S. economic policy.³⁰

Finally, the debt has distorted the structural relationship between the banks, the government, and the debtor countries.³¹ The magnitude of the debt and the inability of debtor countries to finance even the interest payments has placed an artificial strain on the negotiating pro-

W. GREIDER, *supra* note 5, at 520.

²⁵ W. GREIDER, *supra* note 5, at 415.

²⁶ *Id.*

[I]f the U.S. economy did not begin to expand, then the debt problems of the less-developed countries would multiply. America was the major market that bought exports from those debtor nations, but when America was in contraction, its purchases from abroad contracted too. If Americans did not start buying exports again from Mexico or Brazil or the others, there was no way those countries would ever find the income to keep up with their mounting debt payments.

Id. at 504.

²⁷ W. GREIDER, *supra* note 5, at 521.

If Latin America was compelled to accept austerity, if the debtor nations were forced to restrict their imports and save their money to pay off the banks, then those nations could not buy tractors and grain and appliances and all the other goods they purchased from America in prosperous times. Austerity in Brazil and Argentina meant higher unemployment in Michigan and Ohio. Falling living standards in Mexico and Peru meant depressed farm incomes in Iowa and Kansas.

See Meltzer, *supra* note 9, at 5.

²⁸ W. GREIDER, *supra* note 5, at 521.

²⁹ *Id.*

³⁰ *Id.*

³¹ See Memorandum from Michael Chamberlin, Shearman & Sterling, to Participants in the Working Seminar on Debt Equity Exchanges 1 (Oct. 13, 1987) (available from Michael M. Chamberlin, Shearman & Sterling, New York City) [hereinafter Working Seminar] (discussing the "inflexible and unwieldy web of complex multi-party contractual arrangements" resulting from "consolidated restructurings"). Today, the focus has shifted from legal technicalities regarding the complexity in the contractual arrangements between debtors and creditors. *Id.*

cess. To some extent, each party must let its actions be dictated by those of the other party. The debtor countries, as bankrupt nations, must not only forego the normal expectations of rising prosperity in order to pay the banks, but must continue borrowing to maintain interest payments.³² The banks are not only pressured to reschedule the loans³³ in order to realize some return, but are also, because of the need for regulatory support, locked into a reliance on Washington.³⁴ The symbiotic relationship³⁵ thus created is itself dependent on third party intervention to lift the stalemate.

Although there are no simple solutions³⁶ to the debt problem, the financial community, together with the debtor countries, has developed innovative mechanisms to reduce the debt. One such device is the debt/equity swap.³⁷ The Fed's recent Amendments to Regulation K modify the permissible foreign investments of banks made through debt/equity swaps.³⁸ This facilitates bank participation in debt/equity swaps.

3. THE DEBT/EQUITY SOLUTION

A debt/equity swap is a financial mechanism through which external debt is exchanged for equity in a foreign enterprise.³⁹ In the

³² W. GREIDER, *supra* note 5, at 520.

³³ See Brainard, *More Lending to the Third World? A Banker's View*, UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD 31 (1984) (noting that most bank lending to rescheduling countries is "involuntary" since refinancings and new loans are necessary for the debtor countries to make interest payments. A more desirable situation occurs when banks can make individual, uncoerced lending decisions).

³⁴

For all their vigorous rhetoric about the glories of the free market and financial deregulation, the money-center banks would not get out of this mess unless the government stepped in and rescued them. As the IMF lent huge sums to the debtor nations to keep them going, the taxpayers of the United States and other industrial nations were effectively assuming the obligations on behalf of the banks. The more that the public treasuries lent to Mexico and the others, the safer would be the managers and shareholders of Citibank, Morgan Guaranty, Chase and Chemical and the others.

W. GREIDER, *supra* note 5, at 520-21.

³⁵ Comment, *Give Me Equity or Give Me Debt: Avoiding a Latin American Debt Revolution*, 10 U. PA. J. INT'L BUS. L. 89 (1988).

³⁶ The objectives of all parties in dealing with the debt crisis should be to restore the creditworthiness of the debtor countries, to strengthen confidence in the international capital markets, to attain conditions that will allow debtors to service their debts while resuming economic growth, and to create international financial structures that will facilitate a gradual renewal of sound lending by the commercial banks. Feinberg, *supra* note 12, at 3, 4.

³⁷ See *infra* notes 39-85 and accompanying text.

³⁸ See *supra* notes 8-9.

³⁹ The debtor country, unable to pay its debts in dollars, is often able to offer its

context of LDC debt/equity programs, the swap functions in the following way.⁴⁰ An investor—either a bank, or a multinational company or financier going through a bank—proposes an exchange of a portion of a country's external debt for equity in a certain enterprise. The government of the debtor country then reviews the proposal.⁴¹ If approved, the investor, if not the bank itself, buys foreign currency-denominated debt at a discount directly from a bank or indirectly in the secondary market.⁴² The bank receives a brokerage fee and commission for service.⁴³ The investor then presents the debt to the central bank of the debtor country for redemption in local currency. The debt is converted at the official exchange rate⁴⁴ and the central bank issues the investor the local currency or rights to the local currency for the par amount of

creditors something in exchange for cancelling the debt. Through the mechanics of the debt/equity program, debtor countries offer to convert limited amounts of debt, "at or near 100% of its full principal amount, into local currency for the purpose of making an approved investment." Working Seminar, *supra* note 31, at 2.

⁴⁰ See generally *Recent Developments International Debt: Debt-to-Equity Swaps*, 28 HARV. INT'L L.J. 507 (1987); letter from John F. Lee, Executive Vice President, New York Clearing House, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System, app. A (Sept. 30, 1987) [hereinafter Clearing House Letter]; Coopers & Lybrand, *Debt-Equity Swaps*, Bull. No. 1, Aug. 1987, at 2 (available from Coopers & Lybrand, New York City) [hereinafter Coopers & Lybrand]. For a detailed analysis of debt/equity conversions under the Mexican program, see Estrella, *Making the Most of Mexican Debt/Equity Swaps*, INT'L FIN. L. REV. Oct. 1987, at 35; Layman & Kearney, *Debt for Equity: A Solution to the LDC Debt Crisis? (pt.2)*, J. COM. BANK LENDING, Feb. 1988 at 33, 39. For an analysis of the Venezuelan debt/equity program, see Rodner, *Venezuelan Debt/Equity Swap Programme*, INT'L FIN. L. REV., July 1987, at 32. For an explanation of Argentina's debt/equity program, see Cardenas, *Argentina's New Debt to Equity Conversion Programme*, INT'L FIN. L. REV., Aug. 1987, at 32; Layman & Kearney, *supra*, at 41. For a discussion of debt/equity conversion programs in Chile and the Philippines, see Layman & Kearney, *supra*, at 36-39.

⁴¹ For the criteria used by Mexico to prioritize its investment proposals, see Operating Manual for Debt Capitalization and Public Debt Substitution by Investment (Mexico), *reprinted in* Council of the Americas Debt-Equity Seminar Workbook V-5 (Oct. 1987)(available from Council of the Americas, New York City) [hereinafter Operating Manual].

⁴² The catalyst for debt/equity exchanges is the growing secondary market that values the debt at substantially below its full principal amount. The amount of the discount varies in each country and changes from time to time. Working Seminar, *supra* note 31, at 2. The secondary market developed in part because commercial banks wanted to diversify their portfolios by purchasing debt or trading it with other commercial banks. Layman & Kearney, *supra* note 20, at 44. See Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, at 69, 71 (discussing the difficulty of valuing Latin American debt on the secondary market); see also French, *Swapping Debt - Just Hot Air?*, EUROMONEY, May 1987, at 115 (discussing the problems with pricing LDC debt).

⁴³ Coopers & Lybrand, *supra* note 40, at 2.

⁴⁴ This is either a floating rate set by currency exchanges, or a fixed rate set by the government. See generally Hanke, *Chilean Flight Capital Takes a Return Trip*, Wall St. J., Nov. 7, 1986, at 33, col. 3 (discussing the Chilean system of capital repatriation); see also Chile: *Purchase of Foreign Debt*, INT'L FIN. L. REV., July 1986, at 115 (discussing the legal changes which facilitated the purchase of foreign debt).

the debt, less certain discounts.⁴⁵ Thus, the debtor country is able to retire its debt, while the investor gains an equity investment in a particular enterprise.

Banks engage in debt/equity conversions in three ways.⁴⁶ Banks can act as brokers or agents, intermediaries between foreign governments and multinational companies eager to make equity investments in developing countries.⁴⁷ Second, banks, in an effort to adjust their portfolios and limit their exposure, can sell their LDC debt on the secondary market.⁴⁸ Finally, banks can exchange debt for equity investments on their own accounts.⁴⁹

3.1. *Advantages of Debt/Equity Swaps*

Although only a few countries have implemented debt/equity programs as a means of reducing external debt,⁵⁰ the mechanism is becoming extremely popular.⁵¹ The attractiveness of the debt/equity swap stems from the advantages it offers all parties involved.⁵² For banks, the

⁴⁵ The discount comprises transaction fees which include: processing fees; charges for quota rights on conversion availability; the temporary or permanent loss of interest income on debt instruments; the use of off-market exchange rates or discounts imposed by the central bank when providing local currency; and the discount imposed by local financial markets when exchanging debt instruments to generate liquidity. Bentley, *Debt Conversion in Latin America*, COLUM. J. OF WORLD BUS., Fall 1986, at 37, 40. The fee charged by each debtor government also varies according to the conversion program, the particular enterprise involved, and government policy. See Coopers & Lybrand, *supra* note 40, at 2, 3. For instance, in Chile, the central bank auctions the rights to debt conversions, while in Mexico, the debt is converted at a discounted exchange rate, depending on the type of company involved in the conversion. In the Philippines, a bi-level fee is levied according to the type of investment and its priority to the country. By charging a fee, the debtor government obtains some of the benefit from the secondary market discount. *Id.*

⁴⁶ Regulation K, 52 Fed. Reg. 30,912 (1987).

⁴⁷ *Id.*

⁴⁸ See Berg, *U.S. Banks Swap Latin Debt*, N.Y. Times, Sept. 11, 1986, at D1, col. 3.

⁴⁹ Regulation K, 52 Fed. Reg. 30,912 (1987).

⁵⁰ These countries include: Brazil, Chile, Costa Rica, Ecuador, Mexico, the Philippines, and Argentina. Similar programs are likely to be implemented soon by other debtor countries. Layman & Kearney, *supra* note 20, at 43. Even where no formal swap program is in place, swaps can still be done on a deal-by-deal basis. See Working Seminar, *supra* note 31, at 2.

⁵¹ As of 1987, Chile, Mexico, Brazil, Argentina, and the Philippines had formal debt/equity programs. Clearing House Letter, *supra* note 40, app. A at 5. Ecuador, too, introduced such a program in December, 1986, and Uruguay, Peru, Colombia, Morocco, the Dominican Republic and Nigeria have conversion programs under study. Bruce, *Who Are Debt/Equity Swappers?*, EUROMONEY, May, 1987, at 117.

⁵² See *Recent Developments*, *supra* note 40, at 512.

Many investors, taking advantage of the incentives associated with debt-equity swaps, invested an estimated \$2.5 billion in four countries alone in 1986. . . . Since the inception of these programs, two years ago, approxi-

swaps offer a means to reduce their exposure through the removal of undesirable debt.⁵³ For tax and accounting reasons, the use of debt reduction through debt/equity swaps can be preferable to writing off the losses (debt forgiveness) or simply selling the debt in the secondary market.⁵⁴ Other benefits include reduced exposure to default, income

mately \$6 billion have been invested and bankers estimate that this number may grow to \$10 billion in a year.

Coopers & Lybrand, *supra* note 40, at 1. See also Clearing House Letter, *supra* note 40, app. A; Buchheit, *Converting Sovereign Debt into Equity Investments*, 5 INT'L FIN. L. REV. 10 (1986); *A Lesson From Chile*, *supra* note 1, at 88.

⁵³ "Debt/equity swaps offer U.S. banking organizations, and other creditors, the opportunity to diversify assets held under extended rescheduling agreements and to increase their liquidity and quality." Letter from Patrick J. Mulhern, Senior Vice President and General Counsel, Citicorp, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System (Sept. 29, 1987) [hereinafter Citicorp Letter]. But see Ollard, *supra* note 42, at 73 (discussing internal regulations and controls on foreigners as drawbacks to capitalization schemes); see generally McDougall, *supra* note 16 (discussing the risks to banks in debt/equity swaps).

⁵⁴ For a discussion of the implications of debt forgiveness, see sources cited *infra* note 119. According to Rev. Rul. 87-124, 1987-2 C.B. 205, when a bank sells debt in the secondary market, it realizes a loss which (under 26 U.S.C. §1001(a)) is the excess of the property's adjusted basis over the amount realized by the seller. For instance, X, a commercial bank, holds a U.S. dollar denominated debt of a foreign country. This debt evidences a loan of \$100 that X made to the debtor country. Under 26 U.S.C. §1011(a), X's adjusted basis in the debt is \$100. See 26 U.S.C. §1011(a) (1988). Y, a domestic corporation, purchases the debt from X for \$60, which is the fair market value of similar loans to the debtor country in the secondary market outside of the debtor country. X's sale of the debt to Y produces a loss of \$40 (\$100-\$60).

Assume that instead of selling the debt to Y for \$60, X delivers the debt to the central bank of debtor country, which credits an account of a foreign company at the central bank with 900 local currency (\$1=10 local currency). The foreign company then issues capital stock to X. In this situation, X will be treated as if it received 900 local currency from the central bank in exchange for the debt, then contributed the 900 local currency to the foreign company in exchange for stock in the foreign country. Under 26 U.S.C. §1001(a), X recognizes a loss on the exchange of the debt for the 900 local currency to the extent of the excess of its adjusted basis in the debt (\$100) over the fair market value of the 900 local currency. X would thus recognize a loss of \$10. X recognizes no gain on the exchange of the 900 local currency for the stock in the foreign company because its basis in the local currency equals the stock's fair market value. Rev. Rul. 87-124, *supra*, at 206.

Under Standard 15 of the Financial Accounting Standards Board [hereinafter FASB], reprinted in M. MILLER, GAAP GUIDE: A COMPREHENSIVE RESTATEMENT OF ALL CURRENTLY PROMULGATED GENERALLY ACCEPTED ACCOUNTING PRINCIPLES §§40.01-40.07 (1988) [hereinafter GAAP GUIDE], loans must be marked to market when they are bought or sold:

Receipt of assets or equity: When the creditor receives either assets or equity as full settlement of a receivable, he should account for these at their fair value at the time of the restructuring. The fair value of the receivable satisfied can be used if it is more clearly determinable than the fair value of the asset or equity acquired. In partial debt payments the creditor must use the fair value of the asset or equity received . . .

Combination of types: The creditor shall reduce his recorded investment

from the fees gained through service charges,⁵⁵ a more accurate reflection of market value on the bank's balance sheet, portfolio flexibility, and devotion of fewer resources to the LDC debt restructurings.⁵⁶ Assuming that the bank is swapping debt for its own account, the ability to acquire equity in exchange for debt presents the potential for a return on the equity investment when the collectability of the debt might be highly unlikely.⁵⁷ The debtor country might also pay out more in foreign remittances than it previously paid for debt service,⁵⁸ or pay dividends sooner than it would have paid its debt.⁵⁹ The possession of an equity interest in an enterprise also allows some participation in corporate decision making and control over investment return.

The swaps are also advantageous to international financiers and multinational companies. Often these parties have existing interests or subsidiaries in the debtor countries. The swap mechanism allows them to acquire debt cheaply and, when exchanged, to decrease the cost of local currency investment.⁶⁰

Id. at §§40.06-40.07.

Banks have traditionally held LDC loans at historical cost. See W. GREIDER, *supra* note 5, at 549 (noting that Volcker encouraged bank examiners to treat huge portfolios of troubled loans with special care, avoiding too strict an application of the rules in order to avoid the necessity of large write-offs). The historical cost of an investment consists of the actual amounts paid for shares or otherwise contributed to the capital account, measured at the exchange rate effective at the time the investment was made. Amendment to Regulation K, 50 Fed. Reg. 39,984 (1985) (to be codified at 12 C.F.R. §211.5). Once a bank sells a portion of its debt, it must mark it to its fair market value. See Staff Bulletin No. 73, 53 Fed. Reg. 109 (1988) (discussing "push down" accounting method applicable to corporate debt acquisitions and sales); Ricks & Truell, *SEC Tells Banks How to Handle Mexico Debt Swap*, Wall St. J., Jan. 5, 1988, at 7, col. 2 (reporting the SEC's announced intention to apply generally accepted accounting principles under which banks must mark to market assets they intend to sell to debt/bond swaps).

⁵⁵ See generally Bentley, *supra* note 45, at 38 (discussing potential advantages of conversion schemes to creditor banks). Because a bank can earn a fee for acting as an agent or a broker, it will often buy LDC debt of a particular country from other commercial banks in the secondary market. The bank can thus take advantage of the secondary market discount while accumulating enough debt of a particular country to sell to an investor. See also Berg, *supra* note 48, at D5, col. 1 (stating that banks profit enormously by buying foreign debt at a discount from other banks and then redeeming it at close to face value). The bank fees can be as much as \$1 million for every \$100 million swapped. *Id.* See L. MALKIN, *supra* note 24, at 126 (discussing the fees earned and the manner in which Citicorp amassed Mexican debt for Nissan Motor Company).

⁵⁶ *Recent Developments*, *supra* note 40, at 508; conversation with Anthony Taccone, International Economist, Mellon Bank, Pittsburgh, Pa. (Jan. 6, 1988). *But cf.* French, *Mexico's Capital Idea*, EUROMONEY, Sept. 1986, at 170 (noting the drawbacks created by Mexican protectionism and rigid government controls on debt-equity swaps).

⁵⁷ Bentley, *supra* note 45, at 38; Layman & Kearney, *supra* note 20, at 45.

⁵⁸ *Recent Developments*, *supra* note 40, at 513.

⁵⁹ Mellon Bank Senate Letter, *supra* note 9, at 11.

⁶⁰ For an example of how the swap mechanism can benefit a multi-national corporation as well as a debtor country, see Orr, *Anatomy of a Swap*, ABA BANKING J.,

Debt/equity swaps can also have significant benefits for debtor countries.⁶¹ The swaps enable debtor nations to capture some of the discount at which their debt is selling in the secondary market.⁶² The arrangement reduces the debt service burden, since the debt swapped will be retired, and presents an alternative to restructuring the entire debt.⁶³ It also compels the investor to share in both the risks and benefits of an enterprise rather than requiring the debtor to bear full risk of failure.⁶⁴ Moreover, by retiring a portion of the debt, and decreasing the debt service burden, the creditworthiness of the country increases.⁶⁵ The stimulation of the economy through the equity investment and the ability of the debtor government to direct resources to development and sectors that increase export earnings⁶⁶ makes the country more attrac-

Apr. 1987, at 81. Chrysler Corp. wanted to fund a major expansion in Chrysler de Mexico. Through Manufacturers Hanover Trust, it acquired Mexican debt through the secondary market. It then converted the resulting \$100 million into roughly \$92 million worth of pesos designated for the specific project. The Mexican debt was converted at the free-market exchange rate. The funds were released in three payments, allowing the Mexican treasury gradually to absorb the shock of redeeming the dollars with pesos. Ultimately, Chrysler funded its \$100 million expansion with approximately \$60 million in pesos, while Mexico eliminated about \$10 million in annual interest payments and converted a \$100 million, dollar-denominated debt into a \$92 million obligation in its own currency. Both jobs and export earnings were created, as well as the potential for additional foreign investment. *Id.* See also Berg, *supra* note 48, at D1, col. 2 (describing the Nissan Motor Company's Mexican debt swap).

⁶¹ *Recent Developments, supra* note 40, at 512 (discussing advantages of swaps to debtor nations). Coopers & Lybrand, *supra* note 40, at 3; Mellon Bank Senate Letter, *supra* note 9, at 3, 13; Orr, *supra* note 60, at 81.

⁶² A. Quale, *New Approaches to the Management and Disposition by Banks of Their LDC Debt: Legal and Accounting Considerations* 329 (Mar. 21, 1988)(unpublished manuscript).

⁶³ *Recent Developments, supra* note 40, at 508; letter from Michael E. Bleier, Managing Counsel for Regulatory Affairs, Mellon Bank, to William W. Wiles, Secretary, Board of Governors, of the Federal Reserve System (Sept. 30, 1987) [hereinafter Mellon Bank Letter]. The interest savings from debt/equity swaps can be significant. If only 10% of the 1986 debt to private creditors of Chile, Argentina, Mexico, Brazil, and the Philippines were converted over the next five years, interest payments could be cut by some \$4.7 billion. Coopers & Lybrand, *supra* note 40, at 3. See Clearing House Letter, *supra* note 40, app. A at 6 (stating that "in the short run, each 1% of outstanding debt swapped for equity has the same effect as a 1% increase in the country's exports, and each percent of the debt that is swapped into equity is equivalent to a reduction of about 8 basis points in the rate of interest that the country has to pay on its outstanding debt").

A basis point is one-hundredth of a percentage point. *Id.*

⁶⁴ Layman & Kearney, *supra* note 40, at 34; *Recent Developments, supra* note 40, at 513.

⁶⁵ See Newman, *LDC Debt: The Secondary Market, the Banks, and New Investment in the Developing Countries*, COLUM. J. OF WORLD BUS., Fall 1986, at 70; Mellon Bank Senate Letter, *supra* note 9, at 12; Alpern & Emerson, *supra* note 6, at A27, col. 5.

tive to foreign capital.⁶⁷ The country also becomes more attractive to domestic capital that might have been invested outside the country.⁶⁸

3.2. *Disadvantages of Debt/Equity Swaps*

The chief drawback of the debt/equity conversions is the potential inflationary impact on debtor economies.⁶⁹ The exchange of "soft" or local currency for hard currency can be inflationary if the central bank in the debtor country prints money to provide for the local currency.⁷⁰ This does not have to occur, however, because the central bank can "sterilize" an expansionary impact through open market operations.⁷¹

⁶⁷ As the foreign exchange balance improves, some capital from dividends on foreign investment will leave the country.

[T]he net effect should be an easing of the foreign exchange constraints as interest payments are reduced. U.S. Commerce Department data for American multinational corporations indicate that in general (from 1977-1985) about 40% of dividends were repatriated from LDCs, with the remainder being reinvested. Consequently, rather than being entirely an outflow on the service account, reinvested earnings can serve to support investment in later periods.

Kearney, *Debt/Equity Conversions* 3 (Mar. 1987)(available from Mellon Bank, Pittsburgh, Pa.) [hereinafter *Debt/Equity Conversions*]. In addition, business confidence in the country's future increases, stimulating investment even from firms not participating in the debt/equity conversions. *Id.* at 4 *cf.* French, *supra* note 56, at 173 (noting some optimism that Mexico's capitalization program will attract new investment, not just investments previously contemplated); Orme, *Swaps Spur Foreign Investment in Mexico*, *Fin. Times*, Jan. 5, 1987, at 7, col. 1; R. Debs, Study Group on Alternative Sources of Finance for Developing Countries: A Summary Report 28 (1987) (available from the Study Group of Thirty, New York City) (discussing "additionality"); *see also* Coopers & Lybrand, *supra* note 40, at 3 (discussing inflow of foreign capital). *But cf.* *Recent Developments*, *supra* note 40, at 512 (noting critics' arguments that investments in LDCs would have been made even without the conversion schemes).

⁶⁸ *Recent Developments*, *supra* note 40, at 512. *Cf.* Hanke, *supra* note 44, at 33, col. 3 (repatriation of flight capital under Chile's conversion scheme). But some countries, such as Mexico, prohibit or strictly control domestic entities or individuals participating in the conversion program. *See* Public Sector Debt Restructuring Agreement, cl. 5.11 (Aug. 29, 1985)[hereinafter *Restructuring Agreement*], *reprinted* in Council of the Americas Debt-Equity Seminar Workbook V-8 (Oct. 1987) (available from the Council of the Americas, New York City).

⁶⁹ Clearing House Letter, *supra* note 51, app. A at 4; conversation with John Simone, Vice President, Manufacturers Hanover, New York City (Jan. 6, 1988). *See also* French, *supra* note 56, at 170; *A Lesson From Chile*, *supra* note 1, at 88; *Recent Developments*, *supra* note 40, at 515; *Debt/Equity Conversions*, *supra* note 67, at 4.

⁷⁰ *Debt/Equity Conversions*, *supra* note 67, at 4.

⁷¹ *See* Hanke, *supra* note 44, at 33, col. 5. In Chile, the external debt is exchanged for a local debt instrument that is then resold in the local secondary market. In this type of conversion, there is no change in the money supply since no money has been created. The use of local debt can increase the operating costs of the issuer of the local debt instrument as cheaper external debt is exchanged for more expensive local debt. Moreover, the introduction of new debt in the local secondary market can raise local interest rates by increasing the demand for money. "[C]ountries with stable capital markets . . . can absorb the new debt instrument, and moderate inflation rates,

Debt/equity conversions can also confer an unfair advantage on foreigners and local entrepreneurs with flight capital abroad.⁷² The ability to purchase debt at a discount and exchange it for local currency at face value makes investment through foreign currency more advantageous than direct domestic investment with local currency.⁷³ Thus, debt/equity programs have the effect of subsidizing those outside the country to the disadvantage of local investors.⁷⁴

Many LDCs also fear loss of sovereignty as foreigners gain some control of domestic industries.⁷⁵ This is manifest in the nature of many debt/equity programs that exempt the most indigenous or successful enterprises from foreign participation.⁷⁶ Debt/equity conversions may also encourage "round tripping,"⁷⁷ by which foreign firms that would otherwise retain earnings in a country are encouraged to extricate those

which generally reflect adequate monetary control." Coopers & Lybrand, *supra* note 40, at 3. Also, countries can limit the number of conversions that occur per month. Hanke, *supra*, at 4.

Some LDCs have difficulty "sterilizing" the inflationary impact of debt/equity conversions due to a monetary policy that involves keeping domestic interest rates low and servicing large public sector deficits. Coopers & Lybrand, *supra*, at 4. Such countries are concerned with the possible crowding out of private debtors as the government competes with them for funds. See Bentley, *supra* note 45, at 40. However, reductions in the deficit, in loans to domestic entities, or in purchases of domestic assets, such as government securities, can neutralize money created to purchase the debt. Clearing House Letter, *supra* note 40, app. A at 4. Thus, only countries unwilling or unable to neutralize the effects of the swaps will experience inflation. Coopers & Lybrand, *supra*, at 3.

⁷² Coopers & Lybrand, *supra* note 40, at 5; Orme, *supra* note 67, at 7, col. 5; Debt/Equity Conversions, *supra* note 67, at 6.

⁷³ Debt/Equity Conversions, *supra* note 67, at 6.

⁷⁴ This argument is weak in light of the existence of a secondary market for debt, the need to repatriate flight capital, the additional resources beyond financial investment that accompanies foreign interest, and the burden of foreign liabilities. Debt/Equity Conversions, *supra* note 67, at 7. See Clearing House Letter, *supra* note 40, app. A at 2 n.4 (stating that the many variables that form the conversion rate discredit the characterization of debt/equity swaps as a subsidized preferential exchange rate).

⁷⁵ The fear is that debtor countries will sell their most indigenous industries, their "souls," to foreign investors in exchange for an outstanding debt. See L. MALKIN, *supra* note 24, at 125-26 (comparing the debtor countries to the hero in Nathanael West's novel, *THE DREAM LIFE OF BALSU SNELL*, who sells off arms, legs and much else to stay alive). See Clearing House Letter, *supra* note 40, app. A at 4 (perceived threat of "loss of national patrimony"). One concern is that when a foreign company invests in a company in the debtor country, partial or total control over the enterprise may pass to the foreign investor. Critics fear that the profit-maximizing goals of multinational companies will conflict with the development goals of the debtor country. Accordingly, debtor governments have adopted measures to limit the control of foreign investors. These include regulations concerning the types of investments available, the areas of the economy where investment is prohibited, and the time period after which divestiture is required. Layman & Kearney, *supra* note 20, at 41-42.

⁷⁶ See Truell & McCoy, *Third World Creditors Give Debt-Equity Swaps a Try*, Wall St. J., June 11, 1987, at 6, col. 2.

⁷⁷ See generally, Debt, *supra* note 67, at 35.

earnings and reinvest them at the preferential exchange rate.⁷⁸ A final concern is the belief held by some that debt/equity conversions only subsidize investments that would be made anyway, without attracting new investment and fresh inputs.⁷⁹

Debt/equity conversions also present potential down-side risks for the banks. Since some of the debtor countries involved are presently servicing their debt, the banks are exchanging a performing asset for a nonperforming asset.⁸⁰ There are also the risks associated with politically and economically unstable developing countries: nationalization, political and social upheaval resulting in new governments with new policies, and currency devaluations.⁸¹ There is, too, the possibility of economic downturn and business failure that would jeopardize shareholder interests.⁸²

It should finally be noted that debt/equity conversions can offer only a limited solution to the LDC debt problem. There are only a limited number of debt/equity conversion programs available in the debtor countries. The transaction costs of the extensive process are also very high.⁸³ Thus, the overall impact on the total amount of LDC debt

⁷⁸ *Id.*

⁷⁹ *A Lesson From Chile*, *supra* note 1, at 88; French, *supra* note 56, at 173; *Recent Developments*, *supra* note 40, at 512. "[W]ithout additionality, the benefit of substituting foreign equity or domestic debt for external debt is slight at best, since the country could achieve most of the same ends by earmarking foreign exchange to pay off some creditors."

Debs, *supra* note 67, at 28.

⁸⁰ Internal Memorandum from Staff to Board of Governors, of the Federal Reserve 6 (Sept. 2, 1987) [hereinafter Staff Memorandum](discussing Meeting with Bankers' Association for Foreign Trade on Debt-for-Equity Investment Issues); conversation with James Keller, Manager, International Banking Applications, Federal Reserve (Jan. 6, 1988). See also French, *supra* note 56, at 168 (observing that equity is more transferable than debt and that the banks are not undertaking the equity for long-term reasons). "Nonperforming" is defined as having payments over 90 days in arrears. When a loan is termed "nonperforming" a bank must subtract 6 months' interest on the loan from bank earnings. J. MAKIN, *supra* note 5, at 237. The equity investments are nonperforming since dividends and profits from resale come under regulations that prohibit remittance and repatriation for specified time periods. This can present difficulties in the short run, depending on the accounting and tax consequences.

The accounting method to be applied to the investments is controversial. Currently, they are accounted for under the equity method. See generally 2 APB ACCOUNTING PRINCIPLES, APB Op. No. 18 (Am. Inst. of Certified Pub. Accountants 1973). [hereinafter APB Op. No. 18]. This method would allow a bank holding company to carry the investment on its books at a greater value than the debt would bring if sold in the secondary market. Additionally, the method allows banks to account for the value of dividends as they accrue despite the repatriation restrictions. Staff Memorandum, *supra*, at 6.

⁸¹ See J. Makin, *supra* note 5, at 253; French, *supra* note 42, at 120.

⁸² Layman & Kearney, *supra* note 20, at 45 n.10.

⁸³ See Debs, *supra* note 67, at 20 (discussing the intricacy of swap deals); McDougall, *supra* note 16, at 121 (discussing the steps in debt conversion).

may be small.⁸⁴ Nevertheless, debt/equity conversions do offer a valuable means to reduce LDC debt, increase development and privatization, and add flexibility to bank portfolios and the rescheduling process.⁸⁵

4. THE NEED FOR REGULATION

Banks occupy a unique position in the economy.⁸⁶ As intermediaries between savers and investors, producers and consumers,⁸⁷ banks regulate the economy. The Federal Reserve Board effectuates its monetary policy through banks,⁸⁸ whose lending determines the money supply.⁸⁹ The safety and soundness of the banks is thus of utmost concern to the Federal Reserve.⁹⁰ The need for public confidence in the banking system's liquidity and solvency has led to numerous regulations. These regulations, while limiting banking options, shield banks from the marketplace, protecting them from contingencies that could lead to bank failure.⁹¹

The notion that banks' activities should be distinct from commerce

⁸⁴ The external debt swapped in the five countries with the most active debt/equity programs (Chile, Brazil, Mexico, the Philippines, and Argentina) totaled \$4.1 billion at the end of 1986. This represented less than 2% of those countries' outstanding debts that year (\$315.6 billion). But if each country were to convert 2% of its outstanding commercial debt over the next 5 years, \$5 billion on interest service would be saved. Layman & Kearney, *supra* note 20, at 34, 35. See Bruce, *supra* note 51, at 117 (detailing volume of debt conversion in countries where swap programs have been implemented).

⁸⁵ See *supra* notes 50-68 and accompanying text.

⁸⁶ Lissakers, *Bank Regulation and International Debt*, in *UNCERTAIN FUTURE: COMMERCIAL BANKS AND THE THIRD WORLD* 45 (R. Feinberg & V. Kalleb eds. 1984). See generally Feinberg, *supra* note 12, at 5 (discussing the role of banking in the U.S. economy).

⁸⁷ Lissakers, *supra* note 86, at 45.

⁸⁸ The Federal Reserve Board has three overlapping roles: it manipulates the money supply and the course of the domestic economy; it serves as the unofficial supervisor and lender of last resort for the vast network of global finance; and it regulates the banks and monitors the financial system. W. GREIDER, *supra* note 5, at 504. The current international debt crisis has raised serious questions about the adequacy of bank supervision and regulation. See *id.* The provisions in the Amendment to Regulation K, while modifying banks' permissible investments and activities abroad, reflect long-standing notions of the need to insulate banks from the marketplace. See *infra* note 90.

⁸⁹ See Lissakers, *supra* note 86, at 45 (generalized description of relationship between banks and government policies).

⁹⁰ W. GREIDER, *supra* note 5, at 504. At a hearing on bank deregulation, Federal Reserve Board Chairman Paul Volcker observed that "in normal circumstances and in most industries" the free market will restructure failing industries, "but when the safety and soundness, broad confidence in banking institutions and continuity in the provision of money and payments services are at stake, competition alone cannot be relied upon to achieve the goals." Lissakers, *supra* note 86, at 46 (citing *Volcker Defends Bank Interests*, Wash. Post, Apr. 5, 1984, at B1, col. 3).

led to the Glass-Steagall Act of 1933.⁹² This Act was designed to restore public confidence in the banking system after the stock market crash of 1929 and the ensuing depression. It separated investment banking operations from commercial banking. Other regulations that limit the scope and type of bank activities reflect the concern that close ties between banks and nonfinancial companies might jeopardize the safety and soundness of banks.⁹³ Regulators have been concerned that banks could be tempted to extend credit to affiliates⁹⁴ on below-market terms, even if the affiliates were not creditworthy.⁹⁵ Regulators also fear that banks might stand behind the losses of their affiliates and subject the banks to substantial losses.⁹⁶ They are also concerned that a bank might favor its affiliate over other debtors, adversely affecting fair competition.⁹⁷

4.1. Changing Attitudes

In the late 1970s and early 1980s, the Federal Reserve and other regulators imposed few restraints on banks to curb their international lending.⁹⁸ Despite extensive lending to third world countries, banks felt little pressure from regulators to curb their practices.⁹⁹ Banks' activities abroad were considered irrelevant to domestic concerns.¹⁰⁰

In 1979, then Federal Reserve Chairman Paul Volcker began an aggressive effort to curb inflation through a tightening of the money supply.¹⁰¹ The dramatic rise in interest rates and the accompanying recession made the burden of debt owed by non-oil developing countries staggering.¹⁰² In the aftermath of the debt crisis, the permissive attitude toward banks' activities abroad changed.¹⁰³

⁹² 12 U.S.C. §§377-78 (1982); see also W. GREIDER, *supra* note 5, at 311.

⁹³ See, e.g., 12 U.S.C. §§1842, 1843 (1982); Regulation Y, 12 C.F.R. pt. 225 (1988); 12 C.F.R. §211.4 (1988) (regulating Edge and agreement corporations).

⁹⁴ Rule 144(a)(1) of the Securities Act of 1933 defines "affiliate" as the following: "An 'affiliate' of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. §230.144 (1988).

⁹⁵ P. HELLER, FEDERAL BANK HOLDING COMPANY LAW, §4.01 (1987).

⁹⁶ *Id.*

⁹⁷ *Id.*

⁹⁸ W. GREIDER, *supra* note 5, at 519.

⁹⁹ See generally Lissakers, *supra* note 86, at 46, 48-49.

¹⁰⁰ These domestic concerns include the management of savings and credit, monetary policy, and the protection of domestic depositors, borrowers, and investors. *Id.* at 48.

¹⁰¹ W. GREIDER, *supra* note 5, at 519.

¹⁰² *Id.* at 519, 547; see also Lissakers, *supra* note 86, at 49, 56; Feinberg, *supra* note 12, at 5.

¹⁰³ See Statement of General Policy at 12 C.F.R. §211.5:

Initially, the financial community considered the debt crisis a "temporary" condition.¹⁰⁴ The Federal Reserve Board encouraged banks to continue short-term lending, bridge loans, to give debtor countries time to work out the financial crisis through economic growth.¹⁰⁵ Despite Congressional hostility toward banks, the Fed resisted proposals for bank concessions on interest rates or debt forgiveness, while austerity programs in debtor countries were implemented.¹⁰⁶ In 1985, then Treasury Secretary James Baker proposed an optimistic plan which focused on the growth of debtor economies as an alternative to austerity programs for debt reduction.¹⁰⁷

Today, however, repeated debt reschedulings¹⁰⁸ and a growing

rectly, shall be confined to those of a banking or financial nature and those that are necessary to carry on such activities. In doing so, investors shall at all times act in accordance with high standards of banking or financial prudence, having due regard for diversification of risks, suitable liquidity, and adequacy of capital. Subject to these considerations and the other provisions of this section, it is the Board's policy to allow activities abroad to be organized and operated as best meets corporate policies.

12 C.F.R. §211.5(a) (1988).

¹⁰⁴ Working Seminar, *supra* note 31, at 1; Layman & Kearney, *supra* note 20, at 37.

¹⁰⁵ Fishlow, *Coming to Terms With the Latin Debt*, N.Y. Times, Jan. 4, 1988, at A19, col. 1. Alpern & Emerson, *supra* note 6, at A27, col. 2. See *infra* notes 108-16 and accompanying text. Critics warned that the commercial banking structure cannot co-exist with substantial writedowns of LDC loans which are dangerously large in relation to the banks' capital.

¹⁰⁶ W. GREIDER, *supra* note 5, at 547. In a period of economic recovery and gradual renewal of confidence in the banking system, Volcker was eager to protect the greatly exposed earnings of the banks. *Id.* at 547, 549; see Truell & Murray, *supra* note 1, at 1, col. 1. See also Silk, *Brazil's Battle Against Banks*, N.Y. Times, Mar. 4, 1987, at D2, col. 3 (noting the intransigent position taken by Citibank regarding concessions to debtors); Beim, *Must We Torpedo Our Banks?*, N.Y. Times, May 4, 1987, at A25, col. 1 (discussing the problems for banks posed by giving interest rate reductions or debt forgiveness to debtor countries). *But cf.* Broad, *supra* note 5, at A25, col. 5 (suggesting need for "managed write-down of third world debt"). Another reason to avoid capitalization of interest or debt forgiveness is the integrity of the international banking system. Such concessions create a precedent that lessens the incentive for future borrowers to meet the original obligations of a loan agreement. Layman & Kearney, *supra* note 20, at 38.

¹⁰⁷ Ipsen, *Can the Baker Plan Work?*, INSTITUTIONAL INVESTOR, Dec. 1985, at 279; Broad, *supra* note 5, at col. 4; Debs, *supra* note 67, at 12; Meltzer, *supra* note 9, at 7, 8; Horowitz, *Bankers Apprehensive on Further Loans to LDCs*, J. COM., May 2, 1986, at 2A:

The debtor nations that would receive new funding are obliged to pursue policies promoting economic growth through market liberalization measures. The plan's focus on economic growth policies seems to be a shift from the International Monetary Fund's emphasis on austerity and restraint in the debtor economies.

But see Farnsworth, *supra* note 17, at 4, col. 1 (discussing the eventual frustration of the Baker Plan).

consensus that the debt crisis is not a short-term lack of liquidity but a long-term issue of solvency has led to "debt fatigue."¹⁰⁹ Discussions of LDC debt have shifted. The debt is no longer perceived as collectable. Its value lies instead in its attractiveness on the small but growing secondary market.¹¹⁰ Several banks have recently added to their loan-loss reserves to cover their LDC debt.¹¹¹ This suggests a recognition that the loans may never be repaid and may eventually have to be written off.¹¹² It also indicates a willingness on the part of banks to take control at the bargaining table, even to reduce new lending¹¹³ in the face of

56-57.

¹⁰⁹ Layman & Kearney, *supra* note 20, at 37, 38. Farnsworth, *supra* note 17, at D1, col. 6.

¹¹⁰ D. Cates, *Redefining Asset Quality*, THE BANKERS, Jan./Feb. 1988, at 5-6 (noting that value depends on marketability); see Farnsworth, *New Debt Relief Policy*, N.Y. Times, Dec. 31, 1987, at 1 (noting that the Treasury's role in the Mexican debt-bond swap plan acknowledges that part of third-world loans will not be paid). Treasury participation in the Mexican conversion plan represents a major turn in strategy from the Baker Plan, which maintained that the debt was repayable in full. See sources cited *supra* note 107. It is also a concession that the Baker Plan did not succeed. See Farnsworth, *supra* note 17, at 4, col. 1. For the first time, the United States is participating in debt restructuring at below the par value of the debt. Farnsworth, *supra*, at 1. See also Rohter, *Latin America Hails Proposal on Mexican Debt*, N.Y. Times, Dec. 31, 1987, at 23, col. 2 (noting Treasury's implicit acknowledgment that Latin American debts are unlikely to be repaid at full value).

¹¹¹ W. GREIDER, *supra* note 5, at 712; Swardson, *Citicorp Move Brings New Era: Huge Reserve Raises Stakes in Debt Talks*, Wash. Post, May 21, 1987, at F1, col. 2; Benton, *supra* note 10, at 6, col. 2. Banks are currently allowed to include loan-loss reserves in their primary capital, which regulators require them to maintain at a certain minimum ratio to assets. *Id.* However, the International Lending Supervision Act of 1983 requires banks to establish special reserves for troubled foreign loans. 12 U.S.C.A. §3904 (West Supp. 1988). The banks may not consider these reserves capital, nor pool them with other loan reserves, as the banks ordinarily would. Lissakers, *supra* note 86, at 59. See Fishlow, *supra* note 105, at A19, col. 1 (stating that the significant decrease in market value of the old debt, along with the corresponding decline in bank credit ratings, prompted the banks to add so extensively to their loan loss reserves). Bank write-offs would also mean a loss to taxpayers, as banks would receive large tax deductions for their loan losses. *Id.* at A19, col. 2. *But see* Rockefeller, *Let's Not Write Off Latin America*, N.Y. Times, July 5, 1987, at E15, col. 1. The author states that the reserve increases are mere transfers of funds that do not cost the banks anything and do not diminish their incentive to recover their loans. *Id.* at E15, col. 2. Such transfers have not only made "no real immediate impact on the overall debt situation," but they were actually followed by a significant rise in bank stock prices. *Id.* Banks would be unwise to cut back on credit extensions to Latin America; because the banks will probably have to refinance about one-third of the interest to ensure their receipt of the other two-thirds, helping Latin America to maintain economic growth is very much in the banks' own interest. *Id.* at E15, col. 6.

¹¹² W. GREIDER, *supra* note 5, at 712.

¹¹³ See Brainard, *supra* note 33, at 43 (noting more cautious and conservative lending policies by commercial banks). Banks' greater focus on domestic activities and expansion into new product areas reflect a shift of priorities away from sovereign lending.

debtor demands for future concessions.¹¹⁴ Meanwhile, many smaller, regional banks, with less exposure, are prepared to write off their losses and stop lending,¹¹⁵ to avoid "throwing good money after bad."¹¹⁶

The Amendments to Regulation K reflect these changes in several ways. First, they recognize that the debt of many heavily indebted developing countries is "impaired."¹¹⁷ This acknowledges the consensus in the financial community that debtor countries are unable to earn sufficient foreign exchange to service the debt. Second, they admit that bank lending to debtor countries has decreased. Third, they recognize that the solvency of the money-center banks is intimately connected with rescheduling. Finally, they reflect a judgment that debt/equity swaps may offer a new option for managing the debt problem.

¹¹⁴ See W. GREIDER, *supra* note 5, at 712. "Citibank, followed by the others, was prepared to play a new kind of 'hardball' at the bargaining table, and that meant the long-running debt crisis was about to enter a turbulent, new phase." *Id.* See also generally Swardson, *supra* note 111 (Citicorp's massive additions to loan-loss reserves perceived by some as indicating tougher negotiating stance in response to debtors' pressure for concessions or relief).

¹¹⁵ W. GREIDER, *supra* note 5, at 712. See also Truell & Murray, *supra* note 1, at 4, col. 4 (noting that Bank of Boston had apparently begun a new round of reserving in December, 1987); Buckler, *NCNB Writes Off 56% of Mexico Loans*, Wall St. J., Jan. 5, 1988, at 7, col. 2 (noting the strategy of NCBC Corp., a bank holding company, to "aggressively reduce its exposure" to loans to developing countries. NCNB had sold its entire portfolio of Chilean loans in 1986 and all its Argentinean loans in the third quarter of 1987). Regional banks, due to their larger reserves, are considered more able to take big losses on their Mexican loans than the more heavily-exposed money-center banks. *Id.* See French, *supra* note 42, at 118 (discussing possible consequences of the regional banks' hesitancy to continue lending).

¹¹⁶ See W. GREIDER, *supra* note 5, at 549; Bailey, *First Bank System Places Nearly All Its Latin Debt on Nonperforming Status*, Wall St. J., Jan. 7, 1988, at 4, col. 1; Rockefeller, *supra* note 111, at E15, col. 1 (noting that regional banks, which are new to international lending, may now find the perfect excuse to cut off all new credits to developing nations); see also Orr, *supra* note 60, at 84. This action by the smaller banks would further depress the secondary market price of LDC debt. Ganitsky & Lema, *Foreign Investment Through Debt-Equity Swaps*, SLOAN MGMT. REV., Winter 1988, at 21, 24. This in turn would increase the burden shouldered by the money-center banks. Consequently, both the Federal Reserve and the larger banks have pressured the regional banks to adhere to the "We're all in this together" philosophy. Newman, *supra* note 65, at 69.

¹¹⁷ The International Lending Supervision Act of 1983, 12 U.S.C. §§3901-3912 (Supp. IV 1987), mandates that special reserves be established by U.S. lenders when the inability of debtors to repay is sufficiently clear. For the regulations by which the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation determine which loans require such reserves, see International Banking Operations, 12 C.F.R. §§211.41-45 (1988).

4.2. Amendments to Regulation K

4.2.1. The Regulatory Structure

The Federal Reserve Act ("FRA"),¹¹⁸ the Bank Holding Company Act ("BHCA"),¹¹⁹ and Regulations K¹²⁰ and Y,¹²¹ promulgated by the Federal Reserve Board, govern foreign investment activities of U.S. banking organizations. Under Regulation Y, a member bank is not permitted to directly acquire foreign equity investments.¹²² However, §25 of the Federal Reserve Act permits a member bank to invest directly in Edge Act and Agreement Corporations.¹²³ United States banks may thus acquire equity investments through a bank holding company ("BHC") or an Edge Act Corporation, though they may not hold foreign equity investments directly.¹²⁴

Regulation K implements the foreign equity investment provisions set forth in the Bank Holding Company Act, the Federal Reserve Act and the International Banking Act of 1978.¹²⁵ Under Regulation K, prior to the Amendments, a U.S. banking organization could hold all of the shares of a foreign financial company, but only up to 20% of the shares of a foreign nonfinancial company.¹²⁶ This reflected the Federal Reserve Board's philosophy that foreign investments made pursuant to the BHCA and Edge Act should be limited to those considered "usual in connection with the transaction of banking or other financial operations abroad."¹²⁷ The 20% cap on investments made in foreign nonfinancial companies was imposed to ensure that banking organizations maintained only a portfolio interest, and thus would not become involved in management of the foreign company. Banking organizations were permitted to acquire between 20% and 50% (a "controlling interest?") of the voting stock of a foreign company if at least 90% of the company's assets or revenues related to financial activities.¹²⁸

¹¹⁸ 12 U.S.C. §226 (1988).

¹¹⁹ 12 U.S.C., ch. 17, §§1841-1850 (1988).

¹²⁰ 12 C.F.R. §211 (1988).

¹²¹ 12 C.F.R. §225 (1988).

¹²² 12 C.F.R. §§225.21-.22.

¹²³ 12 U.S.C. §§611-631 (1988). Corporations authorized under the Edge Act are bank subsidiaries which are engaged solely in international banking or act as investment holding companies. Agreement Corporations are similar.

¹²⁴ BHCA §4(c)(3); FRA §25(a).

¹²⁵ 12 U.S.C. §3101 (1988).

¹²⁶ See 12 C.F.R. §§211.2(k),(n),(p); 211.5(b)(1)(i)(A), (b)(1)(c), (d) (1988).

¹²⁷ 12 C.F.R. §211.5(d) (1988).

¹²⁸ 12 C.F.R. §211.5(b)(1)(i)(A) (1988).

4.2.2. *The Amendments to Regulation K*

On August 19, 1987, the Federal Reserve Board amended Regulation K¹²⁹ in recognition of the economic value of debt/equity conversions and of the banks' desire to make controlling investments in foreign companies not engaged in financial activities. The August Amendment was structured to parallel in the foreign context the troubled debt restructurings available in the domestic arena under Regulation Y. Regulation Y permits banks to acquire a short-term equity interest in a company to avoid a loss on debt previously contracted ("dpc") with that company.¹³⁰ This provision was designed as a temporary measure, to be invoked only when necessary to prevent loss of a debt previously incurred.¹³¹

The August Amendment permitted banking organizations to own all the stock of nonfinancial companies acquired from the governments of heavily indebted countries but only up to 20% of the shares of nonfinancial private sector companies. Yet the incongruence of the LDC debt situation and the circumstances surrounding the use of the dpc provision domestically limited the impact of the Amendment. The Amendment was extensively criticized by the U.S. banks as misdirected and practically useless.

Subsequently, on February 24, 1988,¹³² the Federal Reserve Board again amended Regulation K to further accommodate the needs of the banks. The new Amendment made four significant changes. It broadened the permissible equity investments to encompass holdings of up to 40% in any foreign private sector nonfinancial company.¹³³ It permitted banking organizations to extend loans, in addition to equity, to a foreign company.¹³⁴ It lengthened the holding period in which banking organizations are allowed to retain investments made pursuant to debt/equity swaps.¹³⁵ It liberalized the general consent and notice procedures.¹³⁶

The February Amendment more effectively addressed the ability of banks to participate in debt/equity swaps by tailoring the dpc concept to the foreign debt context. Many criticisms, however, still remain. Banks are now permitted to own up to 25% of the voting stock of a

¹²⁹ See *supra* note 7.

¹³⁰ 12 C.F.R. §225.12(b) (1988).

¹³¹ 12 C.F.R. §211.5(f) (1988).

¹³² See *supra* note 8.

¹³³ 53 Fed. Reg. 5,360 (1988) (to be codified at 12 C.F.R. pt. 211.5(f)(2)(ii)).

¹³⁴ 53 Fed. Reg. 5,360 (1988) (to be codified at 12 C.F.R. §211.5(f)(2)(ii)(B)).

¹³⁵ 53 Fed. Reg. 5,361 (1988) (to be codified at 12 C.F.R. §211.5(f)(4)).

¹³⁶ 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(5)).

foreign nonfinancial company and up to 40% if an unaffiliated shareholder holds a larger block. As with the August Amendment, the question remains whether the increase in the permissible investment level in a nonfinancial private sector company is significant when coupled with other restrictions concerning how the remainder of the shares must be held, divestiture requirements, debt financing limitations, the type of debt that can be swapped, and the form through which the equity investment must be held.

5. ANALYSIS

The August Amendment to Regulation K received extensive criticism from the banking industry.¹³⁷ The criticism was targeted at four areas. First, banks were interested in making equity investments in more than 20% of the shares of nonfinancial private sector companies. Second, banks foresaw difficulties in the time limit specified for divestiture. Third, banks wanted the provision regulating investment procedures to be liberalized. Fourth, banks wished to hold the investments made pursuant to debt/equity conversions through the bank as well as through the bank holding company.¹³⁸ Each of these criticisms was addressed by the February Amendment.

5.1. *Private v. Public Sector Investments*

The August Amendment restricted equity investments to nonfinancial companies being privatized.¹³⁹ The February Amendment permits a bank holding company to acquire up to 40% of a foreign private sector company subject to certain conditions. These conditions allow a bank holding company to acquire more than 25% of the voting shares of a private sector company only if another shareholder or group of

¹³⁷ See generally Citicorp Letter, *supra* note 53; Mellon Bank Letter, *supra* note 63; letter from R. Simmons, Chemical Bank of New York, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System (Sept. 29, 1987) [hereinafter Chemical Bank Letter]; letter from J. Simone, Executive Vice President, Manufacturers Hanover, to William W. Wiles, Secretary, Board of Governors of the Federal Reserve System (Sept. 25, 1987) [hereinafter Manufacturers Hanover Letter].

¹³⁸ Staff Memorandum, *supra* note 80, at 1-2.

¹³⁹ 12 C.F.R. §211.5(f)(2)(ii) (1988). The process of privatization occurs when state-owned companies are denationalized and sold to the private sector. See Savas, *Private Enterprise is Profitable Enterprise*, N.Y. Times, Feb. 14, 1988, at F2, col. 3 (discussing the advantages of privatization); *but cf.* Wortzel, 'Privatizing' Does Not Always Work, N.Y. Times, Feb. 14, 1988, at F2, col. 3 (discussing the disadvantages of privatization). Since public companies are often undercapitalized, their transfer to private ownership will mean a need to increase capital. See Bentley, *supra* note 45, at 40 (stating that without sovereign debt conversion programs, there will not be enough cap-

shareholders unaffiliated with the bank holding company holds a larger block of voting shares.¹⁴⁰ Additionally, the bank holding company would not be able to extend credit of more than 50% of its total loans outstanding to the foreign company.¹⁴¹ Finally, the bank holding company could be represented on the board of directors of the foreign company only in proportion to its shareholding.¹⁴²

In response to the August Amendment, the banking industry advanced several arguments for bank investment in private sector rather than privatized companies. The industry maintained that the supply of privatized companies included in debt/equity programs was limited.¹⁴³ The banks also claimed that a private sector company was more likely to be well-managed and efficiently operated than a public sector company.¹⁴⁴ They contended that the private sector companies are sounder investments, thus investment in them should be encouraged to foster bank stability and to shield the financial system from further losses.¹⁴⁵ The banks argued, finally, that since foreign banking organizations are not prevented from exchanging their eligible debt for privately held companies,¹⁴⁶ any restriction placed on U.S. banks' private sector investment places them at a competitive disadvantage in attempting to minimize their foreign debt exposure.

These arguments presented significant concerns. There are inherent limits to U.S. bank investment in foreign privatized companies. Debtor governments, fearful of the political and economic consequences of foreign investment in their most productive and indigenous enter-

¹⁴⁰ Federal Reserve Act, 12 U.S.C. 226 (1988).

¹⁴¹ Bank Holding Company Act, 12 U.S.C. §1843 (1988).

¹⁴² 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(2)(ii)(C)).

¹⁴³ Programs in both Argentina and Venezuela explicitly restrict foreigners from using swaps to invest in state enterprises, even if the enterprise is to be privatized. In Costa Rica, foreigners are limited to at most a 40 percent share of such enterprises. The only countries where . . . foreigners have used swaps for investment in privatized companies are Argentina, Chile, Mexico, and the Philippines.

Chemical Bank Letter, *supra* note 136, at 2; *see also* Clearing House Letter, *supra* note 40, at 3; Citicorp Letter, *supra* note 53, at 7.

¹⁴⁴ Privatized companies are seen as substandard investments due to their financial difficulties; major labor problems; lack of competitiveness; cost inefficiencies; level of indebtedness; high purchase price; and the onerous conditions that could be imposed on the purchaser. Clearing House Letter, *supra* note 40, at 3; Savas, *supra* note 138, at F2, col. 3; Wortzel, *supra* note 138, at F2, col. 3; *see* Citicorp Letter, *supra* note 53, at 7 (noting the inferior earnings prospects of companies being privatized).

¹⁴⁵ Clearing House Letter, *supra* note 40, at 7.

¹⁴⁶ American Express proposes to swap \$10 million in LDC debt to construct hotels. A Brazilian investment house has purchased 100% of Atlantic Richfield's gas pumping operations in Brazil and is now syndicating the investment. Chemical Bank Letter, *supra* note 136, at 4; Clearing House Letter, *supra* note 40, at 3; Manufacturers Hanover Letter, *supra* note 136, at 4.

prises,¹⁴⁷ have limited the number of privatized companies available for foreign investment.¹⁴⁸ Although many nationalized companies are in the process of privatization, profound "sovereignty concerns"¹⁴⁹ make these countries wary of "colonialism" and risks of expropriation.¹⁵⁰

The argument that private sector companies are usually better managed, more efficient, and thus better investments is also legitimate.¹⁵¹ The state enterprises that are put up for sale are usually those performing poorly.¹⁵² Even when the debtor countries offer financial incentives, such as converting the debt for equity in privatized companies at a more favorable exchange rate, few transactions actually occur.¹⁵³

The objective of banks, as with all investors, is to invest in those

¹⁴⁷ For instance, Mexico has indicated that certain industries will be reserved for the government. These include the petroleum industry, the nuclear power and radioactive minerals industry, mining, electricity, the railroads, and the telegraph and radio telecommunications industry. Other activities are exclusively reserved for Mexicans: radio and television; urban and federal highways motor transportation; air and sea domestic transportation; forestry extraction; and gas distribution. Operating Manual, *supra* note 41, at V-6. The Operating Manual establishes the official procedures for use by the Mexican government in approving debt/equity conversions. See Truell & Yang, *Fed Agrees to Let U.S. Banks Acquire Nonfinancial Firms in Debtor Nations*, Wall St. J., Aug. 13, 1987, at 3, col. 4. See also Debt-Equity Conversions, *supra* note 67, at app. C (charting the 1987 stance on foreign investment for Argentina, Brazil, Chile, Mexico, the Philippines, Columbia, Ecuador, Nigeria, and Venezuela).

¹⁴⁸ Since Chile's debt/equity swap program began in 1985, only 10% of the assets swapped in Chile have involved privatizations. Clearing House Letter, *supra* note 40, at 2; see Citicorp Letter, *supra* note 53, at 7. Note that most of the swaps that have occurred to date have arisen from the investments of multinational companies in private companies. *But see* Wortzel, *supra* note 138, at F2, col. 2 (stating that often the size of the privatized enterprise in relation to the capital available from potential purchasers may make the purchase difficult for most investors).

¹⁴⁹ See *supra* note 75.

¹⁵⁰ See Mellon Bank Senate Letter, *supra* note 9, at 10. This is evident in the divestiture, remittance, and repatriation restrictions.

¹⁵¹ See Mellon Bank Letter, *supra* note 63, at 3. Privatized companies are often over-staffed, lack a meaningful earnings history, and have often been managed on a not-for-profit basis, to achieve social purposes. These investments might also obligate banks to get involved in the debtor country's political process, particularly if staff reductions or other cutbacks are involved.

¹⁵² Wortzel, *supra* note 138, at F2, col. 3. Many political and ideological concerns hinder privatization. Labor unions and ministries may be unwilling to give up control of the enterprise. Indigenous companies are often seen as national symbols. Additionally, if the enterprise is doing well and earning a profit, the debtor government will want to keep it. Since privatizing every state firm is unrealistic, those that are available are often the least desirable.

¹⁵³ For instance, in Mexico, despite the favorable redemption rate, no transactions involving privatized companies have been reported. This is noteworthy because over \$2.5 billion worth of swap activity has occurred. Similarly, in Chile, where swap activity has totaled approximately \$580 million, and in the Philippines, where the conversions have totaled more than \$100 million, only a few transactions have involved private companies.

companies that promise the greatest return, free from government-imposed restrictions.¹⁵⁴ To the extent that a bank believes that it should undertake debt/equity conversions, it has decided that its long-term strategy is best served by investing rather than liquidating its debt in the secondary market. The quality of the investment thus becomes a material factor in the bank's decision.

In addition, the analog to the dpc provision in the Bank Holding Company Act¹⁵⁵ may be overly restrictive in the debt/equity context. In a dpc restructuring, a creditor is allowed to foreclose on a bad loan and to acquire the pledged collateral as a means of offsetting the loan obligation.¹⁵⁶ In a debt/equity restructuring, a bank's sovereign lending is secured by a government's guaranty¹⁵⁷ rather than private collateral. This raises the issue of whether unrelated third party property can be accepted in exchange for the debt. A recent no-objection letter issued by the Comptroller of the Currency authorized the International Bank of Miami, under dpc authority, to convert \$2 million of its Mexican public debt for an interest in a privately owned Mexican hotel, pursuant to the Mexican government's debt/equity conversion program.¹⁵⁸ This letter broadly interprets the dpc guidelines to permit conversion of public sector debt into private equity. In some ways it serves as a precursor for bank ownership of shares in nonfinancial private sector companies.

The contention that nonbanks and foreign banks are able to invest in private sector companies suggests that U.S. banks may be at an unwarranted competitive disadvantage. However, banks can avail themselves of the secondary market, both as a means to liquidate their debt and to realize some of the benefit of the discount through brokerage fees. Banks may thus be able to remain competitive without swapping debt for their own accounts. Allowing banks who possess the debt to swap debt for equity in private nonfinancial enterprises might even give banks an unfair advantage over nonbanks and private investors.¹⁵⁹ The provision may limit the scope of bank activities abroad precisely because of the threat posed to the banking system when banks engage in nonfinancial activities.

The February Amendment recognizes that encouraging banks to

¹⁵⁴ Mellon Bank Letter, *supra* note 63, at 4.

¹⁵⁵ *See id.*

¹⁵⁶ Often the collateral that is pledged is ownership in a business enterprise owned by the debtor. Layman & Kearney, *supra* note 20, at 43.

¹⁵⁷ *Id.*

¹⁵⁸ No-Objection Letter from Comptroller of the Currency to the International Bank of Miami, 5 (Nov. 27, 1987).

¹⁵⁹ *See Debs, supra* note 67 (stating that international debt policy should decrease the role of commercial lenders by encouraging private investment).

engage in debt/equity conversions means allowing them to make equity investments in attractive companies. Otherwise, banks will not find it economically advantageous to undertake conversions. The provision in the February Amendment allowing bank holding companies to maintain an interest of up to 40% in private nonfinancial companies appears to be an economically advantageous and prudent measure. Despite the conditions, banking organizations can make substantial investments in private nonfinancial companies and take advantage of the tax consequences of an operational investment.¹⁶⁰

Although banking organizations inevitably wish to exert as much control as possible over companies where they maintain investments, the Federal Reserve Board must act cautiously. The February Amendment refuses to allow banks to gain "working control" or a greater than 25% interest unless an unaffiliated entity has as great an interest. Conflict-of-interest situations that might further jeopardize the financial position of banks are avoided. The February Amendment thus adapts the structure of the dpc provision in the foreign context while maintaining the fundamental concept that investment is a bail-out measure rather than a new source of investment activity.

5.2. *Divestiture Requirements*

The divestiture restrictions imposed by the recent Amendments¹⁶¹ also arise from the dpc analog to foreign investments.¹⁶² The restrictions underscore the investments as a means of portfolio restructuring rather than a long-term profit opportunity.

The Federal Reserve Board initially proceeded cautiously, requiring divestiture after five years, with extensions allowed on a case-by-case basis for up to five more years. The banking industry was concerned about these short time limits. Most debtor countries structured their conversion agreements to prohibit repatriation of the investment principal for a period of ten to twelve years.¹⁶³ If banks were required to divest after five years, they might be forced to make sales on unfa-

¹⁶⁰ See *supra* note 54.

¹⁶¹ 12 C.F.R. §211.5(f)(1)(iv) (1988): "[T]he shares are divested within five years of acquisition unless the Board extends such time period for good cause shown but no such extension may in the aggregate exceed five years."

¹⁶² See *supra* note 54.

¹⁶³ Chemical Bank Letter, *supra* note 136, at 6, 7. Foreign divestiture requirements are as follows: Argentina-10 years; Brazil-12 years; Chile-10 years; Mexico-12 years; Venezuela-no repatriation for 5 years, then up to 12% for the next 8 years, and no limit after 13 years. These restrictions are designed to reflect the debt restructuring agreements and the political and economic policies behind them. *But see* Staff Memorandum, *supra* note 80, app. A; according to the information provided to the Board, only Mexico prohibited repatriation for a period longer than 10 years.

orable terms.¹⁶⁴ There might be few potential purchasers of investments during the period when repatriation is not permitted by local rules, due to the difficulties of transferability.¹⁶⁵

The agreements formulated by most countries prohibited domestic buyers from purchasing investments resulting from these swaps.¹⁶⁶ Many swap programs have technical specifications that forbid sales to nationals altogether and restrict foreign sales to those foreigners who are parties to the country's restructuring agreements.¹⁶⁷ Local provisions that third parties must consent to the original terms of the swap agreement further limit the feasibility of the sale.¹⁶⁸ Dividend and profit remittance restrictions also complicate sale possibilities.¹⁶⁹ The depressed condition of the debtor economies and the riskiness of the investment also limit the attractiveness of the investment and its resale potential.¹⁷⁰ With few available purchasers, a bank would be forced to accept the prices offered for its equity.

The February Amendment, therefore, extended the time limit to the lesser of fifteen years or two years beyond the end of the period established by the country restricting repatriation of the investment.¹⁷¹ The February Amendment also requires a bank holding company to report its divestiture plan to the Board no later than ten years after the investment is made and again two years before the final date for divestiture.¹⁷² Additionally, if the bank holding company engages in impermissible business in the United States, then the Board has the authority to require earlier divestiture.¹⁷³

The February Amendment appropriately recognizes that the short-term nature of the dpc provision must be reconciled with the long-term goals of debt/equity conversions. To the extent that the Board believes that a divestiture period more in line with the debtor programs will not jeopardize the banking system, it has accommodated both the banks and the debtors.

¹⁶⁴ Clearing House Letter, *supra* note 40, at 4.

¹⁶⁵ Chemical Bank Letter, *supra* note 136, at 7, 8.

¹⁶⁶ *Id.*

¹⁶⁷ *Id.*

¹⁶⁸ *Id.*

¹⁶⁹ *Id.*

¹⁷⁰ *Id.*

¹⁷¹ Amendment to Regulation K, 53 Fed. Reg. 5,361 (1988); *see also* Clearing House Letter, *supra* note 40, at 4 (discussing the uncertainty created by the need to seek periodic Board approval to extend the holding period as a "material detract[ion] from the viability of the Swap Investments").

¹⁷² Amendment to Regulation K, 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(4)(i) and (ii)).

¹⁷³ Amendment to Regulation K, 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(4)(iii)).

5.3. *Portfolio Investments*

Few banks have expressed a desire to acquire 100% ownership in a nonfinancial company.¹⁷⁴ While banks may desire to exert influence over the companies in which they invest,¹⁷⁵ they are not interested in "permanent investments in nonbank concerns."¹⁷⁶ In seeking a liberalization of the investment restriction, banks want to take advantage of the accounting and tax consequences that arise when banks hold equity interests of greater than 20%.¹⁷⁷ Under generally accepted principles of accounting, the equity method of accounting must be employed by investors who own 20% or more of a company or exert other significant influence over that company.¹⁷⁸ Under Regulation K, equity investments in private companies below 20% are termed "portfolio investments."¹⁷⁹ The disadvantage associated with portfolio investments is that investors must account for them by the cost method.¹⁸⁰ This precludes them from including earnings gained from investments in income as they accrue.¹⁸¹ Thus, the banks' objective in seeking to liberalize the investment limit stems less from a desire to gain control of a nonfinancial company than from a desire to take advantage of equity accounting rules. This is particularly true because the banks are swapping a per-

¹⁷⁴ Cf. McDougall, *supra* note 16, at 121 ("Those who have lent to Latin America do not want to own great chunks of it any more than Latin America wants all its assets in foreign hands."); Staff Memorandum, *supra* note 80, at 4 ("[M]ost of our members have not expressed an interest in making controlling investments in private companies in debt/equity swaps.").

¹⁷⁵ McDougall, *supra* note 16, at 121; Staff Memorandum, *supra* note 80, at 4.

¹⁷⁶ Our interest . . . is not in acquiring permanent control of such companies but rather [in] being able to make a meaningful investment in a company that will ultimately enable us to treat the investment on an equity accounting basis, while allowing us to divest of the interest in an economically sound fashion.

Mellon Bank Letter, *supra* note 63, at 5. See also Staff Memorandum, *supra* note 80, at 4.

¹⁷⁷ Banks are currently allowed to make portfolio investments in nonfinancial companies abroad. 12 C.F.R. §211.5(b)(1)(i)(C) (1988).

¹⁷⁸ The equity method can be employed by investors retaining less than 20% interest in certain circumstances where significant influence from an accounting standpoint can be shown. APB Op. No. 18, *supra* note 80, para. 17. For instance, representation on the board of directors, substantial policy making responsibility, interchange of managerial personnel, or material intercompany transactions have been considered indicia of control by the Board. *Id.* Without 20% equity interest, it is unlikely that the banks could demonstrate significant control.

¹⁷⁹ 12 C.F.R. §211.2(n) defines portfolio investment as an investment in an organization that is not a subsidiary (more than 50% investment or control, 12 C.F.R. §211.2(h)), and not a joint venture (more than 20% investment or control but less than 50%) 12 C.F.R. §211.2(k) (1988).

¹⁸⁰ Mellon Bank Letter, *supra* note 63, at 5; see APB Op. No. 18, *supra* note 80, para. 17.

forming loan for a nonperforming asset.

The \$15 million general consent limit and the forty-five-day prior notice requirement allow the Board to regulate individual banks' activity.¹⁸² Under the August Amendment, any investment of less than \$15 million and less than five percent of the investor's capital may be made without prior notice to the Board.¹⁸³ Under the February Amendment, general consent exists if the total amount invested does not exceed the greater of \$15 million or one percent of the equity of the investor.¹⁸⁴ All other investments would require prior notice or specific consent of the Board.¹⁸⁵ Although most swap transactions to date have been below \$15 million, a few have exceeded \$100 million.¹⁸⁶ Banks claim that the flat dollar limit restricts their flexibility to make quick decisions about large investments.¹⁸⁷ Banks also contend that this limit places them at a competitive disadvantage with nonbanks and foreign banks.¹⁸⁸

There is, however, much support for the Board's cautious approach to bank investment. These restrictions reflect the Board's desire not to interfere with an expedited handling of investments, but to oversee investments when they become substantial and potentially costly.¹⁸⁹ The general consent limit and notice provisions constitute important safeguards. They encourage discipline and caution, particularly when substantial amounts of capital are committed to nonfinancial endeavors. The limit provision facilitates the Fed's role as supervisor of the banks. Moreover, the ability of banks to make quick decisions regarding investments is already hampered by the approval delays in the debtor country.¹⁹⁰ The general consent limit thus imposes minimal hardship on the banks.

5.4. *Holding Investment Through the Bank Holding Company*

The requirement that banks hold the equity investments resulting from a debt/equity conversion in a bank holding company or a non-

¹⁸² Like the privatization requirement, these provisions were modeled on the guidelines. Conversation with Ricki Tigert, Assistant General Counsel of the Federal Reserve (Jan. 6, 1988).

¹⁸³ 12 C.F.R. §§211.5(c)(1)(i)(A), (B) (1988).

¹⁸⁴ Amendment to Regulation K, 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(5)(i)).

¹⁸⁵ Amendment to Regulation K, 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(5)(ii)).

¹⁸⁶ McDougall, *supra* note 16, at 121-22.

¹⁸⁷ See Clearing House Letter, *supra* note 40, at 6-7.

¹⁸⁸ See Clearing House Letter, *supra* note 40, at 7; Mellon Bank Letter, *supra* note 63, at 6.

bank subsidiary reflects the traditional notion that banks function in a sphere distinct from commerce. The February Amendment slightly relaxed this provision by permitting an investment to be made through an insured bank subsidiary of the bank holding company.¹⁹¹ However, the bank holding company must demonstrate that this form of ownership is necessary due to special circumstances such as local law requirements.¹⁹² The Board also reserves the authority to impose additional conditions, such as prohibiting loans from the bank to the foreign company.¹⁹³ The fear is that the affiliation of the bank with the nonfinancial company will tempt the bank to extend loans at below market rates.¹⁹⁴ Or, with a joint venture, the Board might prohibit a bank from making more favorable loans either to the company or to the partners.¹⁹⁵

The holding company provision¹⁹⁶ works in conjunction with other conditions in the Amendment, such as the company name and the exchange of information conditions, to make the company and bank operations appear distinct. The company name condition¹⁹⁷ requires that any company acquired pursuant to a debt/equity conversion must maintain a name different from that of the bank. This condition stems from a desire to prevent a misleading perception in the market. With different names, the chance that the nonfinancial company and the bank will be identified as one diminishes. This lessens the likelihood that the bank will confront external pressure to support its nonfinancial company in case of losses. The name separation also reinforces the notion that the Federal Deposit Insurance Corporation ("FDIC") backing that protects banks in the domestic context will not be available to the nonfinancial company.¹⁹⁸

Another provision in the Amendments limits the exchange of confidential information between the bank and the nonfinancial company. Since the affiliate is engaged in nonfinancial activities, it may be involved in areas similar to, and thus potentially competitive with, the banks' customers or affiliates.¹⁹⁹ This provision bars the use of confidential information for improper purposes.²⁰⁰

¹⁹¹ Amendment to Regulation K, 53 Fed. Reg. 5,362 (1988) (to be codified at 12 C.F.R. §211.5(f)(3)).

¹⁹² *Id.*

¹⁹³ *Id.*

¹⁹⁴ P. HELLER, *supra* note 95, at §4.01, 4-4.

¹⁹⁵ Amendment to Regulation K, 52 Fed. Reg. 30,913 (1987).

¹⁹⁶ 12 C.F.R. §§211.5(f)(3)(i), (ii) (1988).

¹⁹⁷ 12 C.F.R. §211.5(f)(3)(i) (1988).

¹⁹⁸ Amendment to Regulation K, 52 Fed. Reg. 30,913-14 (1987).

¹⁹⁹ Clearing House Letter, *supra* note 40, at 8.

²⁰⁰ 12 C.F.R. §211.5(f)(3)(ii) (1988).

Banks object to the requirement that their equity investments acquired through debt/equity swaps be held in bank holding companies or nonbank affiliates. Their discontent concerns the tax and accounting consequences of the provision.²⁰¹ Banks fear that a transfer of debt to the bank holding company will constitute a disposition of assets requiring a valuation.²⁰² Banks, however, want to undertake the debt/equity conversions precisely to avoid this mark-down of the debt. Additionally, according to Federal Reserve Act §23A,²⁰³ the bank holding company must be capitalized to purchase the debt. This makes financing more costly for banks, who are then forced to raise capital in the market rather than use funds from their own deposits.

Banks would like to see this transaction exempted from §23A if they are forced to set up holding companies for these equity investments.²⁰⁴ This would permit banks to contribute debt outright to their affiliates within the context of the swap program, without the collateral-

²⁰¹ Staff Memorandum, *supra* note 80, at 8; *see* Citicorp Letter, *supra* note 53, at 9; Clearing House Letter, *supra* note 40, at 5 (“[C]ertain debtor countries require that an investor be a subsidiary of a banking institution. Thus, holding the Swap Investment outside the bank may not be feasible”).

²⁰² The transfer of the debt from the bank to the holding company raises two issues. First, the transfer may be considered a tax-free capital contribution. Second, if the transfer is not treated as tax-free, then it is necessary to determine whether the transfer would result in a taxable gain to the U.S. bank.

The regulation under the current tax law relating to tax-free capital contributions is unclear. If capital is contributed by a U.S. company to an 80% foreign corporation, then it might qualify for tax-free treatment. However, this is not available for contributions characterized as “tainted” property. It is presently unclear whether LDC debt will constitute “tainted” property in this context.

If the transfer is not treated as a tax-free capital contribution, then the U.S. company may realize a gain on the transfer of appreciated property under 26 U.S.C.A. §61(a)(3) (West Supp. 1988). The gain would be measured by the difference between the dollar value of the local currency to be received by the subsidiary on retirement of the debt and the amount the U.S. bank originally paid for the debt. 26 U.S.C. §1001(a) (1988).

There is a strong argument that the bank would not realize a gain on the transfer. In a simultaneous transfer, the fair market value of the debt when transferred should equal the amount paid for it by the U.S. bank. Additionally, the U.S. bank usually does not have the right to receive the local currency from the foreign government, since this is directed to the holding company. It could be argued that the transfer has no effect on the fair market value of the debt held by the U.S. bank because the bank would be unable to sell the debt to a third party for any more than its original cost. Thus, this transfer might not result in any taxable gain being realized by the U.S. bank. Coopers & Lybrand, *supra* note 40, at 6, 7.

²⁰³ 12 U.S.C. 371(c) (1982). This provision restricts transactions between banks and affiliates. It prevents banks from extending loans to their affiliates unless they are collateralized. *But see* Clearing House Letter, *supra* note 40, at 6 (noting that the Board could alternatively address its concern by placing §23A restrictions on loans to enterprises controlled by banking organizations, without requiring that the investment be held outside the bank).

alization requirement. The issue will most likely be resolved by treating the transaction as a simultaneous transfer, thereby eliminating any negative tax consequences.²⁰⁵ Thus, this restriction should have no detrimental economic effect on the banks. Since the provision establishes accepted and important safeguards, it should be maintained despite bank arguments to the contrary.

6. PROPOSAL

6.1. *Blue Skies Abroad: Freedom of Banking Beyond U.S. Borders*

One alternative to the Amendments to Regulation K is further, or total, deregulation. Without U.S.-imposed restrictions, banks would be able to engage in debt/equity swaps within the framework of foreign conversion programs. Total deregulation, however, would be inappropriate for several reasons.

First, although banks ought to be encouraged to make debt/equity swaps for their own accounts,²⁰⁶ it would undermine basic principles of safety and soundness to allow long-term equity investments in non financial companies.²⁰⁷ The interests of banks and those of regulators may diverge in several areas. The speculative nature of bank interests, together with problems of potential conflicts of interest and preferential treatment, suggest a need for safeguarding restrictions.

Where the safety of the U.S. financial system is at stake, to rely on foreign regulations to supervise divestiture is risky and troublesome. The security of banks would be subject to the political and economic instabilities of developing countries.²⁰⁸ New governments and policies

²⁰⁵ See Coopers & Lybrand, *supra* note 40, at 7.

²⁰⁶ See *supra* notes 50-68 and accompanying text.

²⁰⁷ See *supra* notes 86-97 and accompanying text.

²⁰⁸ See *supra* note 81. Although the major banks have joined to form a creditors' cartel for the purpose of debt restructurings, the debtors have never organized a joint default. The crucial reason for this has been that the financial crises of the debtor countries have never coincided. For instance, in 1984, when Argentina challenged its creditors, both Brazil and Mexico believed that their crises were easing. They discouraged Argentina from defaulting. Similarly, in 1985, when Peru limited its debt payments to 10% of its export earnings, it received no support from other debtors. In 1986, when Mexico came close to suspending its debt payments, Brazil and Argentina, sure that their new stabilization programs would succeed, offered little support. Again, in 1987, when Brazil called its debt moratorium, Mexico and Argentina had just concluded new agreements and were uninterested in concerted action.

Despite the inability of debtor nations to coalesce in the past, the possibility of a joint moratorium still exists. Debtor countries increasingly regard the burden of servicing their debts as the chief cause of their economic stagnation. Additionally, for the first time since 1982, Brazil, Mexico, and Argentina are suffering the effects of high inflation, minimal growth, rising unemployment, and weak governments. See Riding, *supra*

could quickly repudiate safeguards that would no longer seem desirable to them but which had been necessary to protect important U.S. concerns.²⁰⁹ The use of debt/equity swaps to allow banks to gain controlling investments in nonfinancial companies would also allow them to gain entrance into new markets to which they are denied access domestically. This might set an unwarranted precedent for deregulation of banks' domestic activities.

Second, total deregulation overlooks the realities of multiparty cooperation. While one goal of deregulation may be to eventually return to a two-party negotiating process,²¹⁰ the current debt situation demands the participation of international organizations and governments.²¹¹ The unenthusiastic reception of the Mexican zero-coupon bond proposal²¹² suggests the inability of banks and debtors, even with government support, to find mutually advantageous terms.²¹³

Debt/equity swaps were originally introduced as a means to encourage recapitalization and new investment in debtor countries while reducing their outstanding debt.²¹⁴ The mechanism was designed for investors, not for banks. It was also created as a means to reduce reliance on bank lending by fostering private investment.²¹⁵ The latter

²⁰⁹ See *supra* note 81 and accompanying text.

²¹⁰ See Meltzer, *supra* note 9, at 10.

²¹¹ See Feinberg, *supra* note 12, at 8 (noting that banks' future lending levels will be influenced by many factors, including actions taken by governments and international financial institutions).

²¹² Mexico and the Morgan Guaranty Trust Company developed a proposal in which a portion of Mexican debt held by U.S. banks would be exchanged at a discount for as much as \$10 billion in new, marketable Mexican securities. These securities would be backed by 20-year, zero-coupon U.S. Treasury bonds. See *A New Handle on Third World Debt*, N.Y. Times, Jan. 11, 1988, at A18, col. 1; Truell & Murray, *supra* note 1, at 1, col. 1; Hill, Truell & Bailey, *Some Big Banks Plan to Shun Mexican Plan*, Wall St. J., Jan. 8, 1988, at 2, col. 3; *Banks' Plans on Mexico*, N.Y. Times, Feb. 13, 1988, at 48, col. 5 (stating that leading U.S. banks are not expected to participate in Mexico's debt-reduction plan).

²¹³ The debt/equity program offers both debtor and creditor distinct advantages. It is an informal mechanism by which debtors and creditors can reduce debt and stimulate investment. But it is also a tool that increases the liquidity and marketability of the debt. As such, its real benefit is in the additional option it gives debtors, creditors, and their governments in developing a global solution to the debt crisis.

²¹⁴ See Meltzer, *supra* note 9, at 7.

²¹⁵ Debs, *supra* note 67, at 12; see Layman & Kearney, *supra* note 20, at 36 (noting that bank credit became the single most important form of new financing in the early eighties and discussing the cost of such heavy reliance on development projects and balance-of-payments deficits); see also Feinberg, *supra* note 12, at 5 (stating that banks have become the most important source of financing for imports and investment in developing countries); Brainard, *supra* note 33, at 33 (charting the share of commercial bank borrowing in the current account financing of non-oil developing countries from 1974 to 1983).

principle should not be lost by allowing banks to take advantage of swaps for their own portfolios. Since both banks and debtors have limited debt available for debt/equity swaps,²¹⁶ too much bank participation could limit the access of traditional private investors to nonfinancial enterprises. This would not reduce the reliance on banks as the primary source of capital.

Finally, by acting as brokers, i.e., agents of private investors, banks are able to recoup some of the discount on the debt while stimulating new investment. Functioning as intermediaries, banks can both benefit from and serve the original objectives of the conversion programs. By making debt-swapping for bank portfolios too advantageous, regulators risk minimizing the banks' role in facilitating additional private investment.

While it is important that banks be able to use debt/equity conversions as a mechanism for debt reduction, the scheme should not be viewed as a complete solution. The real contribution of such conversions should be the increased liquidity and marketability they give to the debt. By increasing the flexibility of bank portfolios, the conversions change banks' perception of the debt. They thus become an important tool in the rescheduling process. Restrictions are necessary to prevent bank entrance into nonfinancial activities from subverting the goals of the conversion programs and jeopardizing the solvency of the U.S. financial system.

6.2. *Limited Liberalization*

While total deregulation may not be the answer, the Amendments do provide some deregulation.²¹⁷ The August Amendment gave the banks much freedom in terms of the permissible size of investments. Yet it restricted both the types of nonfinancial companies in which a bank could invest as well as the period in which the bank could hold the investments. The February Amendment is more successful in bal-

how, technology and training opportunities for local workers; and access to global production and marketing systems." Layman & Kearney, *supra* note 20, at 41. *But cf. id.* at 42 (noting the obstacles to a favorable investment climate, e.g., overvalued exchange rates, lack of access to imported capital goods and other inputs; unrealistic domestic wages and labor market rigidities; price and market controls on outputs; and restrictions on repatriation of earnings).

²¹⁶ For the banks, this is because the sale of debt would entail losses, even for those heavily reserved.

²¹⁷ While one immediate objective is to allow banks more flexibility in adjusting their portfolios, the ultimate objectives encompass the need for greater flexibility, liquidity, and security in the financial system. *Cf. Feinberg, supra* note 12, at 19 (citing proposed new schemes which reflect banks' increased interest in flexibility, liquidity

ancing the freedom of banks to engage in debt/equity swaps with the restrictions necessary to discourage speculative and risky behavior.

The February Amendment corrects several problems presented by the August Amendment. First, it contains a more liberal analog to the dpc provision, providing the additional flexibility needed by the banks without compromising the principal concerns behind the troubled debt restructurings. This feature lessens the tension between the short-term "bail-out" nature of the dpc provisions and the more long-term consequences of the debt/equity conversions, while leaving the structure and policy of the dpc analog intact.

As a temporary recoupment measure, the dpc arrangement works effectively in a two-party situation when a debtor cannot make a timely payment. It works less effectively when a debt is being serviced according to its scheduled or rescheduled terms even though it is not collectable. Its effectiveness is further diminished when the debt is exchanged for third-party property whose value is intended to increase with time. Given the time period of the private agreement, demanding divestiture before the equity interest has attained its full maturity diminishes the value of the bargain. Extending the divestiture provision to coincide with those provided by the individual foreign programs might make the debt/equity conversions more attractive and workable for banks, without implicating bank solvency.

Second, the February Amendment allows banks at least the flexibility for conversions afforded by the debtor countries. Debt/equity conversions broaden the framework within which reschedulings can occur. One of the means by which debtors generally obtain beneficial rescheduling agreements is by offering concessions in other areas. In the context of debt/equity conversions, debtors may offer the opportunity for substantial investments in exchange for favorable restructuring agreements. The increased liquidity of the debt, and the chance to swap debt for an investment in a nonfinancial company in a productive sector of the debtor economy, might make the bank more amenable to debt capitalization or interest rate concessions. Allowing banks to convert sovereign debt for equity interests in nonfinancial private sector companies offers the banks more attractive opportunities without jeopardizing their financial soundness.²¹⁸

Moreover, increasing bank deregulation in the domestic context suggests that judicial attitudes towards the role of banks have changed. A recent decision by the Court of Appeals for the Second Circuit upheld an order of the Federal Reserve that allows banks to engage in

limited securities activities through wholly-owned subsidiaries.²¹⁹ Because there were provisions limiting the scope of this activity, the Court ruled that the order did not violate the Glass-Steagall Act of 1933.²²⁰ The decision suggests some judicial support for limited bank involvement in securities.

The February Amendment effectively recognizes the need to further liberalize the divestiture and the privatization restrictions. In both these provisions, the economic advantages offered by increased liberalization are more important than the policy concerns behind the limitations.

The provisions encompassing fundamental safety and soundness concerns must remain in the February Amendment as reminders that debt/equity swaps should not be used as a means of entrance into non-financial activities. The provisions governing private sector investment, the bank holding company provision, the notice requirement, and the general consent limits safeguard the banks from the instabilities of the marketplace and the debtor countries. The Amendments allow banks the advantage of equity accounting while preventing over-involvement in nonfinancial endeavors. With these regulations permitting banks effective but controlled participation, debt/equity swaps facilitate private arrangements and restore flexibility to the restructuring process.

7. CONCLUSION

Seven years after the beginning of the debt crisis, developing countries are still futilely scrambling to rebuild their economies while maintaining debt payments. Banks are gradually building up their loan-loss reserves and decreasing their vulnerability to suspensions of payments. But they are still reluctant to lend new money. After numerous restructurings, both parties are in need of new options to manage the global

²¹⁹ *Securities Indus. Ass'n v. Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988) *cert. denied*, 108 S.Ct. 2830 (1988). This decision functionally allowed banks to underwrite and deal in certain securities, although it limited the scope of their involvement. See Squiers, *Bank Affiliates Allowed to Deal in Securities*, N.Y.L.J., Feb. 10, 1988, at 1.

²²⁰ The order did not violate Glass-Steagall because § 20 of the Act, which prohibits affiliations of banks with entities engaged principally in underwriting and securities dealing, is ambiguous as to the meaning of the term "securities." The issue was whether securities meant governmental securities (in which banks can deal) or bank-ineligible securities, such as municipal reserve bonds, mortgage-related securities, and commercial paper. The Board held that "securities" meant the latter. The court upheld the Board's interpretation as consistent with the Congressional scheme. The Board's qualitative and quantitative interpretation of "engaged principally," and thus their limitation on the activity of bank affiliates, was also upheld. *Securities Indus. Ass'n v. Federal Reserve System*, 839 F.2d 47 (2d Cir. 1988).

debt crisis.

Debt/equity conversions offer one such alternative. By decreasing bank exposure and encouraging investment in developing countries, the swaps can be a useful mechanism. The Amendments to Regulation K have sought to use the debt/equity programs in the foreign context as the troubled debt restructurings were used in the domestic context. Accordingly, the Amendments broadened the framework within which banks may swap debt for equity.

The Amendments to Regulation K are an important symbolic step. They are a signal to banks and to Congress of the Board's dissatisfaction with the status quo. They reflect the Board's recognition that the debt cannot be collected and that new options must be explored. The practical effect of the August Amendment was limited. The conflicting provisions within it resulted in an economic stalemate. Allowing the banks to maintain up to 100% equity ownership in a nonfinancial company appeared to be a great liberalization. The corresponding provisions regarding divestiture and the type of nonfinancial equity that could be acquired, however, negated the economic incentives they were designed to create. The February Amendment, heeding bank commentary and market realities, went further, permitting sizeable investment in private-sector companies and more realistic divestiture provisions. While the August Amendment fell short of encouraging bank participation in debt/equity programs, it initiated the debate that led to the February Amendment. The latter Amendment has gone far in reducing the regulatory barriers to debt/equity swaps.²²¹