

1-1-1990

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Recommended Citation

Saturnino E. Lucio II, *Debt-Equity Swaps and U.S. Banks: Alternatives to Regulation K*, 21 U. Miami Inter-Am. L. Rev. 455 (1990)

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DEBT-EQUITY SWAPS AND U.S. BANKS: ALTERNATIVES TO REGULATION K

SATURNINO E. LUCIO, II*

I. INTRODUCTION

United States banks which hold, as creditors, the external debt obligations of certain countries, have several choices concerning such debt. The simplest option is for the bank to keep the debt in its portfolio and await eventual repayment from the debtor. However, in the case of most sovereign debt due by lesser developed countries, the banks may have been forced to reschedule the payment terms of the debt several times during the past five years; and it is entirely possible that the banks may have to further reschedule such debt in the future. In general, debt rescheduling involves an alteration of one or more of the following terms of the debt: 1) a reduction in the interest payable on the unpaid amounts of the debt, at rates approximating, with successive reschedulings, the London Interbank Offered Rate (LIBOR) of interest, and away from the higher rate of interest originally agreed to between the banks and the debtor; 2) an extension of the maturity date of the repayment of the principal portion of the debt, from the usual three to five year term of such loans to terms extending up to twenty-five years; and 3) an extension in the grace period before commencement of payments on the principal amount of the obligation. Reschedulings also may involve other troublesome aspects for banks. For instance, the sovereign debtor may require additional loans from the creditor banks as part of the rescheduling.

There are several problems with continuing to hold the debt through successive reschedulings. First, the terms of a rescheduled debt are invariably worse than when the bank originally extended credit. Second, there is always the possibility that a sovereign debtor may be unwilling or unable to pay the debt (in essence, repudiating the debt). Moreover, the sovereign debtor may demand an additional period of time (*i.e.*, a moratorium), even without the consent of the creditors, before making any further payment of

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principal or interest. In such situations, creditor banks must choose between pressuring the debtors for payment or entering into a new agreement with the debtor country that will likely involve further concessions by the banks. Third, if a U.S. bank holds troubled sovereign debt, it will find that U.S. bank regulators and the bank's own auditors will increasingly insist on the bank taking certain measures to protect itself against a total loss of the debt. These measures may involve further reporting obligations by the bank, the creation of special reserves and write-offs of all or a portion of the debt, all of which consume management time and create additional costs for the banks.

A second option for the bank is to dispose of the debt. The bank may either sell the debt instrument to a third party or trade a particular country's debt for the debt of another country which the bank prefers to hold or which the bank believes has a greater ability to pay.

Thus, the bank can sell the debt on the international secondary market for foreign debt. Many banks and other institutions regularly trade foreign debt, usually at a percentage discount of the face amount of the obligation due. The discount depends on the market's assessment of many factors, including the external debt policy of the country, the amount of its international reserves, its ability to borrow from international organizations (*i.e.*, the World Bank), and the degree of inflation in the domestic economy. The discount percentage can vary over time as well as from country to country. Recently, for example, Peruvian debt was generally trading at approximately five percent of its "face value" compared to Chilean debt which investors bought and sold at approximately sixty percent of its face value.

This secondary market can be quite "thin" with respect to the debt of certain countries. It also may be speculative and subject to rapid fluctuation. Many intermediaries may be involved in sourcing and placing the debt being traded, charging substantial commissions based on a percentage of the transactions.

The bank selling the debt, however, must properly account for its sale. A bank that valued a foreign debt on its books at US\$1,000,000 cannot maintain this value when it sells the debt at a deep discount. For example, on a sale of debt at fifty percent of its face value, the bank must record the incoming cash of US\$500,000 and account for the US\$500,000 loss. This situation can become extreme, as in the case of Peruvian debt, which trades on the sec-

ondary market at about five percent of its face value; thus forcing the bank to account for a loss of ninety-five percent.

These losses require an accounting adjustment which lowers the total asset value of the bank, and thereby reduces the bank's overall capital-to-assets ratio. Because U.S. law requires U.S. banks to maintain a certain capital-to-assets ratio, the losses resulting from a swap may make a bank fall below its required ratio. In this event, the shareholders of the bank will need to invest additional amounts of capital in the bank.

The third major option for U.S. banks with respect to such sovereign debt is to convert such debt into an equity investment in a foreign country under the applicable debt-equity swap program that may be in effect in such country. Not all debtor countries have such debt-equity programs, nor are such programs uniform among the countries in which they exist. Debt-equity swap programs are currently in effect in Argentina, Chile, Honduras, Jamaica, Venezuela, and the Philippines. Similar programs have been in existence in Brazil, Mexico, Ecuador, and Costa Rica, but these have either been suspended temporarily or terminated (although they may be reactivated in the future). Other countries, such as the Dominican Republic and Paraguay, are in the process of implementing debt-equity swap programs. The basic purpose of these programs is to convert a large and pressing external debt obligation of the sovereign debtor, which must be serviced with scarce hard currency earnings of the country, into a productive medium to long-term investment in a targeted economic sector of that country.

II. DEBT-EQUITY SWAP PROGRAMS

Under a typical debt-equity swap program, the debtor government arranges for the payment of local currency to the holder of the debt in return for cancelling such debt. The local currency must then be invested in certain targeted investments within the debtor country. These investments are, in most cases, limited to the acquisition or development of "hard assets," such as land, buildings and machinery, and perhaps working capital and other soft costs. The purpose of these programs is to attract foreign investment to the debtor country.

The face amount of the foreign debt is redenominated in local currency through a formula consisting of the exchange rate be-

tween the two currencies, and a "conversion factor." The "conversion factor" that is applied by a foreign government will vary with market conditions and the type of investment, including the resulting contribution to local economic development or the generation of hard currency earnings for the country. In order to assure such an impact, countries usually impose some restrictions on the ability of the former holder of the debt to repatriate the proceeds of the swap investment (*i.e.*, the investor cannot repatriate the investment for eight years, or only in twenty percent annual portions).

For a bank holding sovereign debt, a debt-equity swap offers certain tantalizing opportunities, tempered, of course, by the risks and costs involved in such an arrangement. First and foremost, the bank has the opportunity to convert a long-term and possibly questionable debt repayment into a current productive investment in a foreign country. For example, a bank holding Brazilian debt, which has been subject to a payment moratorium, may be able to convert such debt into an equity interest in a new tourist hotel. If the hotel can be operated at a profit, particularly by bringing in joint venture partners with experience in the hotel or tourist industry, the bank may improve its financial position as a result of the swap. Second, the bank may eliminate the debt from its troubled loan portfolio and cease reporting the converted debt or discontinue maintaining any reserves with respect to such debt, thus freeing up bank personnel and resources for other tasks. Third, the bank may be able to diversify its traditional banking activities into other activities not necessarily closely related to banking. Fourth, a debt-equity swap may be the only method through which a bank can avoid taking a substantial loss on its books when it trades the debt it holds. Equity investments are generally valued by banks at the lower of cost or market, offering various ways in which a bank could successfully argue to its auditors and regulators that it has incurred only a minimal loss because of the swap.

III. U.S. BANKING REGULATORY CONSIDERATIONS

Until recently, the principal authority under which U.S. banks could engage in a foreign debt-equity swap was found under "Regulation K" of the Board.¹ Although a discussion of the intricacies of Regulation K is beyond the scope of this article, suffice it to say

1. 12 C.F.R. §§ 211.1-7, 211.21-23, 211.31-34, 211.41-45, 211.601, 602 (1989).

that it offers very limited authority for these types of transactions, particularly for smaller U.S. banks.

As a result of the complexity and limitations of the Regulation K process, some banks may prefer to follow an alternative route for making the debt-equity swap. In two no-objection letters issued in late 1987 and in early 1988, the Office of the Comptroller of the Currency ("OCC") validated this alternative approach,² which is based on the principle of "debt previously contracted" ("dpc") under Title 12, Sections 24 and 29 of the United States Code.³ Because the OCC is the agency which regulates the activities of national banks in the United States, these letters are not binding on the regulators of state chartered banks. Nevertheless, the "dpc" concept is generally found under various state banking laws as well as under various laws administered by the Board.⁴

A. *Basis for Authority to Conduct "DPC" Acquisitions*

A bank's authority to carry out a swap investment under "dpc" principles derives from two sources: 1) Title 12, Section 29 of the United States Code which permits national banks to hold real property in satisfaction of debts previously contracted; and 2) Title 12, Section 24 (Seventh) of the United States Code, which, along with judicial precedent and analogies to Title 12, Section 29 of the United States Code, authorizes national banks to hold equity securities in satisfaction of debts previously contracted.⁵ This authority is a *necessary and implied power* of banks recognized since the earliest days of the United States and included among the powers granted in the National Currency Act of 1863.⁶

2. *Exchange of Bank's Mexican Sovereign Debt Portfolio for Interest in Privately Owned Mexican Hotel Pursuant to Mexican Government's Debt/Equity Swap Program*, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,039 (Nov. 27, 1987) [hereinafter OCC Letter I]; *Debt/Equity Swap Transaction in Chile in Satisfaction of Debts Previously Contracted*, [1988-1989 Transfer Binder] Fed. Banking L. Rep. (CCH) ¶ 84,047 (May 20, 1988) [hereinafter OCC Letter II].

3. 12 U.S.C. §§ 24, 29 (1988).

4. For an example of a state law recognizing the "dpc" principle, see Fla. Stat. § 658.67(9) (1984).

5. OCC Letter I, *supra* note 2.

6. National Currency Act of 1863, ch. 58, 12 Stat. 665 (1863). See *Atherton v. Anderson*, 86 F.2d 518 (6th Cir. 1936), *rev'd on other grounds*, 302 U.S. 643 (1937) (national bank permitted to operate manufacturing company in order to salvage the bank's unpaid debt); *California Bank v. Kennedy*, 167 U.S. 362 (1897) (although national bank may not generally acquire stock in a corporation, incidental to the power to loan money is the power to secure loans with stock and to become the owner of the stock in order to salvage the debt).

B. *Special Issues in Debt-Equity Swap Context*

Although a "dpc" acquisition is a common banking practice in the United States, particularly in domestic foreclosure situations, no attempt was made until 1987 to apply this concept to foreign debt-equity swaps. Consequently, there existed several open issues, which have now been settled, regarding the application of "dpc" principles in this context.

1. "Default" of Debt as Necessary Condition

One open issue was whether there had to be a default under the "debt" before a bank could exercise its "dpc" authority. The OCC, however, has recognized that no law or regulation required a finding that the debt was in default to permit such type of acquisition.⁷ So long as the bank could show, based on all facts and circumstances, that its purpose in making the acquisition was not to speculate but rather to simply effect a maximum salvage of a troubled debt, "a bank has implied power when faced with a loss growing out of a legitimate banking transaction to acquire stocks or other property when it is honestly believed at the time that under more favorable circumstances a loss which would otherwise accrue might be averted or diminished."⁸ A bank has this power even if no default has occurred, but the bank concludes in good faith that there has been a negative "change in the financial capacity of the borrower sufficient to invoke the use of DPC authority."⁹

The advisability of converting a foreign debt into an equity position in a foreign company, like the issue of whether the bank should continue to operate a manufacturing company, is not to "be resolved by the application of arbitrary or empirical tests, and much must be left to the business judgment of those responsible for its solution if such judgment is honestly exercised."¹⁰ As noted earlier, there are many sound reasons why U.S. banks may desire to pursue debt-equity swaps. If the circumstances are right and the opportunity exists, U.S. banks are permitted to exercise their sound judgment and convert the debt into an equity investment under "dpc" principles.

7. OCC Letter I, *supra* note 2.

8. *Atherton v. Anderson*, 86 F.2d at 525. See also *First Nat'l Bank of Charlotte v. Nat'l Exchange Bank of Baltimore*, 92 U.S. 122, 128 (1875).

9. OCC Letter I, *supra* note 2.

10. *Atherton v. Anderson*, 86 F.2d at 525.

2. Taking "DPC" Property from a Third Party

Another open issue was whether the property obtained in the swap had to be the property of the debtor as opposed to property of a third party. As noted by the OCC, there is no requirement under "dpc" cases that the property conveyed to a bank to satisfy debts previously contracted served as collateral security for the debt or had been the property of the debtor.¹¹ While this may be the typical pattern, there are probably many instances in which U.S. banks have obtained interests in real property and companies, where third parties conveyed these interests to the banks (whether or not they were guarantors of the loan) to satisfy unsecured debts.

In contrast, sovereign debt tends to be unsecured. Moreover, it is not likely that a sovereign debtor would swap the national palace in lieu of paying its external debt.¹² Instead, sovereign debtors with debt-equity swap regimes have established a system whereby their foreign debts can be exchanged for currency or other property to be invested in their countries. Indeed, the two OCC letters accept that mechanism as being in compliance with the "dpc" concept.¹³

3. Necessity for Debt to Have Originated with a Bank

Finally, OCC Letter II settled the issue of whether the debt to be exchanged for the swap investment had to be the debt of the country originally in the bank's portfolio or could be another country's sovereign debt which the bank acquired by trading.¹⁴ In OCC Letter II, a national bank held Brazilian and Venezuelan debt, but located a good swap investment opportunity in Chile. The bank desired to swap the Brazilian and Venezuelan loans for Chilean debt held by another bank, and then to contemporaneously swap the acquired Chilean debt for the investment in Chile. Noting that the bank would not engage in the first part of this transaction (as to which it had the inherent power to reconfigure its loan portfolio) without assuming itself it could complete the second step of the transaction, and viewing all these steps as part of an integrated

11. See *supra* note 2.

12. There is an increasing tendency among debtor countries, e.g., Argentina, to offer to exchange state-owned companies for foreign debt. This "privatization" approach is becoming an important route for debt-equity swaps in Latin America.

13. See *supra* note 2.

14. OCC Letter II, *supra* note 2.

operation, the OCC did not object to the bank's "dpc" acquisition of the shares of a Chilean insurance company.

C. *Holding Periods for "DPC" Acquisitions*

"DPC" acquisitions differ from typical investments in that they are generally regarded as temporary and permitted only for a limited period of time within which the bank must make reasonable efforts to dispose of the "dpc" property. Holding periods for "dpc" property are generally limited to five years by statute¹⁵ and by judicial and OCC precedent, although Title 12, Section 29 of the United States Code permits the OCC to extend the holding period of real estate for another five years (based on annual justifications).¹⁶ Under the Board Standard for Regulation K "dpc" acquisitions, the holding period is two years.¹⁷ In contrast, Section 211.5(f) investments under Regulation K provide for a fifteen year time period within which the bank must dispose of its swap investments.¹⁸

Because many debt-equity regimes prohibit a swap investment from being repatriated from the country for periods of time ranging from three to twelve years, care must be taken to structure the transaction in order to comply with both banking restrictions and foreign law. In the two OCC rulings, the bank in question established a system of multi-level subsidiaries in which shares could be sold to other subsidiaries without the need to repatriate the investment from the country by simply substituting the owner of the investment. In addition, "put and call" agreements were negotiated with important financial groups, providing the bank with the option of requiring such groups to purchase the bank's interest in the swap investment within a short time frame.

D. *Approval of "DPC" Acquisitions*

Because a bank carries out a "dpc" acquisition pursuant to its *inherent powers*, there is really no requirement that the OCC (and presumably any other primary regulator) review or pass upon the proposed transaction. Nevertheless, a prudent national bank that

15. 12 U.S.C. § 29 (1988).

16. *Id.*

17. 12 C.F.R. § 211.5(e) (1989).

18. 12 C.F.R. § 211.5(f) (1989).

believes it may be departing, even slightly, from prior cases and rulings may request a no-objection letter from the OCC concerning the transaction. These no-objection letters serve as informal rulings from the OCC. The process essentially requires describing the transaction in detail and then discussing at length with OCC representatives any issues raised regarding the transaction. Although requests for no-objection letters are normally sent to the OCC regional office, the OCC's Washington, D.C. office usually decides transactions involving foreign debt-equity swaps.

If a bank expends any funds in addition to a mere swap of the debt in the course of a "dpc" investment, however, the OCC may require prior notification and, once it has notice, may object to the transaction or require it be restructured.¹⁹

E. "DPC" Acquisition Versus Regulation K Investment

There are various advantages and disadvantages in choosing a "dpc" format for a swap investment over that permitted by a Regulation K format. First, Regulation K permits few foreign investments for U.S. banks (as opposed to bank holding companies or other banking entities). Additionally, there are significant interaffiliate transaction problems in arranging the transfer of foreign debt from the bank holding the debt to the investor. Regulation K also establishes certain prudential limitations in terms of the amount that can be invested without a thorough review by the Board,²⁰ whereas a "dpc" acquisition can be made irrespective of the relationship between the amount of the investment and the capital and surplus of the bank.²¹ Regulation K also establishes numerous other limitations which must be observed.²² Under a "dpc" acquisition, in contrast, the only critical issue is whether the banking investor is speculating or genuinely attempting to effect a maximum salvage of a troubled debt. As a result, OCC no-objection letters in this area, therefore, tend to be very fact-specific. Under Regulation K, however, there is no general requirement of divestiture of an investment and, where there are some time limits for divestiture, these limits extend further than those applicable to "dpc" acquisitions.

19. See OCC Examining Bulletin 80-14 (Aug. 20, 1980).

20. 12 C.F.R. § 211.5(c) (1989).

21. 12 U.S.C. § 29 (1988).

22. See *supra* note 1.

IV. CONCLUSION

As of the date of this article, the mechanisms set out above constituted the principal options for U.S. banking organizations that are contemplating making an investment in a foreign country through a debt-equity swap. Somewhere in the maze of federal banking regulation (and presumably under state regulation as well), a bank can probably find an acceptable route for conducting a desired transaction. As evidenced by the recent OCC letters and the Board's recent expansion of the options available under Regulation K, banking regulators in this country are aware that U.S. banks face very difficult choices regarding the foreign debts they hold. These regulators are willing to grant banks considerable flexibility in order to confront these problems and overcome them. From all of the recent developments, however, it appears that the law in this area is not completely settled. Indeed, new approaches and initiatives are likely to be developed in the future.