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THE PROMOTION OF DEBT-EQUITY SWAPS IN LATIN AMERICA: A SURVEY OF THE REGULATORY REGIMES AND THE INTERNATIONAL POLICY FRAMEWORK

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I. INTRODUCTION

August 1988 marked the sixth anniversary of the "Latin American debt crisis."¹ This crisis has burdened Latin American

1. Mexico's announcement in August 1982 that it would be unable to meet its loan obligations triggered the so-called "debt crisis" in Latin America. From 1983 through 1986, \$243.1 billion of debt was renegotiated among developing countries and both banks and official creditors. Latin American debt represented a significant portion of this amount. See INT'L BANK FOR RECONSTR'N AND DEV., WORLD BANK, WORLD DEV. REP. 1987: BARRIERS TO ADJUSTMENT AND GROWTH IN THE WORLD ECONOMY, INDUSTRIALIZATION AND FOREIGN TRADE WORLD DEVELOPMENT INDICATIONS 20-21 (1987) [hereinafter WORLD BANK 1987]; Kuczynski, *The Outlook for Latin American Debt*, 66 FOREIGN AFF. 129 (1987) [hereinafter *Outlook*]; Sachs & Huizinga, *U.S. Commercial Banks and the Developing-Country Debt Crisis*, in BROOKINGS PAPERS ON ECON. ACTIVITY 555 (W. Brainard & G. Perry eds. 1987).

governments, private citizens, and corporations with debt obligations estimated at \$388 billion² owed to banks and governments in the industrialized world, and has posed a constant threat to both the continued growth of the developing world and to the stability of the international banking system. Accordingly, the substantial fear of slowed interest payments³ and default has forced major creditors to search for alternatives designed to ensure maximum repayment of these loan obligations.⁴

The innovation of the debt-equity swap,⁵ whereby external

2. This figure constitutes the external debt of the 22 Latin American member countries of the Inter-American Development Bank as of December 31, 1986. This external debt figure takes into account long-term private debt (i.e., debt with repayment exceeding one year), long-term public debt, and short-term debt (i.e., debt with repayment of one year or less). INTER-AM. DEV. BANK, ECONOMIC AND SOCIAL PROGRESS IN LATIN AMERICA, 1987 REP. 33-39 (1987).

More recently, the World Bank calculated the total external debt for 27 Latin American and Caribbean nations to be \$442 billion. INTERN'L BANK FOR RECONSTR. & DEV., WORLD BANK, WORLD DEBT TABLES: VOLUME 1, ANALYSIS AND SUMMARY TABLES 18 (1988-1989 ed.) [hereinafter DEBT TABLES 1988].

3. See *Outlook*, supra note 1, at 140. The author identifies several reasons for the burden of paying interest on the external debt. These are:

- (1) the shortage of external capital flows, which has made it necessary to maintain large trade surpluses and to keep imports and thus economic growth down;
- (2) the lack of growth itself, combined with persistently high inflation in several major economies;
- (3) the unfavorable outlook for traditional exports as well as the increasing threat of protectionism to more recent manufactured exports; and
- (4) the very large fiscal burden of servicing the debt, which puts pressure on governments to raise taxes, most of which are indirect and thus inflationary in their initial application.

Id.

As of mid-1987, eight Latin American countries had unilaterally halted or reduced debt service. *Latin Debt Update: Innovations Arise but Old Problems Remain*, 1987 BUS. LAT. AM. 161. Note that banks are required to place loans on non-accrual status when interest payments are 90 days late, thereby recognizing income when interest payments are received rather than earned, as under the accrual basis. Pollack, *3 Banks Reclassify Brazil Debt*, N.Y. Times, Apr. 2, 1987, at D1, col. 6 (nat'l ed.).

4. One economist, Howard J. Wiarda, has commented that it is inconceivable that Latin America can ever pay this debt back, and "no one believes seriously that the debt can or will ever be paid back in full." Marlowe, *Foreign Loans Not Likely To Be Paid Back*, Tampa Tribune, May 27, 1987, at ID, col. C. Accordingly, some bank creditors have considered forgiving a portion of these troubled loans as a form of debt management.

5. The term "debt-equity swap" is a short-hand term that has been used to describe what should more appropriately be called "debt conversion." As part III of this article explains, debt may be converted not only into equity or direct investment, but also into debtor country currency. The authors will attempt to be as specific as possible in their use of terms, but regret that the term debt-equity swap has become such a catch-all phrase that its misuse has become commonplace among many commentators. To this extent, an occasional lack of precision becomes unavoidable. See, e.g., Roberts & Remolona, *Debt Swaps: A Technique in Developing Country Finance*, in FINANCE FOR DEVELOPING COUNTRIES 18-19 (R. Debs ed.

debt obligations are purchased at a substantial discount and converted into domestic obligations, has become one of the most attractive debt management alternatives to emerge from the debt crisis.⁶ Transactions initially were limited and confined to portfolio swaps between commercial banks. Recently, though, not only has the debt-equity swap market become well organized, but trading volume also has grown, and the participation and variety of transactions has significantly increased.⁷ Although debt-equity swaps are no panacea to the debt crisis, they are expected to reduce Latin America's debt burden by approximately 10%.⁸

In general, debt-equity swaps represent an attempt on the part of a debtor country to retire some of its debt and to minimize the heavy burden of payments of interest and principal by swapping an external obligation for a domestic obligation. This, it is hoped, will encourage new investment in the debtor country's economy. In order to meet these objectives, each debtor country wishing to participate in debt-equity swaps must develop its own program requirements. These requirements must be consistent with the country's goals of ameliorating its debt burden and generating new investment. At the same time, the unique character of each country's debt-equity program provides the potential investor with an opportunity to select appropriate investment climates, levels of risk, and restrictions which best suit the investor's needs.

This article will survey the Latin American debt-equity re-

1987). For a further discussion of this problem, see WORLD BANK 1987, *supra* note 1, at 22.

6. Professor Alan Meltzer, of Carnegie-Mellon University, is considered to be the first proponent of having debtor countries exchange debt for equity as a means of retiring debt obligations. Meltzer, *A Way to Defuse the World Debt Bomb*, FORTUNE, Nov. 28, 1983, at 137.

7. See Orme, *Trading Latin Debts: Has the Secondary Market Come of Age?*, LATIN FINANCE, Oct. 1988, at 39 ([I]n 1983 bankers bought and sold half a billion dollars in third world and East European debts at rates well below the paper's face value In 1987 volume topped \$10 billion and profits an estimated \$100 million). See also Peagam, *On the Edge of a New Wave*, EUROMONEY, Mar. 1988, at 147. ("The Latin American debt market will continue to expand this year, as both debtors and creditors seek new ways out of the debt morass. . . . Trading volume should grow as the five-year-old market becomes more sophisticated and as creditor banks manage their Latin American exposure more actively.")

8. It was estimated that over \$12 billion of developing country debt was swapped through 1987 by debt-equity programs, most of which was from Latin America. Roberts & Remolona, *supra* note 5, at 19. As of March 1988, Chile has reduced its total external debt by approximately \$2.9 billion, representing about 10% of its foreign debt, since launching its debt-equity program in May 1985. See Peagam, *supra* note 7. Specific figures, however, are difficult to compile since prices are negotiated and there is no central trading floor or reporting system. Forecasts for volume in 1988 were placed unofficially at between \$12 billion and \$25 billion. *Id.*

gimes and consider them in light of major international trends, namely, as responses to recent shifts in patterns of international finance, and as attempts to facilitate growth in Latin American debtor countries while preserving the stability of the international banking system. Part II will discuss the economic motivations behind debt-equity swaps from the perspectives of the major participants in the transaction. Part III will provide an overview of the mechanics of a debt-equity swap and compare it with other debt conversion alternatives. Part IV will provide a detailed and comparative analysis of Latin American nations which have active debt-equity programs. Part V will address the direct and indirect effects of debt-equity swaps on the program participants. Finally, Part VI will analyze the United States regulatory environment and the way in which it may promote or constrain debt-equity swaps. We conclude that debt-equity swaps offer a limited opportunity to reduce foreign debt obligations and promote direct investment, but that existing regulations nevertheless should be coordinated and liberalized to encourage participation in these programs.

II. PERSPECTIVES ON DEBT-EQUITY SWAPS

Debt-equity swaps, by definition, involve a shift from debt finance to equity finance.⁹ To the extent that this shift to equity finance is designed to maximize debt retirement in the midst of economic uncertainty, many Latin American countries consider it to be a desirable alternative at this stage of the debt crisis. The proliferation of these programs reveals a great deal about the economic incentives that control the calculus of debt repayment and potentially could offer an insight into the proper role of public and governmental agencies in ameliorating the debt crisis.¹⁰

9. Financing obtained through bank lending, official finance, or bonds represents debt finance. When a country engages in debt finance, the debtor must repay the face value of the loan, including interest, regardless of its future inability to repay the loan. Equity finance, however, encompassing direct investment, has a different set of effects on the debtor. In the case of direct investment, the foreign owners of the investment have a claim only to a share of the investment's earnings. Unlike debt finance, the foreign shareholders do not have a claim to a periodic stream of fixed payments and, accordingly, adverse economic events affect only the output of the investment. In the case of debt finance, a failing economic condition does not minimize the responsibility of the debtor to meet its payment obligations. P. KRUGMAN & M. OBSTFELD, *INTERNATIONAL ECONOMICS* 591 (1987) [hereinafter KRUGMAN & OBSTFELD].

10. It is important to distinguish the economic rationale behind debt-equity swaps from the standpoint of the participants of the swap, which is discussed in this section, from the desirability of the swaps in a macroeconomic sense, which is discussed in section V, *infra*.

In order to appreciate more fully the economic impulses which have led to the widespread adoption of debt-equity programs, it is necessary first to explain in detail the objectives of the three major groups of players in the debt-equity swap process — the debtor countries, the creditor banks, and the investors. The government of the creditor, a fourth major creditor, has the ability to generate or discourage the use of these swaps through a wide range of policy tools; the role of the government will be discussed in Section VI by analyzing the regulatory response of the United States government, the principal regulator of a majority of the investors in debt-equity swaps.¹¹ By focusing attention on the underlying economic rationale of swaps, it is hoped that creditor and debtor countries will be sensitive to the economic realities that underlie the policy debate as they formulate their policies.

A. *The Lending Environment*

Debt-equity swaps must be understood as a reaction to the dominant model of debt finance and involuntary lending that has evolved over the last decade.¹² As the Latin American debtor coun-

Although this distinction becomes blurred when one looks at the economic rationale of the debtor country for participating in the swap, it is an important distinction to make. To the extent that the incentive to participate in a swap may be greater for one participant than another, this may result in a swap where the terms and conditions contribute little to the economic health of the host country, which nevertheless may approve the swap because of the mistaken belief that all swaps are desirable.

11. Any discussion of governments' role in the debt crisis would be incomplete without a consideration of the desirability of regulatory reform not related to the debt-equity process occurring within the debtor countries. The literature concerning the need for Latin American countries to liberalize their economic policies to generate growth and foreign investment is extensive, and warrants separate treatment. The literature which calls for a stronger state presence in the economy as a desirable solution to the region's economic ills is equally extensive. Nevertheless, a country's investment climate is the sum of many factors, and it would be remiss not to include in our analysis these concerns where they are most appropriate.

12. Involuntary, or forced, lending is the increase in the exposure of a bank to a borrowing country that is in debt servicing difficulty and that, because of the corresponding loss of its credit rating, would not be able to attract new lending from banks that are not already exposed to that country. Thus, banks which have outstanding loans to these debtor countries lend the countries new money so that they may meet their old obligations. See W. CLINE, *INTERNATIONAL DEBT AND THE STABILITY OF THE WORLD ECONOMY* 74 (1983). Bank lending during the 1970s, wherein banks recycled their vast holdings of "petro dollars" to the developing world at low rates of interest, was the first act in the sequence which culminated in the involuntary lending cycle. The reliance on bank lending, as opposed to debt financing through bonds, for example, largely can be traced to the relative advantages of bank borrowing in financing development, and not the specific events of the decade which made the supply of credit easily available. More specifically, bank financing was much

tries experience greater difficulty in servicing their present loan obligations, however, and become more unwilling to commit to more debt, the popularity of debt conversion schemes increases. Debt conversion schemes, as noted, relieve the burdens caused by the interest and principal payments by matching repayment to the economic success of the equity investment and thus help control the tremendous net outflow of resources from debtor to creditor.¹³ In comparison to the "involuntary lending" solution of using new loans to help facilitate the repayment of old loans, this conversion approach recognizes that interest and principal repayment without new lending is speculative at best. Debtor countries, to their advantage, also relieve some immediate obligations in return for extended repayment periods under the terms of a conversion plan. In debt-equity swaps, the repayment period is controlled by the provisions of the debt-equity program rather than by the underlying

cheaper during the 1970s than its alternatives. Additionally, the ease with which banks would reschedule loans embodied a flexibility that was advantageous to the debtor country. The general obligation nature of the lending, and the concentration of lending in the hands of a few banks, also served to provide a mechanism of enforcement which encouraged bank lending. Nevertheless, the inability of bank loans to correspond to shifting economic conditions, the general obligation nature of the loans which fails to link repayment with the success of the project for which the money was loaned, and the effect undermining local capital markets all contribute to the inability of the debtor countries to repay their loans. This difficulty in repayment, when coupled with the concentration of outstanding obligations to a few banks, generated the cycle of new loans to repay interest on outstanding obligations, thereby creating a process of involuntary lending. For a description of the events leading up to this involuntary lending cycle, see D. LESSARD & J. WILLIAMSON, *FINANCIAL INTERMEDIARIES BEYOND THE DEBT CRISIS* 40-45 (1985). See also *infra* notes 22-24 and accompanying text.

Of course, the concept of involuntary lending is not peculiar to an international debt system. Lenders often find it necessary to extend additional credit to non-paying debtors in order to meet their existing obligations, thereby improving the creditors' position. See generally, Lopucki, *A General Theory of the Dynamics of the State Remedies/Bankruptcy System*, 1982 Wisc. L. Rev. 311, 336-38 (1982).

13. *Outlook*, *supra* note 1, at 144; *supra* notes 9-10 and accompanying text. The underlying theory of simultaneously injecting new capital and retiring debt is supported by recent government studies. For example, at a December 1, 1986 "congressional summit" on trade and debt issues, U.S. Trade Representative Clayton Yeutter called on poor nations "to reduce the role of government in their economies." Treasury Secretary James A. Baker III warned that new private investment is unlikely unless it is "combined with vital market-oriented policy changes." Deputy Secretary of State John C. Whitehead said that "continued borrowing is not the long-term answer to growth in the lesser developed countries. The answer is increased equity investment." This means that poor nations should sell state-run enterprises, swear off economic planning, allow U.S. banks full access to local financial markets, and generally eliminate laws or regulations that limit foreign investment. Debt-equity swaps are a device in vogue which satisfies these twin objectives. Ganitsky & Lema, *Foreign Investment Through Debt-Equity Swaps*, SLOAN MGMT. REV. 21, 27-28 (Wntr. 1988).

loan agreement.¹⁴

B. *The Debtor Country's Perspective*

The debtor country, when considering its debt strategy, faces a range of options extending from default to repayment under the present terms of its loan agreements. Within this range, renegotiation of existing loans and debt conversion present the most popular alternatives, as do the new innovations outlined in Part III.¹⁵ From the standpoint of the debtor country, the relative desirability of these alternatives must be addressed in light of two noncontroversial objectives that would appear to apply to all Latin American countries — the retirement of external debt obligations and the preservation of capital flows.¹⁶

Debt conversions have become popular among Latin American countries because they offer palatable alternatives to either default or repayment under present conditions, which would be problematic for the debtor country. Although default theoretically represents the most attractive short-term alternative for countries wishing to retire debt obligations, it is not without its costs. For example, default may result in the seizure of the debtor's assets, the exclusion of the debtor country from future borrowing, and the reduction of any possible gains from trade that might have benefited the country.¹⁷ The debtor country must weigh these costs against the benefits of default, which primarily involve the elimi-

14. For a discussion on repatriation restrictions, see *infra* notes 115-29 and accompanying text.

15. In addition to the analysis which focuses on the relative costs and benefits of default and continued repayment discussed herein, Sachs and Huizinga also consider the effects of maintaining the status quo. The mere presence of a debt can harm both the creditor and debtor. First, protracted renegotiation of the debt can be very costly. Second, any possible disruption of the negotiations could result in the fear of a possible default, which would provoke the same response as an actual default. Third, the debt can stifle economic reform within the debtor country. Presently, any economic gains from reform flow directly into the coffers of the creditor banks; this process serves as a significant disincentive to reform and fuels whatever significant political opposition there may be to the reforms. Sachs & Huizinga, *supra* note 1, at 595.

16. No long-term solution to the debt problem is possible without a mixture of economic reform in the debtor countries and additional fresh capital, both of which are needed to revive economic growth. See generally B. BALASSA, G. BUENO, P. KUCZYNSKI & M. SIMONSEN, *TOWARD RENEWED ECONOMIC GROWTH IN LATIN AMERICA* (1986). For the development of these objectives as the overriding concern of Latin America, see generally, R. MATTIONE & T. ENDERS, *LATIN AMERICA — THE CRISIS OF DEBT AND GROWTH* (1984).

17. See KRUGMAN & OBSTFELD, *supra* note 9, at 605-06; *infra* note 21.

nation of the payment obligation on interest and principal.¹⁸

The debtor country must approach continued repayment under present terms and conditions with equal caution. Declining levels of trade coupled with increased interest payments make this position untenable for most debtor countries.¹⁹ Renegotiation of existing loans or the infusion of new loans merely delays the eventual repayment, and does little to address the problem that the debtor countries' current accounts are insufficient to sustain economic growth and continue interest payments. Furthermore, Latin American leaders and economists, as well as their counterparts in developed countries, strongly oppose any suggestion that further cuts be made in the standard of living in order to fulfill commitments to foreign banks.²⁰ Nevertheless, defaulting on the loans creates the distinct possibility that the debtor will be the subject of economic ostracism from the outside world.²¹

As noted, this impasse has resulted in the phenomenon of involuntary lending, where banks continue to lend money to the debtor countries so that they may continue to meet their interest payments and avoid default on outstanding loans;²² however, the involuntary lending does not respond to fundamental issues that need to be addressed by both the creditor banks and the debtor governments. It is a short-term palliative designed to create the appearance of tranquility,²³ but it does little to encourage new lending for purposes other than repayment. New debt continually

18. KRUGMAN & OBSTFELD, *supra* note 9, at 606-07.

19. Total long-term debt as a percentage of gross national product and as a percentage of exports of goods and services has increased dramatically among the Latin American countries. See INT'L BANK FOR RECONSTR. & DEV., WORLD BANK, WORLD DEV. REP. 1988 256-57 (Table 18) (1988).

20. Recent protests in Venezuela over higher prices generated by an economic austerity program reveal the dramatic upheaval that can accompany economic reform in Latin America. See Mann, *Troops Move to Halt Price Riots in Venezuela*, Fin. Times, Mar. 1, 1989, at 1, col. 6. See also Rohter, *Latin Chiefs Urge Overhaul of Debt and of O.A.S. Too*, N.Y. Times, Nov. 30, 1987, at 1, col. 4 (nat'l ed.) (Presidents of eight Latin American countries demanding ceiling on repayment of foreign debt).

21. See also *Outlook*, *supra* note 1, at 130 ("following this path means that their economies would gradually become disconnected from the international financial system; credit would be difficult if not impossible to obtain, and foreign trade would be reduced to bare essentials").

22. See *supra* note 12.

23. If a bank is merely making loans to fund the interest payments on an otherwise uncollectible loan, then the current earnings are illusory. Conway & Siegenthaler, *Loan Loss Reserves: Tax, Regulatory, and Adequacy Issues*, J. COM. BANK LENDING, Sep. 1987, at 4, 9. This charade does not make the banks any healthier, which is reflected through reduced stock prices. See Meltzer, *supra* note 6, at 139.

is being created, rather than old debt being retired in the involuntary lending cycle, and banks without a significant exposure in Latin America shy away from lending the debtor country new debt funds.²⁴ Debtor countries thus feel the need for new investment mechanisms that attract new investment without exacerbating a repayment problem that already has pushed many Latin American countries to their economic limit.

The debt-equity swap responds to this financial impasse by linking repayment to economic success.²⁵ In the event of economic hardship, the shareholder of the equity investment, not the debtor country, feels the pain of economic decline.²⁶ The debtor country thus views this solution in no-lose terms. Additionally, the foreign or domestic investor is provided with a real incentive for bringing new capital into the debtor country through the purchase of debt on the secondary market at a significant discount.²⁷ Together, the actions of the investor and the host country help satisfy the debtor country's dual objectives of debt retirement and capital inflow.

C. *The Creditor Banks' Perspective*

The debt-equity swap presents the creditor bank with a unique opportunity to either sell off its debt instruments on the secondary market and rid itself of a particular country's debt, acquire more of a particular country's debt and strengthen its hand in future debt renegotiations, or transform its position from a holder of debt to a holder of equity.²⁸ The desire to achieve one of these objectives results in a decision that contributes to the supply side of the secondary debt market. In addition to the various regulatory incentives and constraints that influence the banks' decisions,²⁹ these transfers of sovereign debt may prove to be desirable

24. Of further interest, U.S. bank exposure to debtor countries has fallen, in absolute dollars, from 1982-86. See Sachs & Huizinga, *supra* note 1, at 565-67.

25. See *supra* notes 12-13.

26. For a discussion of the disadvantages to creditor banks, see *infra* notes 170-82.

27. For a discussion of the advantages to investors, see *infra* notes 150-53 and accompanying text.

28. It is important to distinguish the bank as an intermediary in the debt-equity transaction from the bank as a supplier or seller of debt in the transaction. Many banks actively serve as intermediaries in debt-equity swaps, with fees ranging from one percent to four percent of face value. In these instances, the bank's role is that of a broker. Roberts & Remolona, *supra* note 5, at 20.

29. For example, banking regulations which require a minimum ratio of primary capital (at book value) deter banks from selling their debt claims on the secondary market. This problem can occur when banks increase loan loss reserves, which involves a shift from stock-

to those banks which no longer have confidence in the present debt repayment and rescheduling regime. Rather than involuntarily lending new money to the debtor country to enable that country to repay old obligations,³⁰ the bank participating in a debt-equity swap can focus on loaning new money to more creditworthy borrowers, or can assume an equity position potentially yielding greater returns. At the same time, if the bank does sell off its debt, the new purchaser of the debt will transform that obligation into new investment in the Latin American country.

The negative effect of carrying the risky debt on its books also may motivate the creditor bank to sell its debt on the secondary market. To the extent that a particular bank's exposure to Latin American countries reflects a significant risk of non-repayment, any indication of possible declines in the repayment position of the Latin American countries has a negative effect on the stock prices of these banks, which makes it more difficult for them to raise cap-

holders' equity and, therefore, is merely a cosmetic move and does not affect banks' cash flow. The increase in these unallocated reserves immediately reduces reported net income but not taxable income; this reduction otherwise would not occur until such time as the loans would be written off, if ever. When the bank subsequently writes off troubled loans by charging the loan loss account, its capital base and taxable income is then reduced, without affecting reported income. Since U.S. bank regulators formerly counted loan loss reserves as part of primary capital, however, an increase in this reserve did not affect measured primary capital. This approach could have possibly jeopardized the bank's freedom if the decline in book value was large enough to cause the bank to fall below regulatory limits on this ratio. Sachs & Huizinga, *supra* note 1, at 570, 572-73, 588.

In December 1987, 12 countries, including the United States, announced their intentions to increase capital requirements and link them to the riskiness of a bank's assets, which would include foreign loans. This would further the dilemma of creditor banks holding substantial portions of risky Latin American debt, and possibly restrict the supply of debt obligations in the secondary market. See Nash, *12 Countries Want Banks to Increase Capital*, N.Y. Times, Dec. 11, 1987, at 1, col. 2 (nat'l. ed.). On December 16, 1988, the Federal Reserve Board adopted as final these requirements. *Fed Adopts Risk-Based Capital Guidelines; Will Also Propose Minimum Leverage Ratios*, BNA's Banking Rep. (BNA) at 4 (Jan. 2, 1989). The Office of the Comptroller of the Currency issued its final guidelines on Jan. 19, 1989, and the Federal Deposit Insurance Corporation was expected to follow shortly with guidelines of its own. *OCC Issues Final Risk-Based Capital Guidelines, Will Adopt Leverage Ratio*, BNA's Banking Rep. (BNA) at 213 (Jan. 30, 1989).

To the extent that these risk-based capital regulations reduce the role that loan-loss reserves play in calculations of capital by excluding loan-loss reserves from its definition of "Tier 1 capital" and requiring that Tier 1 capital equal four percent of assets (total capital, including the "Tier 2 capital" that includes loan-loss reserves, must equal eight percent of risk-weighted assets), banks may be encouraged to shed a greater share of their debt to reduce the riskiness of their portfolio. See generally DEBT TABLES 1988, *supra* note 2, at xxx-xxxi.

30. See *supra* note 12.

ital.³¹ Banks able to sell their loans for more than they are valued by the stock market thus stand to gain from such a transaction. The rationale behind this transfer of a riskier asset with a higher face value for a safer asset with a lower face value applies regardless of the form of the new asset,³² which may be cash, bonds, an equity interest, or any other form of marketable security.³³

D. *The Investors' Perspective*

The motivation of the investor in the debt-equity swap, regardless of whether the investor is a private individual, multinational corporation, or bank,³⁴ appears to be the easiest to appreciate. By purchasing debt on the secondary market at a discount and then reselling it at a higher price, the investor is financing an investment at a discount.³⁵ Assuming that the investor would have made an identical expenditure in the absence of the swap program, the difference between the purchase price and the redemption rate represents the net savings to the investor.

At first glance the investor appears to be in an ideal situation when participating in a swap, but the removal of the assumption that the investor would have made the investment in the absence of the program generates an entirely different analysis.³⁶ Investment in Latin American countries never has been free from economic and political risks, and successful participation in most equity investments requires that a wide range of variables be

31. See generally Sachs & Huizinga, *supra* note 1, at 576-87. It is important to recognize this difficulty since an increase in capital/asset ratios might require a bank to enter the capital markets itself.

32. *Id.*

33. *Id.*

34. Note that the commercial bank creditors, who hold the external debt obligations, typically are not the investors in the domestic asset under debt conversion programs because most of these banks wish to sever the debtor-creditor relationship with these financially troubled nations, and possibly because of unfavorable U.S. regulatory restrictions. See World Bank, *Report on Chilean Debt Conversion, with Chilean Rules on Investments With Foreign Debt Instruments and Provision in a Debt Restructuring Agreement for Such Investments*, 26 I.L.M. 819, 827 (1987) [hereinafter *Chilean Report*]. See also *supra* notes 29-31.

35. See *infra* notes 148-51 and accompanying text (discussing advantages to investors).

36. Some commentators gauge the success of a debt-equity program by the degree of "additionality" that the program produces. "Additionality" represents the additional investment that is induced by the introduction of the new debt-equity guidelines, or investment that would not have taken place but for the new regulations. W. CLINE, *MOBILIZING BANK LENDING TO DEBTOR COUNTRIES* 47 (1987) [hereinafter *MOBILIZING*]; Roberts & Remolona, *supra* note 5, at 28.

considered. Investors who are attracted only by the steep discounts on the secondary market debt might reconsider whether the purchase-redemption differential more than substantially compensates the investor for the additional risk that the investor undertakes. Investors also should assess their knowledge of the host country and the business practices that they may encounter in the course of the investment.³⁷ Most investment advisors, in fact, counsel that the investor refrain from investing in any project that would not have been attractive without the financing discount.³⁸

E. Summary of Parties' Perspectives

The foregoing analysis suggests that, in the absence of regulatory mechanisms reducing the incentives to participate in debt-equity swaps, all parties benefit from participation. This observation, however, does not preclude the possibility that swaps may have adverse indirect economic or social effects on the participants which may limit their use. Moreover, although swaps may be desirable from the standpoint of a static cost-benefit analysis, they may not be as attractive as their volume increases.³⁹ Considering the magnitude of Latin America's debt problem, policy-makers and investors cannot overlook these possibilities. Debt-equity swaps certainly appear to possess the economic incentives that could make them extremely popular among investors, banks, and debtor countries, but a final prognosis on their economic impact cannot be fully made

37. According to two investment consultants, debt-equity swap projects that imply a diversification in either products or markets, as most do, must pass three essential tests: (1) the industries chosen must be structurally attractive or capable of being made attractive; (2) the costs of entry must not capitalize all the future profits; and (3) either the new investment must gain a competitive advantage from its link with the corporation, or the corporation must gain a competitive advantage from its link with the new investor. A firm's decision to use debt-equity swaps should reflect an integrated analysis of both debt-equity swap opportunities and the investor's global strategy. The investor's operational and managerial fundamentals, as well as its capacity to support the investment implicit in a given swap, are critical to the swap's success. Ganitsky & Lema, *supra* note 13, at 27-28.

Investors interested in engaging in a debt-equity swap must be willing to meet the requirements of the host country. Management must be receptive to the debtor country's managerial processes unique to debt-equity swap transactions, and to the country's perspectives and priorities in regard to debt-equity swaps, which usually are targeted at specific projects such as privatization or job creation, and which therefore might focus on economic sectors unlikely to offer reasonable profits. *Id.* at 28.

38. *Id.* This advice to the prospective investor may run contrary to the best interests of the host country which seeks both debt retirement and new capital investment. See *supra* note 16.

39. For a consideration of these effects, see Section V, *infra*.

until the vast array of regulations⁴⁰ and the indirect effects of the swaps are more fully analyzed.

III. DEBT-EQUITY SWAPS AND THEIR ALTERNATIVES

The prototypical debt-equity swap has inspired a host of variations which can be categorized broadly under the heading of debt conversion.⁴¹ In the interest of clarity, these approaches must be distinguished from one another and evaluated from the standpoint of their respective abilities to meet the objectives of the host country.⁴²

A. Debt-Equity Swaps

The debt-equity swap involves the exchange of debt, purchased on the secondary market at a discount, for equity participation in a host country's industry or for participation in a mutual fund.⁴³ The central bank of the host country redeems the debt, usually at close to face value, and the proceeds of the redemption are subject to restrictions on the type of investment that may be made. These restrictions, which primarily are contained in formal regulations, vary considerably among the Latin American countries that have programs in place, and will be discussed in greater detail

40. For an analysis of the regulatory environment, see section VI, *infra*.

41. For a discussion on the use of these terms, see *supra* note 5.

42. These objectives already have been identified as the retirement of external debt obligations and the preservation of capital flows. See *supra* note 16.

These approaches must also be considered as alternatives to the traditional options of continued repayment, rescheduling, and default. For a discussion of these alternatives, see *supra* notes 15-22.

43. One Latin American country, Chile, allows an investor to diversify the re-denominated local investment into a pool of equity investments in Chilean corporations. This investment through a particular country's mutual fund should not be confused with closed-end mutual funds offered by American investment banks, which package stock-based equity investments or repackaged high-yield debt paper, aimed at attracting a broader range of "non-specialist" investors. In closed-end equity funds, investors contribute lesser developed country debt to a domestic fund manager who negotiates the debt-equity conversion terms, building up an equity portfolio for the benefit of all subscribers. As with any mutual fund, investors would receive shares that would trade at the net asset value of the portfolio. See *Next Wave of Variations on Debt-Equity Swaps Offers Creative New Options*, 1987 BUS. LAT. AM. 106. With the debt paper funds such as the Chile offer, however, external debt is purchased on the secondary market at a discount, packaged together by the fund and the interest payments flow to the investor. For example, country debt which bears a 10% interest rate and sells at 50% of its face value provides a 20% yield. See, e.g., Roberts & Remolona, *supra* note 5, at 24; Wolfson, *Wall Street Firms Plan LDC Debt Swap Funds*, J. Com., Dec. 9, 1987, at 12, col. 2.

in Section IV.

B. Debt-Debt Swaps

A debt-debt swap occurs when creditors holding foreign debt exchange the debt of one debtor for the debt of another debtor. The motivation behind the creditors in these swaps is a desire to adjust the composition of debt within their portfolios, either through distributing their risk among a wider range of countries or by narrowing their risks to a few countries, eliminating uncomfortable risks in the process.⁴⁴ Tax, accounting, and liquidity considerations also may encourage debt-debt swaps.⁴⁵ These swaps are facilitated through either an assignment of loans between creditors or through the offering of a sub-participation, and may take place between outside creditors or between an outside creditor and a domestic creditor.⁴⁶

C. Debt-Home Currency Swaps

The exchange of debt for the home currency of a country, when it is transacted by a national of the country repatriating funds, should be distinguished from the conventional debt-equity swap. Many countries allow these transactions to take place in an effort to repatriate capital flight, which has been attributed by many commentators as a leading factor in the difficulty of Latin American countries to meet their debt obligations.⁴⁷

44. Most banks engaging in these swaps appear to be consolidating their exposures into the countries which the banks perceive to have long-term strategic interest. Conversely, banks appear to be ridding themselves of debt when there is little chance of repayment. See Roberts & Remolona, *supra* note 5, at 21. This process of debt exchange among banks helps overcome the resistance of banks in syndicated loan agreements to lend new money to financially troubled countries in that it removes many of the "free rider" concerns. According to this free rider theory, no one bank has an interest in lending money to a country where there is a syndicated loan, and all countries automatically benefit from the actions of the bank or banks which in turn assume all the risk on the new loan. Thus, there is a certain resistance on the part of many banks with smaller exposures to lend new money to the debtor when they realize that the banks with a greater exposure will most likely make the new loan together if they are forced to do so. *Id.* at 37.

45. *Id.* at 22.

46. *Id.*

47. For a discussion of capital flight, see *infra* note 164 and accompanying text.

D. Debt-Goods Swaps

Bearing a strong resemblance to many aspects of countertrade, the debt-goods swap entails an exchange of goods from the exporting/debtor country in return for a simultaneous retirement of a portion of its debt.⁴⁸ As a debt conversion device, debt-goods swaps have received mixed signals from the banking community. Proponents argue that they create exportation which otherwise would not have taken place; critics argue that they give investors preferential access to a country's export earnings.⁴⁹ Regardless of their merits, industry analysts estimate that creditor banks might use this swap to eliminate up to five percent of their outstanding loans to the participating country.⁵⁰

Peru is the only country to date to have participated in debt-goods swaps, negotiating three deals with creditor banks. To participate in these swaps, Peru requires that they result in a positive flow of foreign exchange, lead to an increase in net exports, and involve non-traditional goods, the export of which increases the value of the local economy.⁵¹ In its largest transaction, Chase Manhattan Bank would receive \$45 million in products, to be marketed by its wholly-owned trading company, to retire \$15 million in debt.⁵² The \$30 million difference between the sale price and the debt retired under the plan then would be paid back to Peru in cash.⁵³

E. Debt-Reform Swaps

For the lack of more appropriate terminology, the term "debt-reform swap" will be applied to any exchange of debt that is designed to promote a non-economic objective. For example, under a debt-for-nature swap arranged between Conservation International and Bolivia, \$650,000 of Bolivian debt was retired in return for a Bolivian commitment to create conservation areas totalling

48. See generally Zuckerman, *Midland Debt for Goods*, INT'L FIN. L. REV., Nov. 1987, at 25.

49. See Montagnon, *Peru Signs Debt-for-Goods Deal With Midland Bank of UK*, Fin. Times, Sep. 16, 1987, at 6, col. 6.

50. *Id.*

51. See Zuckerman, *supra* note 48.

52. See Zuckerman, *Chase May Swap Peru Debt for Products*, Am. Banker, Dec. 23, 1987, at 3, col. 1.

53. *Id.*

more than four million acres.⁵⁴ Other proposals have attempted to link debt swaps to employee participation plans, particularly employee stock ownership plans (ESOPs).⁵⁵

F. Other Debt Reduction Schemes

An analysis of debt-equity swaps and other debt conversion schemes must be considered in the light of alternative suggestions for reducing the burdens of Latin American countries. Although a thorough discussion of these alternatives falls well beyond the scope of this article, these alternative suggestions usually assume three forms.⁵⁶

First, interest capitalization has been suggested in the wake of many of the creditor banks' increase in their loan loss reserves.⁵⁷ Under an interest capitalization scheme, interest rates may be reduced or interest payments deferred, with the deferred or reduced interest added to the level of outstanding principal.⁵⁸

Second, many commentators have called for securing outstanding Latin American debt.⁵⁹ These proposals take many forms, but essentially involve the exchange of debt for bonds, debentures,

54. See Agreement Between the Government of Bolivia and Conservation International (copy provided by Conservation International, signed in Washington, D.C. on July 13, 1987 and on file at the offices of the University of Miami Inter-American Law Review). An edited version of this agreement is reprinted at 19 U. MIAMI INTER-AM. L. REV. 515 (1987).

55. See, e.g., CENTER FOR ECONOMIC AND SOCIAL JUSTICE, HIGH ROAD TO ECONOMIC JUSTICE, U.S. ENCOURAGEMENT OF EMPLOYEE STOCK OWNERSHIP PLANS IN CENTRAL AMERICA AND THE CARIBBEAN (1986) (containing Report to the President and the Congress by the Presidential Task Force on Project Economic Justice); McClaghry, *Revive a Plan to Put Stock in Central America*, Wall St. J., Apr. 1, 1987, at 28, col. 3; Middendorf, *An ESOP's Moral for the Third World*, Fin. Times, Mar. 25, 1987, at 25, col. 6 (concluding "[that] ESOPs promote greater justice by breaking through restricted ownership patterns" and strengthen respect for private property and individual responsibility); *Employee Stocks: A Third World Option*, Wash. Times, Sep. 26, 1984, at 6C, col. A (interview with Norman Kurland, one of the founders of the Center for Economic and Social Justice, who concludes that the concept of economic justice through expanded property ownership will eliminate the Marxism-Leninism mentality).

56. By comparison, Bergsten, Cline, and Williamson have identified 24 alternatives to bank lending, categorizing them into four types: (1) recent innovations and extension of existing measures; (2) payments smoothing and interest capitalization; (3) payments linked to capacity; and (4) debt relief. C. BERGSTEN, W. CLINE & J. WILLIAMSON, *BANK LENDING TO DEVELOPING COUNTRIES: THE POLICY ALTERNATIVES* 237 (1985).

57. For a discussion regarding loan loss reserves, see *infra* note 170.

58. See Cooper, *Image, Fiction and Fact About Swaps*, EUROMONEY, Jan. 1987, at 20 (Supp.); *Outlook*, *supra* note 1, at 137-43.

59. Evans, *New Debts for Old — And the Swapper is King*, EUROMONEY, Sep. 1987, at 72.

notes, or other financial instruments. These secured forms of indebtedness then could be traded, in either secondary market or through multilateral institutions.⁶⁰

Third, a few Latin American countries have engaged in the direct repurchase of their debt on the secondary market.⁶¹ This method of debt retirement differs from the "debt-home currency swap" described above in that the debtor country itself, and not a private citizen of that country, buys the debt on the secondary market. When translated into a comprehensive debt relief solution, the repurchase scheme often involves a central agency auctioning off a country's debt at intervals. When coupled with a commitment by the debtor country to purchase a specified amount of debt, at the lowest bid offered by the banks, the mechanism could allow for a discounted reduction of their debt.

G. Conclusions

The wide range of debt conversion and debt reduction schemes represents a comprehensive search for solutions to a prob-

60. In March 1988, Mexico retired almost \$4 billion of long-term debt in a sophisticated debt defeasance plan which retired the debt at an average discount of thirty percent. As an exchange for the retired debt, Mexico issued \$2.5 billion thirty-year coupon bonds that were backed by specially issued U.S. Treasury zero-coupon bonds Mexico purchased for \$442 million. The redemption value of these zero-coupon bonds equalled the redemption value of the thirty-year coupon bonds. DEBT TABLES 1988, *supra* note 2, at xxii.

For a discussion of Latin American countries' attempts to swap debt for bonds as a debt reduction technique, see VandenBrandt, *Banana Bonds*, FIN. WORLD, Aug. 11, 1987, at 14-15; Otwell & Torres, *Mexican Plan Sour's Debt Market Activity*, J. Com., Jan. 26, 1988, at 15A, col. 2; Rockwell, *World Bank Criticized For Debt Crisis Laxity*, J. Com., Jan. 6, 1988, at 10A, col. 1; Otwell & Torres, *Mexican Debt Plan May Boost Swap Mart*, J. Com., Jan. 4, 1988, at 7A, col. 2; Orme, *Mexican Officials Praise Debt Plan*, J. Com., Dec. 30, 1987, at 7A, col. 5; *U.S. to Sell Bonds to Help Mexico Pay Its Debts*, J. Com., Dec. 30, 1987, at 7A, col. 2; Commins, *Brazil Urged to Convert Foreign Debt Into Bonds*, J. Com., Sep. 3, 1987, at 7A, col. 2.

61. Bolivia, for example, repurchased its debt at an 89% discount from its bank creditors, eliminating \$308 million in principal payments and over \$150 million in interest arrearages and penalties. See *Management Alert (Bolivia)*, 1988 BUS. LAT. AM. 103.

This practice of debt repurchase, however, has recently come under attack by the creditor banks. As a result Bolivia has been prevented from engaging in a second purchase of its debt on the open market. Paisley, *Lenders Reject Debt Buyback from Bolivia*, Am. Banker, Feb. 28, 1989, at 10, col. 4. In the case of Bolivia, many of its creditors feared that allowing a second buyback would send the wrong message to other debtor countries, that eventual repayment, not just reduction, was the ultimate purpose of debt restructuring. *Id.* Ironically, these banks' concerns over buybacks have come at a time when some economists have begun to question the utility of debt buybacks to the debtor country. Bulow & Rogoff, *The Buyback Boundoggle*, in BROOKINGS INSTITUTION, BROOKINGS PAPERS ON ECONOMIC ACTIVITY 675 (1988).

lem of incredible magnitude. The variety of solutions also reflects an attempt to tailor solutions to a hemispheric problem to the specific demands of each debtor country. The debt crisis in Latin America cannot be addressed as if the country's debt positions are identical; instead, solutions must be evaluated according to the specific circumstances of each country's economic outlook and debt position. Within the parameters of a menu of options, the maintenance of the present strategy of lending and renegotiation also must be considered an option, as must the option of default. Viewing this menu of options, however, it is apparent that debt-equity swaps can play an important role in Latin America's search for solutions to its debt crisis. An analysis of the significance of this role must proceed from a preliminary assessment of the swaps and move forward with a slight degree of reluctance, awaiting the empirical data that should ultimately reveal the relative success of the swaps.⁶²

IV. SURVEY OF LATIN AMERICAN DEBT CONVERSION PROGRAMS

An analysis of the specific requirements of the various Latin American debt-equity programs provides a useful vehicle for a comprehensive examination of the mechanics of a debt-equity swap.⁶³ Comparing the various provisions of each country's program also permits a subjective analysis of the effectiveness of the

62. The institution in February 1988 of a formal debt-equity program in Brazil, Latin America's largest debtor, should reveal a great deal about the ultimate influence that swaps can play, either alone or as part of a "menu of options." Together with the anticipated reinstatement of Mexico's program and greater market interest in the swaps, it appears that there is a strong likelihood that they will soon be playing a much greater role in Latin America's debt reduction strategy, although an accurate assessment of the swaps' potential is premature at this time.

63. Although the literature on debt-equity swaps is quite extensive, it is very difficult for an investor or researcher to obtain copies of the Latin American regulations, either in the original or translated form. Additionally, it is extremely difficult to separate official from unofficial versions. Banks often maintain unofficial translated copies for investors, or explanations of the regulations, without having copies of the original legislation or regulations. The authors of this article have made every attempt to compile and utilize the official versions of the regulations. In many cases, however, it has been necessary to rely on unofficial versions and secondary sources. With the exception of the official versions or reprints of the official versions which we have used, and which will be cited where used, the following survey articles are helpful in filling the void which researchers will encounter. *See, e.g., Profile of Debt-to-Equity Conversion Programs in Latin America*, 1988 BUS. LAT. AM. 44 [hereinafter *Profile*]; *Capitalisation Programmes: A Survey*, INT'L FIN. L. REV., Jan. 1988, at 38 [hereinafter *Survey*]; Chase Manhattan Bank, *In-house Guide to Debt-Equity Swaps* [hereinafter *In-house Guide*] (copy on file at the offices of the INTER-AMERICAN LAW REVIEW).

regime's provisions in ameliorating the host country's debt burden and in generating new investment. It also may serve as a guide for other countries interested in formulating a debt-equity program of their own. As of May 1988, seven Latin Caribbean nations have active official debt conversion programs, three have suspended their programs and are contemplating reinstatement, and at least two countries are on the verge of implementing a program.⁶⁴

For ease of analysis debt-equity programs will be considered by focusing on four areas: (1) the nature of the debt that is eligible for conversion; (2) the requirements of the program from the standpoint of the eligibility of the investor, the project, and the equity investment; (3) the procedural aspects of the transaction; and (4) the restrictions on the swap, from restrictions on remittances of profits and capital to restrictions on investment permitted through the swaps.

A. *Eligible Debt*

There is a wide range of differences among the Latin American debt-equity regimes regarding the nature of the debt that is eligible for conversion. Some countries limit the eligible debt to public sector debt, while others allow both public and private sector debt to be converted. Within each category, further restrictions apply which characterize more specifically the debt that may be converted.

Under the Mexican debt-equity program, for example, convertible debt is limited to debt evidenced by Mexican public sector restructuring agreements.⁶⁵ This restrictive approach can be contrasted with the Chilean regulations, which include both public and private sector debt, provided that the debt is stated and "payable in foreign currency abroad, with an original or extended term

64. Argentina, Bolivia, Brazil, Chile, Jamaica, Uruguay, and Venezuela have active programs; Costa Rica, Ecuador, and Mexico have suspended their programs; and the Dominican Republic and Peru were close to implementing their programs.

65. As of the time of the writing of this article (May 1988), the Mexican debt-equity program had been suspended, but the financial community was expecting it to be back in place shortly, under the prior guidelines. As to the nature of the eligible debt, see, e.g., NATIONAL COMMISSION OF FOREIGN INVESTMENT, OPERATING MANUAL FOR CAPITALIZATION OF LIABILITIES AND SUBSTITUTION OF PUBLIC DEBT BY INVESTMENT 7 [hereinafter OPERATING MANUAL (MEXICO)] (section IV — "Substitution of Public Debt by Investment"); Creel, *Mexico*, in *Survey*, *supra* note 63, at 42 ("According to the *Operating Manual (Mexico)*, only debt evidenced by the Mexican public sector restructuring agreements is eligible for conversion into shares of Mexican public or private entities.").

exceeding 365 days."⁶⁶ Argentina's regulations reflect the intermediate approach, allowing the conversion of all public sector debt (brought in as of May 1, 1987) excluding short-term trade credits and debt owed to official agencies or guaranteed by non-Argentine official agencies.⁶⁷ As with many other regimes, Argentina limits public sector debt eligible for conversion to that debt whose conversion would not trigger a prepayment obligation.⁶⁸

B. Program Requirements

1. Eligible Investors

The differences between the regulatory regimes regarding the eligibility of the investor appear to result from the host country's willingness to overlook the actions of foreign nationals who may have violated exchange controls in their native country and previously transferred foreign exchange out of their countries. Those countries that allow nationals to participate in their debt-equity program thus may be accused of acquiescing in the return of this capital at an exchange rate that has been artificially inflated by the program. In addition to failing to punish the original behavior of the foreign national in "expatriating" the capital, the debt-equity program also may effectively subsidize the favorable return to the national.⁶⁹ To the extent that certain countries may not desire to reward the behavior of the national, these countries often do not allow nationals to participate in their debt-equity programs.⁷⁰ Nevertheless, of the ten Latin American countries with debt-equity regulations, six allow nationals of the country to participate in the program, perhaps in an attempt to reverse a long tradition of capital flight.⁷¹

66. Chapter XIX, section 1(a), Rules on Foreign Exchange of Chile, as reprinted and translated in *Chilean Report*, *supra* note 34, at 843 [hereinafter Chilean Regulations]. Section 1(b) requires that the "instruments must have been executed, as direct obligor, by the Treasury, Banco Central de Chile, 'agencies in the public sector', . . . banking organizations or financial institutions authorized to operate in Chile. . ." *Id.*

67. La Porta Drago, *Argentina*, in *Survey*, *supra* note 63, at 41.

68. *Id.*

69. See Bucheit, *Debt/Equity Conversion Programmes From the Debtor Country's Perspective*, in DEBT-EQUITY SWAPS 48 (published transcript of Euromoney Conference, Jun. 30 - Jul. 1, 1987, London) [hereinafter Euromoney Conference].

70. The following Latin American countries do not permit local investors to participate in the debt-equity conversion: Chile (for chapter XIX investments), Costa Rica (program suspended), Jamaica, Mexico (program suspended), and Uruguay. *Profile*, *supra* note 63.

71. See *Profile*, *supra* note 63, at 41. The five countries are Argentina (chapter III,

2. Project Eligibility

The wide range of regulations governing eligible projects under a debt-equity regime reflects the unique nature of each country's debt composition, political orientation, and evaluation and assessment of its future economic performance. Some countries attempt to utilize debt-equity programs to "manage" their economy, while others are less restrictive, permitting the investor a wider range of investment options.⁷² In many instances, debt-equity regulations represent government-sponsored attempts to privatize state-owned enterprises.⁷³

To the extent that a swap into an existing company reflects a discounted source of funding, the regulations must also be careful to attract new investment only.⁷⁴ For those countries having problems generating sufficient foreign exchange, investment in exporting industries is also highly desirable.⁷⁵ The Mexican government's regulations, for example, strongly favor investments

section 5), Bolivia, Brazil, Chile (for chapter XVIII investments), Ecuador, and Venezuela. This list may not be exclusive. The Jamaican regulations, for example, define eligible investors as "any person (natural or juridical) domiciled and resident abroad." This regulation does not seem to preclude participation by Jamaican citizens who are domiciled and resident in foreign countries. See Bank of Jamaica, Programme for the Conversion of Jamaican External Debt Into Equity Investments, ch. III, sec. 4 (July 28, 1987) (copy on file at the offices of the Inter-American Law Review) [hereinafter Jamaican Regulations]. For a discussion on capital flight, please refer to the authorities cited *infra* note 164.

72. Officials will often set investment priorities by type of venture and geographic area. The highest priorities, and therefore the highest redemption prices, are for buyers of state enterprises being privatized and for new investments of capital expenditures that generate exports, reduce imports, create jobs, or are located in special zones. See Hannon & Haugen, *Latin America Debt Conversion Proliferates*, BUS. AM., Jun. 22, 1987, at 2, 6. See generally *Profile*, *supra* note 63, at 45. See further La Porta Drago, *supra* note 67 (investments that produce an increase in efficiency, productivity or the supply of goods or services, with special focus on those which increase Argentina's balance of payments, are eligible); Central Bank of Brazil, Resolution No. 1.460, chapters VIII, X (Feb. 1, 1988) (translated copy provided by Antonio Angotti, Vice President, Security Pacific Merchant Bank, New York) (converted proceeds must be invested in new projects or in the expansion of existing projects) [hereinafter Brazilian Regulations] chapter VIII, X; Illanes, *Chile*, in *Survey*, *supra* note 63 (chapter XIX does not specify types of eligible investments, although the Chilean authorities prefer projects that generate exports and employment); Jamaican Regulations, *supra* note 71, at chapter IV, section 5(i); OPERATING MANUAL (MEXICO), *supra* note 65, at 29 ("Table of Conditions and Discounts For Use of the Mechanism of Substitution of Public Debt By Investment").

73. The Mexican regulations, for example, redeem debt at face value, where the proceeds are intended to purchase a government company. See OPERATING MANUAL (MEXICO), *supra* note 65, at 29.

74. For a discussion of additionality, see *supra* note 36.

75. See *supra* note 72 (listing regulation sections of foreign government programs that grant priority to investments that, *inter alia*, increase exports).

designed to increase exports, generate investment in new fixed assets or new products, and bring new technology into Mexico.⁷⁶

3. Eligible Equity Investment

The host country closely regulates the type of stock issued to the foreign investor through a debt-equity swap. In Mexico, the regulations are precise as to the type of stock that may be issued and the methods by which it subsequently may be transferred.⁷⁷ Accordingly, the Mexican corporation receiving the investment must issue "qualified capital stock"⁷⁸ to the investor. This stock must be in registered form and may not be transferred to a Mexican individual or entity before 1998.⁷⁹ The issuing Mexican company must amend its bylaws to allow for this stock, which may not be convertible into anything other than additional qualified capital stock.⁸⁰ In an effort to prevent the swaps from depleting valuable foreign exchange, the holder of this qualified capital stock may not redeem the shares more quickly than the principal payments are made on the underlying debt for which it was exchanged.⁸¹

C. Procedural Aspects

The degree of procedural complexity surrounding the various debt-equity regimes would seem to affect greatly the demand for conversions under the specific program. From the investor's standpoint, in addition to the high net payout,⁸² lower processing costs⁸³

76. See Creel, *supra* note 65.

77. See generally section 5.11 of the Agreement on the Restructure of the Foreign Public Debt, included in OPERATING MANUAL (MEXICO), *supra* note 65, at 24.

78. *Id.* at provision (b).

79. *Id.*

80. Under section 5.11, such stock must be subject to certain restrictions regarding its transferability, redemption, and conversion into other instruments. Creel, *supra* note 65.

81. *In-house Guide*, *supra* note 63, at 3.

82. This phrase refers to the stage of a debt-equity swap where the host country redeems the redenominated debt "at close to face value." Naturally, the investor desires conversion at face value, which will be approached in most cases if the local proceeds are invested in projects of high priority to the host country. See *supra* note 72.

83. See LaPorta Drago, *supra* note 67, at 41-42 (In Argentina, an investor must provide a one percent performance guarantee in the form of bank bond or deposit, which will be refunded once the debt is accepted by the bank through the public bidding process); *In-house Guide*, *supra* note 63, at 8 (Chile has no fees in chapter XIX, but the bid price necessary to gain access to transactions must be paid to the government in chapter XVIII transactions); Jamaican Regulations, *supra* note 71, at 13 (assessing a Jamaican \$250.00 processing fee on a swap application).

encourage investment and reduce delays⁸⁴ in the completion of the application process, allowing the investor to respond more quickly to changing economic conditions. The host country, however, must address a different set of concerns before it approves a project. A more careful and lengthy application process is sometimes required to identify the most worthwhile investments and maintain the necessary control over the country's economy.⁸⁵ Especially when considering the potential for inflationary pressures that swaps may place on the domestic money supply,⁸⁶ many countries must counterbalance investor concerns for expediency with their own concerns for productive investment within the parameters of a desired monetary target.

Most countries review proposed investments on a case-by-case basis,⁸⁷ granting or denying applications based on their specific needs at the time. Others prefer a more market-oriented approach allowing the rationing process to occur through an auction.⁸⁸ Some of these auctions occur only after an initial review has been made by the appropriate government body, while others serve as the sole determinant of who may participate in the program.

The Chilean guidelines serve as a useful model to compare the ration system with the auction system.⁸⁹ Under Chile's Chapter

84. For the average time of approvals (after completion of the application) of debt capitalizations from the host country's central bank, see Brazilian Regulations, *supra* note 72, at chapter IX, article 20 (60 days); Illanes, *supra* note 72 (1-3 months); Jamaican Regulations, *supra* note 71, at 13 (45 calendar days); *In-house Guide*, *supra* note 63, at 2 (Approvals from Mexican Ministry of Finance and Foreign Investment Commission granted in 8 weeks).

85. See *infra* note 100 which discusses particular countries' application procedures.

86. For a discussion of inflationary effects of debt-equity conversion programs, see *infra* notes 184-88 and accompanying text.

87. See, e.g., Creel, *supra* note 65 (Mexico analyzes direct foreign investment in accordance with applicable provisions of the Foreign Investment Law and its own regulations, accepting or rejecting investments using the same general criteria as when reviewing other cases of foreign investment); *Rules for the Conversion of Foreign Debt Into Investment*, in *Venezuela*, 19 U. MIAMI INTER-AM. L. REV. 259, 278 (1987) [hereinafter *Venezuelan Regulations*] chapter V, article 18, at 282 (external public debt converted into internal debt under financial conditions equal or better for the debtor entity, as determined in each case by the Central Bank and Ministry of Finance). Chile (for chapter XIX investments), Jamaica, Mexico, and Venezuela evaluate debt-equity conversion projects on a case-by-case basis. See *Profile*, *supra* note 63, at 45.

88. For the Latin American countries using the auction system, see La Porta Drago, *supra* note 67, at 42 (offers are processed through a public bidding process held every other month); Brazilian Regulations, *supra* note 72, at chapter II. Argentina, Brazil, and Chile (for chapter XVIII investments) primarily use the auction system. See *Profile*, *supra* note 63, at 45.

89. See *Annex 2: Illustration of Transactions Under Chile's Debt Conversion Scheme*,

XIX guidelines, applicable to banks, multinational corporations, and individuals, the Central Bank rations the projects through a case-by-case review.⁹⁰ Under the Chapter XVIII guidelines, applicable to Chilean nationals and non-residents,⁹¹ the auction mechanism determines the investment.⁹² Since the Chilean debt-equity conversion scheme is generally acknowledged as the pioneer in swaps,⁹³ a more detailed explanation of the Chilean conversion procedure is also helpful as a model for other countries considering the introduction of a debt-equity program.

The Chilean program primarily consists of Chapters XVIII and XIX of the Compendium of Rules on International Exchange, and Decree Law 600, the Foreign Investment Law.⁹⁴ As outlined in Chapter XIX, the foreign investor must first find a foreign debt instrument eligible for conversion and reach an agreement with the original debtor in order to convert the debt instrument into an obligation denominated in pesos.⁹⁵ The foreign investor must use external funds to complete the transaction.⁹⁶ Further, the agreement between the investor and debtor must include an express waiver to any right of access to the foreign currency market for payment of the debt.⁹⁷ Chapter XVIII provides for the purchase of Chile's ex-

in *Chilean Report*, *supra* note 34, at 834-38.

90. *Chilean Report*, *supra* note 34, at 826.

91. "Chapter XIX is specifically for foreigners who must seek Central Bank approval for a specific investment and are guaranteed access to foreign exchange." Hannon & Haugen, *supra* note 72, at 4.

92. *Chilean Report*, *supra* note 34, at 826-27.

93. The Chilean debt-equity swap design began in mid-1985 and is considered the most successful to date, converting the largest amount of debt. *Id.* As one authority has noted, "[m]ajor factors explaining Chile's success are the clear-cut rules, lack of foreign investment restrictions, and the country's favorable investment climate." Hannon & Haugen, *supra* note 72, at 4.

94. Under chapter XVIII, the peso proceeds need not be used for investment purposes, there is no right of access to foreign exchange for eventual repatriation of principal or earnings, and no approval from the Central Bank is required; under chapter XIX, conversions are used exclusively for investment purposes, and there are capital and dividend repatriation restrictions. Decree law 600 enables a creditor holding foreign currency-denominated paper of a Chilean debtor to convert it into an equity holding in the host country and permits remittances of capital and dividends abroad. See *Chilean Report*, *supra* note 34, at 826-33; *Annex 1: Legal Framework for Debt Conversion in Chile*, *id.* at 831-33; for a further comparative analysis of these instruments.

95. *Id.* at 832.

96. The primary purpose of requiring investors to fund a portion of a proposed investment with freely convertible foreign currency (or its equivalent in tangible assets or technology) is to prevent the local currency generated through a debt-equity swap transaction from funding an overseas expenditure by a recipient entity/company. *Id.*

97. *Id.* at 832.

ternal debt by nationals. The peso proceeds need not be used for investment.⁹⁸

The foreign investor then receives approval from the host country's central bank to invest the local currency proceeds derived from the debt conversion in particular activities.⁹⁹ The formal application to the central bank must include the names of all parties included in the investment and shall provide the necessary information regarding the proposed investment.¹⁰⁰ The investor must agree to accept various restrictions on the type of investment and on the repatriation of profits and capital, as well as other miscellaneous requirements.¹⁰¹

After having received central bank authorization, the foreign investor purchases the eligible debt instrument from the foreign creditor, and delivers it to a Chilean bank.¹⁰² At this point, the Chilean bank must then either collect the face value of the redenominated note in cash or exchange it for a new debt instrument which may be payable in local currency.¹⁰³ In some cases, the debt instrument may also be payable in local currency at terms negotiated with the debtor, as opposed to indexed units of exchange.¹⁰⁴ In the event that the central bank is the debtor on the instrument, the terms of the repayment are governed by regulation; for other debtors, the prevailing market conditions govern.¹⁰⁵

98. *Id.* at 826.

99. *Id.*

100. For other specific country application requirements, see La Porta Drago, *supra* note 67 (investment proposal, including a disbursement schedule and other documents, must be submitted); *In-house Guide*, *supra* note 63, at 20 (Brazil is currently studying a number of specialized applications); Illanes, *supra* note 72, at 40 (documents require details of the investor, investment project, debt to be converted and the redenomination and prepayment terms); Jamaican Regulations, *supra* note 71, at chapter VI, section 9 (written agreement with the Jamaican government) and Exhibit A therein; Creel, *supra* note 65 (Mexico requires an outline of proposed investment and background of investor, questionnaire providing projected U.S. dollar inflow amounts, and capitalization agreement).

101. *See infra* text accompanying notes 114-37.

102. *Chilean Report*, *supra* note 34, at 835.

103. *Id.*

104. *Id.*

105. *Id.* The rate of exchange that applies to the debt-equity conversion varies among the participating countries. *See Profile*, *supra* note 63 (Argentina converts at the financial rate); Guimaraes, *Brazil*, in *Survey*, *supra* note 63, at 41 (registration of investments in the public sector will be made at the face value of the converted debt, less a discount which will be fixed by the Central Bank); *Profile*, *supra* note 63, at 44 (Jamaica converts at the official rate); *In-house Guide*, *supra* note 63, at 3 (Mexico exchanges at the average of the free rate of exchange for purchase and sale quoted by at least three domestic banks at closing, peso proceeds are deposited with the Central Bank and disbursed per invoices, the excess proceeds earn interest at T-Bill rates); *Profile*, *supra* note 63, at 44-45 (Venezuela exchanges at

If the Chilean bank has exchanged the debt instrument for a new debt instrument payable in local currency, this new debt instrument may then be sold in the Chilean secondary market (usually with the aid of a Chilean broker) for cash. Because of the normally low interest rate of the note, however, this new debt instrument is generally sold at a discount from its face value.¹⁰⁶ Upon sale, the Chilean bank disburses the proceeds of the sale directly for the acquisition of shares of equity in Chilean corporations or through other forms of investment that have previously been authorized.¹⁰⁷ The Chilean broker or bank which handles the transaction, like the foreign broker earlier in the transaction, receives a commission which is usually about one percent of face value.¹⁰⁸

Under both the Chapter XVIII and Chapter XIX procedures, the Chilean investor locates the eligible foreign debt and obtains a redenomination agreement with the Chilean debtor.¹⁰⁹ After this point, Chapter XVIII procedures are different from Chapter XIX. The Chilean bank, on behalf of the investor, submits a closed bid to the Central Bank which declares the total foreign currency face value to be paid by the investor to acquire the foreign debt instrument and the additional price (the commission as a percent of the acquisition cost) that the Chilean investor is willing to pay for the authorization to convert the debt to local currency.¹¹⁰

After having received all of the sealed bids, the central bank selects the highest bid and continues to select downward until the predetermined auction amount is fully utilized. The bank notifies

the official rate, reviewable every six months).

A necessary precondition for exploiting the advantages of a debt-equity swap is that the "transactions must take place at a free market rate, or the official rate must be close to the free rate, in order that the discounts available on the debt are not outweighed by the exchange rate considerations." *Chilean Report, supra* note 34, at 823. Additionally, "[t]he incentives provided by converting discounted external debt into a domestic obligation with a higher market value can be offset if such conversions involve the use of an official exchange rate that does not reflect the free market rate." *Id.* at 829.

Note that critics of Venezuela's swap program have been quick to point out the disincentives built into the program which force conversions to take place at an official exchange rate that is almost twice the free market rate. Hannon & Haugen, *supra* note 72, at 5.

106. *Chilean Report, supra* note 34, at 835.

107. *Id.*

108. *Id.* at 835, 836. For a discussion on the benefits to brokers who handle debt-equity swap transactions, see also *infra* notes 166-67.

109. *Chilean Report, supra* note 34, at 837.

110. *Id.*

the appropriate Chilean banks of their selections.¹¹¹ At this point, the central bank debits the account of the Chilean bank for the commission and value-added tax on the commission.

The Chilean investor must purchase the foreign debt obligation and deliver it to the Chilean bank. The Chilean bank redenominates the debt in local currency at a rate equal to the face value of the debt at the official exchange rate, and creates a new local currency debt instrument to replace the redenominated instrument.¹¹² The Chilean debtor is the direct obligor and the debt is payable to bearer, denominated in local currency, at the agreed upon terms and conditions. This new instrument is sold in the financial market at a discount and the proceeds of the sale are delivered to the Chilean bank for disbursement to the investor.¹¹³

D. Restrictions

Considering that the desire to limit the outflow of foreign currency reserves is one of the economic motivations behind the debt-equity swap, it seems that any debt-equity regime would attempt to ensure that the demands on currency reserves caused by the equity investments do not exceed those placed by payments on the debt.¹¹⁴ Chile's determination of a ten year capital repatriation restriction, for example, approximately reflects the average life of "new money" loans.¹¹⁵ Since these demands, in the equity context, can take the form of rights to repatriate capital and pay dividends in a foreign currency, it is not surprising that a well-crafted program would attempt to place limits on capital and profit remittances.¹¹⁶ These limits are common to all Latin American regimes, but vary considerably in their details.

111. *Id.* Note that these rights may be transferred to the other banks.

112. *Id.* at 838.

113. *Id.*

114. Were it otherwise, countries might see an immediate outflow of capital or profit remittances by the private investor, thus paying both principal and interest immediately rather than just debt service. Hannon & Haugen, *supra* note 72, at 3.

115. *Chilean Report*, *supra* note 34, at 833.

116. Profit and dividend remittances may eventually exceed debt service, creating greater capital outflows. Hannon & Haugen, *supra* note 72, at 3. These restrictions are necessary because, as many Latin American debt experts have noted, one of the main problems with the Latin American economy is that the income from countries' assets abroad is not being repatriated. For example, it has been estimated that if the interest on Mexico's estimated US\$20 billion in American bank accounts had been brought home in 1983, it would have paid for an estimated 10% of the country's debt-servicing bill. See *Latin America: The Other Side of Debt*, *ECONOMIST*, Jun. 23, 1984, at 73, 74.

Restrictions on capital repatriation range from five years, in Bolivia and Venezuela,¹¹⁷ to twelve years,¹¹⁸ in Ecuador, Brazil, and Mexico.¹¹⁹ Some exceptions apply, however, to these restrictions. Jamaica allows capital to be repatriated after three years for "priority" projects,¹²⁰ while Uruguay provides that capital cannot be repatriated at terms more favorable than terms of the original debt.¹²¹

Restrictions on profit remittances also vary considerably. Some countries have no restrictions on profit remittances,¹²² others allow profits to be repatriated as soon as they are realized,¹²³ and many limit repatriation to a period from three to five years.¹²⁴ Under Chile's Chapter XIX guidelines, investors may not remit profits for four years, but no restriction exists on new profits after the fifth year.¹²⁵ For accumulated profits derived from the first four years, profits may be repatriated as of the fifth year, but only at a rate not to exceed 25% of the first four years' profits.¹²⁶ This restriction represents a trade-off because, as the conversion reduces or eliminates the exposure of the relevant creditor to Chile, the liability of such creditor to new exposure through "invol-

117. Venezuelan Regulations, *supra* note 87, at 281 (chapter 3, article 13 prohibits repatriation during the first five years of the investment, then permits 12.5% per year for years 6-13).

118. Brazilian Regulations, *supra* note 72, at chapter VI; Guimaraes, *supra* note 105 (the converted proceeds may not be used to acquire foreign investments during this capital repatriation period, unless the proceeds of the acquisition are reinvested in Brazil; furthermore, the foreign investor must deposit an amount equal to the return of capital, limited to the investment, during this period). See also *Profile*, *supra* note 63, at 45.

119. For other country specifics of when capital may be repatriated, see La Porta Drago, *supra* note 67 (ten years); Chilean Regulations, *supra* note 66, at 7 (chapter XIX, section 6(a) specifies ten years, but 12 years if capital invested in a mutual fund); Illanes, *supra* note 72 (investor not granted access to foreign exchange under chapter XVIII); Jamaican Regulations, *supra* note 71, at chapter V, section 6A (3-7 years depending on the investment).

120. Jamaican Regulations, *supra* note 71, at chapter V, section 6B. The restriction period is seven years for other qualified investments as specified in chapter V, section 6A.

121. Herrera, *Uruguay*, in *Survey*, *supra* note 63, at 39.

122. Bolivia is one such example. See *Profile*, *supra* note 63, at 44.

123. *Id.*

124. *Id.*

125. *Chilean Report*, *supra* note 34, at 846 (chapter XIX, section 6(b)). Net profits may not be remitted for five years if the investment was made in a mutual fund. Illanes, *supra* note 72.

126. *Id.* Chilean Regulations, *supra* note 66, at chapter XIX, section 6(b). Note that these repatriation restrictions are not applicable under chapter XVIII because, as the swap conversion is strictly peso denominated, the investor is not granted access to foreign exchange. *Chilean Report*, *supra* note 34, at 826, 831.

untary new money" calls is reduced or eliminated.¹²⁷ Mexico limits remittances within the first five years to an amount less than the amount of interest on the original debt, while Venezuela allows ten percent remittance during the first three years, followed by a rate of twenty percent plus the rate of LIBOR.¹²⁸

Some countries, however, permit the investor to sell his equity interest in the foreign country and transfer the share certificates or other documents evidencing the ownership interest to another investor.¹²⁹ The variations on these restrictions also reveal a great deal of diversity.

Foreign investment that is generated by debt-equity swaps is also subject to other restrictions generally placed on direct foreign investment. Many Latin American countries restrict foreign investment to certain sectors of the economy or place limits on the percentage of equity ownership that a foreign investor may hold in a host country's company.¹³⁰ The foreign investor, or the national as a foreign investor, must carefully consider the local taxes that complement the debt-equity regulations.

127. *Chilean Report*, *supra* note 34, at 833.

128. See, e.g., *Venezuelan Regulations*, *supra* note 87, at chapter III, article 6 (no more than 10% per year for the first three years, then remitted pursuant to Decree No. 1,200); Hannon & Haugen, *supra* note 72, at 5. For a discussion of the provisions of Decree No. 1,200, see *Venezuelan Regulations*, *supra* note 87, at 274. LIBOR is the London Interbank Official Rate.

129. *La Porta Drago*, *supra* note 67, at 41 (after three years, a foreign investor may sell its investment and convert the proceeds into foreign currency, provided the proceeds are deposited with a public sector bank until the ten-year capital repatriation period has elapsed); *Guimaraes*, *supra* note 105, at 41 (eligible debt may be converted into equity by the original creditor or its assignees); *Jamaican Regulations*, *supra* note 71, at chapter V, section 7 (subject to the approval of the Bank of Jamaica, an investor may sell an interest in a Qualified Investment before the end of the repatriation period provided that: (i) the Purchaser is an "eligible investor"; (ii) consideration for the transaction is foreign currency obtained other than through the Auction Market for Foreign Exchange; and (iii) the Purchaser submits to the Debt Capitalization Unit a certificate confirming that the Purchaser understands that the capital and dividend restrictions continue and agrees to assume all obligations of the original investor regarding the original investor's investment); *Venezuelan Regulations*, *supra* note 87, at 280 (chapter 3, article 7 provides that capital proceeds from liquidation may only be used for investment in another enterprise or to acquire Development Portfolio Securities. The date of first investment realized shall be taken as the base).

130. See, e.g., *La Porta Drago*, *supra* note 67 (the purchase of equity participation and personal property or financial investments is not eligible, and investments in real estate or in working capital required for the project are limited to 10% of the project value); *Brazilian Regulations*, *supra* note 72, at chapter XXVI; *In-house Guide*, *supra* note 63, at 4 (Mexico reserves the following economic activities for the state. They are therefore not subject to foreign investment: petroleum, petrochemicals, radioactive and nuclear energy, mining, electricity, railways, and telegraphic and radiotelegraphic communications).

The prospective investor must be fully aware of the traditional Latin American predisposition against direct foreign investment in their economies. Investors in Argentina's debt-equity program, for example, are subject to the provisions of the country's Foreign Investment Law, which states that investments in certain sectors require prior approval.¹³¹ The Investment Law also places a special tax on net profits and capital gains in excess of the 12% registered investment.¹³² In addition, Argentina taxes corporate income at a rate of 33%, and dividends, except stock dividends, that are paid to foreign residents are subject to a withholding tax of 17.5%.¹³³ Mexico's recent income tax reform imposes a 20% tax on the price differential between debt purchased and the redemption price.¹³⁴

Direct foreign investment in Mexico is subject to the country's Foreign Investment Law, which clearly restricts the degree of foreign ownership in specific areas of the economy.¹³⁵ Some industries, such as oil and petrochemicals, are reserved exclusively for state ownership, while other areas require either complete Mexican ownership, a majority Mexican participation, or, in most cases, a limit of 49% foreign participation.¹³⁶ As an exception to these rules, the National Commission on Foreign Investment has the authority to authorize up to 100% foreign ownership in a Mexican corporation or allow direct foreign investment under specific guidelines in furtherance of the country's National Development Plan.¹³⁷

V. ADVANTAGES AND DISADVANTAGES OF DEBT-EQUITY SWAPS

Proponents and critics of debt-equity swaps have set forth

131. La Porta Drago, *supra* note 67, at 42 (e.g., public services, telecommunications, defense, oil and gas, financial entities, steel, petrochemicals, mining, as well as investments which result in de-nationalization of local entities and investments in excess of \$5 million).

132. The excess over 12% in one year can be offset against deficiencies below that percentage in the previous five years. *See id.* Mexico also taxes companies located in Mexico. Stock companies are taxed at a maximum rate of 42%, with the possibility of making deductions from revenue. Dividends paid to foreign residents are taxed at a flat 55%. Creel, *supra* note 65.

133. La Porta Drago, *supra* note 67. *See also* Guimaraes, *supra* note 105 (supplemental income tax of 40% to 60% on the distribution of profits applies when the average distributed profits, after deducting the 25% withholding tax, for three consecutive years exceeds 12% of registered foreign capital).

134. *Profile*, *supra* note 63, at 45.

135. *See* Creel, *supra* note 65, at 45.

136. *Id.* *See also Profile*, *supra* note 63, at 45 (debt-equity investments in Argentina limited to 70% of the project costs, the balance requiring financing in dollars or australs).

137. Creel, *supra* note 65.

many arguments concerning the advantages and disadvantages of the swaps to the major participants.¹³⁸ Most of these arguments, however, are contingent upon the structure of the country's conversion program as well as the country's overall view towards the investment.¹³⁹ Nevertheless, some general propositions can be made regarding the effects of a swap or swap regime on the participants as the swap is implemented.

A. *Advantages*

In analyzing the benefits of debt-equity swaps, attention should be directed to the four major participants: (1) the foreign bank creditors which hold debt; (2) the investor desiring to purchase the debt through a debt-equity swap; (3) the debtor country, whose debt is sold to investors; and (4) the broker, who facilitates the debt-equity swaps. Advocates of debt-equity swaps argue that all participants benefit because the bank creditor unloads troubled loans, the investor secures inexpensive financing in local currency, and the debtor country reduces external debt while attracting foreign investment and promoting growth. Upon further examination, however, these benefits are not so clear.

1. Foreign Bank Creditor

The bank creditor initially evaluates the possibility of unloading problem loans from its portfolio, which in turn supplies the debt used in the debt-equity conversion programs.¹⁴⁰ This evaluation entails a consideration of the loan, the debtor country, the impact of unloading the loan on the bank's bargaining power with the debtor country and other debtors, and the evolution of discounts

138. The popular literature discussing the desirability of debt-equity swaps is enormous. For some useful comments on the relative advantages and disadvantages, see Curtis, *Here Comes The Repo Man*, THE NATION, May 2, 1987, at 570-74; Evans, *supra* note 59; French, *Swapping Debt — Just Hot Air?*, EUROMONEY, May 1987, at 115-22; Kuttner, *Third World Debt: A Flawed Solution*, BUS. WEEK, Jan. 19, 1987, at 18; Marton, *The Debate Over Debt-For-Equity Swaps*, INST'L INVESTOR, Feb. 1987, at 177; Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, at 67-75; Riemer, *A Way To Turn Debt From a Burden to a Boom*, BUS. WEEK, Dec. 22, 1986, at 25-26; Schubert, *Trading Debt for Equity*, THE BANKER, Feb. 1987, at 18; Hayes, *Debt/Equity Swaps*, Miami Today, Apr. 30, 1987, at 13, col. A.

139. Hannon & Haugen, *supra* note 72, at 3.

140. Thus a major factor determining the evolution of the debt conversion market will be the attitude of the U.S. major money center banks, who hold the bulk of Latin American debts, and whether they will be willing to supply the market by selling part of their holdings at a discount. See *Chilean Report*, *supra* note 34, at 824-25.

in related debt-equity swap markets.¹⁴¹ If the bank decides to sell the loan, it defines a negotiation discount range that will satisfy its own financial requirements.¹⁴²

Although the original lender is the least beneficial participant because it absorbs extensive losses by selling its debt from financially troubled debtors at huge discounts, it is nonetheless relieved to eliminate undesirable loans from its books for part of their cash value.¹⁴³ If losses are recognized through sale at a discount, the loan is then removed from the bank's books, which reduces the bank's exposure to that country by the full value of the loan sold.¹⁴⁴ By removing some of the bank's sovereign exposure from its books, its short-term liquidity increases, allowing it to focus lending strategy toward healthier and more promising opportunities.¹⁴⁵ Additionally, cleaning up the composition of the bank's loan portfolio by removing some of these problem loans decreases its exposure to default/currency risks, thereby increasing its earnings per share.¹⁴⁶ Finally, selling these debts through debt conversion programs relieves the bank from continuing to make "involuntary loans" to debtors of financially troubled countries as part of "res-

141. Ganitsky & Lema, *supra* note 13, at 22.

142. *Id.* See also *infra* note 168.

143. It is important to distinguish the bank as a supplier of debt on the secondary market from the bank as an active participant/investor in the swap itself. If the bank decides to participate directly in the debt-equity swap, as opposed to selling off its debt to the ultimate purchaser or serving as the broker of the transaction, the loss it suffers is equal to the discounted rate at which the central bank of the debtor country will redeem the debt. See Hayes, *supra* note 138.

144. Evans, *supra* note 59, at 82. If, however, the losses are recognized through the forced write-down on loans held by the banks, their exposure declines only by the size of the write-down. *Id.*

145. Ganitsky & Lema, *supra* note 13, at 24.

146. Some banks maintain a fiction that their uncollectible loans will be fully paid off to prevent increasing loan loss reserves. However, the stock markets generally see through this accounting veil and write down the value of those banks with heavy exposure in the problem debtor countries. Sachs & Huizin *ga*, *supra* note 1, at 576-77. On May 20, 1987, John Reed, Chairman of Citicorp, announced an increase in the bank's loan loss reserves by 150%, to \$5 billion, incurring an immediate \$1 billion loss. At the time of the decision, Mr. Reed said the increased reserves gave Citicorp the increased flexibility to break the debt deadlock by allowing the creditor banks to swap debt for equity, or to trade the debt on the secondary markets. Citicorp's stock price rose \$3 (six percent) the morning after, evidencing Wall Street's vote of confidence. *Citicorp Comes Clean on Third-World Debt*, THE ECONOMIST, May 23, 1987, at 77. One interpretation of the resultant increase in stock prices could be that banks were being rewarded for increasing their reserves and ensuring the long-term viability of future earnings, even at the expense of reduced long-term earnings. Conway & Siegenthaler, *supra* note 23, at 5. However, earnings should not be overlooked at the expense of protecting a bank's solvency from loan losses. *Id.* at 90. See *infra* note 170 (discussing recent additions to loan loss reserves and the U.S. regulatory response).

cue" packages.¹⁴⁷

2. Investor

Debt-equity swaps provide an excellent opportunity for a foreign investor, and now local investors under many conversion programs, either to make an investment in a Latin American country or to secure additional equity in its investment portfolio in the indebted country by securing low-cost financing in local currency.¹⁴⁸ For example, by purchasing a one million dollar domestic loan at 60% of face value and then converting the proceeds into local currency at close to face value to be invested into a subsidiary in that country, the investor has received a substantially greater amount of local currency for the amount invested than it would have obtained through normal investment procedures. This discount incentive is equivalent to a preferential exchange rate.¹⁴⁹ The average discount of Latin American debt varies tremendously from country to country.¹⁵⁰

Engaging in debt-equity swaps also gives the investor access to protected foreign markets that might not otherwise be available to him. It may also provide a basis for more harmonious relations with host governments, and an improved ability either to circumvent existing barriers to entry in global markets or to erect new

147. Ganitsky & Lema, *supra* note 13, at 24. For a discussion of the involuntary loan phenomenon, see *supra* note 12.

148. Ganitsky & Lema have explained that:

The net value at which a corporation exchanges currencies through debt-equity swaps is obtained by subtracting the broker's discounts and the administrative or governmental fees from the proceeds paid in the secondary market adjusted by the redemption exchange rate. The yield is computed by dividing the net value by the nominal value and subtracting one. The net value, the discounts, and the yield are immediate valuations in international financial markets of the LDC's long-term political and economic risks, its immediate ability to service its debt, and its capacity to generate a favorable investment climate. If the country's long-term outlook is gloomy, the short-term discount tends to be high, and vice versa.

Ganitsky & Lema, *supra* note 13, at 23.

149. See *Chilean Report*, *supra* note 34, at 830.

150. Although the discounted prices primarily reflect the prospects for loan repayment, many other factors have a possible influence, one being the degree of disagreement that exists among banks or among debtors and creditors over specific rescheduling programs. Roberts & Remolona, *supra* note 5, at 20. Other factors affecting the market price for this debt in the secondary market include the capacity of the country to generate exports, the investment outlook, political stability, and natural disasters. Hayes, *supra* note 138.

ones.¹⁵¹

3. Debtor Country

The benefits to the debtor country are numerous. Most noticeably, the debtor country generates new investment which fosters growth,¹⁵² improves its balance of payments, thereby reducing the strain on export earnings, improves its economic climate and its utilization of resources and opportunities, cancels some of its foreign debt, and reduces interest payments on existing loans.

Debt-equity swaps improve a country's balance of payments. As its foreign debt is reduced, its interest payments on the debt correspondingly decrease.¹⁵³ However, these benefits are potentially offset by the increased profit or dividend repatriation which flows from the new foreign owner's capital stock.¹⁵⁴

The purpose of a conversion from debt to equity parallels linking debt-servicing payments to exports.¹⁵⁵ Both free up some foreign exchange, net of the loss of new lending, permitting increased imports and larger domestic output.¹⁵⁶ The conversion delays the amount of foreign exchange moving out of the country for debt servicing. Additionally, the conversion directly reduces the government's debt-servicing obligations as the country replaces its loan repayment obligations with the less certain and deferred outflows

151. *Chilean Report*, *supra* note 34, at 825.

152. Financial flows to developing countries tend to be unstable, reversing to outflows during times of economic crisis. See BERGSTEN, CLINE & WILLIAMSON, *supra* note 56. In contrast, direct investment is more permanent, and its rate of earnings outflow actually moderates during cyclical recessions. In one respect, then, this conversion would have unfavorable systemic effects. If forced on banks against their will, this measure would leave scar tissue that would adversely affect the country's future credit rating, thereby impeding the country's return to more normal access to capital markets. In another respect, however, conversion of debt to equity would have favorable systemic effects, because it would help redress the current imbalance between the two. All else being equal, this will result in a greater inflow of foreign investment into the country than would occur in the absence of such a program. *Id.*

153. See, e.g., Fierman, *John Reed's Bold Stroke*, *FORTUNE*, June 22, 1987, at 26; French, *supra* note 138, at 120. Swapping public debt for equity in private businesses reduces the respective foreign governments' interest bill and brings in a significant amount of foreign exchange, as would new loans. For a discussion of debt versus equity finance, see *supra* note 9.

154. See Dornbusch, *Impact on Debtor Countries of World Economic Conditions*, in *EXTERNAL DEBT, SAVINGS, AND GROWTH IN LATIN AMERICA* 60, 81 (A. Martirena-Mantel ed. 1987).

155. See BERGSTEN, CLINE & WILLIAMSON, *supra* note 56.

156. *Id.*

associated with foreign direct investment.¹⁵⁷ The debtor country could thus reduce the amount of interest it would have to pay out that year by the equivalent of the interest on the debt sold in the secondary market.¹⁵⁸

Debt-equity programs can give the debtor countries access to badly needed investment in export-oriented industries.¹⁵⁹ Only through increasing exports and earning dollars can the debtor countries ever hope to stay one step ahead of the creditors. The swaps also benefit the country's economic development through new investment in equity or real property acquisition, the expansion of plant capacity, or additional export sales in markets where it is currently noncompetitive. Instead of borrowing to provide for growth, the debtor country can bring in foreign direct investment¹⁶⁰ and have the same rate of growth.¹⁶¹ If the new investment occurs in export items, the investment can lead to increases in the amount of foreign exchange that is available.¹⁶² Finally, the new investment can lead to increases in employment, and decreases in the cyclical fluctuations of the country's economy by diversifying the economic base, especially if these new investments are required to take place in areas where investment is not typical.¹⁶³

Debt-equity swaps can also be tailored to reverse the flow or flight of capital from debtor countries, which has been commonly attributed to such factors as overvaluation of the exchange rate, financial repression translating into negative real interest rates, fiscal deficits, tax evasion, risk factors, and external incentives provided by foreign banks and governments.¹⁶⁴ Accordingly, a well-

157. *Chilean Report*, *supra* note 34, at 828.

158. Hayes, *supra* note 138, at 13, col. B. It is argued, however, that these benefits will not be achieved for a country with a budget problem because a net reduction in interest will depend on the discount rate of the external debt and the amount by which interest rates exceed the rate on external debt plus exchange depreciation. If the government does not appropriate most of the discount at which the external debt now trades, it is likely that the required debt service would increase. See Dornbusch, *supra* note 154, at 80-81.

159. Marton, *supra* note 138.

160. See generally LESSARD & WILLIAMSON, *supra* note 12, at 46-48 (appraisal of economic benefits associated with direct foreign investment).

161. Hayes, *supra* note 138, at 14, col. F.

162. *Id.*

163. *Id.*

164. For a comprehensive examination of the problem of capital flight for developing countries, see generally D. LESSARD & J. WILLIAMSON, *CAPITAL FLIGHT AND THIRD WORLD DEBT* (1987) [hereinafter *CAPITAL FLIGHT I*]; D. LESSARD & J. WILLIAMSON, *CAPITAL FLIGHT: THE PROBLEM AND POLICY RESPONSES* (1987) [hereinafter *CAPITAL FLIGHT II*]. In particular, see Rodriguez, *Consequences of Capital Flight for Latin American Debtor Countries*, in

designed debt-equity program could help reduce capital flight by allowing foreign nationals to repatriate money held in foreign banks without corresponding penalties. Along these lines, Chile's "Chapter 18 guidelines" should serve as a model for other Latin American countries.¹⁶⁵

4. Broker

The broker links the various participants in the transaction, and, through competitive bidding, helps disseminate financial and market information. Debt-equity swap brokerage services have been provided by traditional financial brokers and investment bankers,¹⁶⁶ who charge a commission usually ranging from one to two percent of face value.¹⁶⁷ Participation in debt-equity swaps also benefits brokers by allowing them to expand their financial services and develop broader skills to facilitate the transactions.

B. Disadvantages

1. Foreign Bank Creditor

The most immediate disadvantage to the bank creditor is that it incurs heavy cash and accounting losses because of the sale of its debt at heavy discounts.¹⁶⁸ However, a more important concern regarding loss recognition is whether accounting principles will require the bank creditor to write down the remaining portfolio to market after selling problem loans at a discount. Current U.S. accounting standards do not require such a write down. Nevertheless, critics argue that the responsibility to record assets at net realiza-

CAPITAL FLIGHT I, at 129.

165. See Arellano & Ramos, *Case Studies, Chile* in CAPITAL FLIGHT I, *supra* note 164, at 166.

166. Note that because of the popularity and high brokerage fees earned by facilitating debt-equity swaps, it has been observed that "[e]veryone and his dog has set up in business as a debt-for-equity swap arranger." Mark, *Debt-Business Boom in Latin America*, EUROMONEY, Sept. 1987, at 81.

167. Also note that the role and the fees commanded by brokers decline as public officials, banks, and corporations learn the ins and outs of debt-equity swaps. Ganitsky & Lema, *supra* note 13, at 22.

168. The loss is important because it reduces the bank's book capital, which is important for regulatory purposes, and is charged against taxes. See *supra* note 29. Bank creditors selling troubled debts should also be alert to the tax benefits (savings) when determining its sales price. See Sachs & Huizinga, *supra* note 1, at 591; *supra* notes 140-42 and accompanying text.

ble value through the provision of loan loss reserves forces management to increase the reserves at the expense of either making alternate investments or paying dividends to shareholders.¹⁶⁹ However, banks would be in a better financial position in the future if they would increase their loan loss reserves and report the losses currently.¹⁷⁰ Finally, creditor banks might not want to establish an

169. This is a weak argument, however, because major banks holding debt from financially troubled nations have begun reporting record losses by increasing their loan loss reserves, regardless of whether or not they have sold that debt to investors engaged in debt-equity swaps or whether required by U.S. accounting regulators. For a discussion of recent record additions to loan loss reserves, see *infra* note 170, and, for further discussion of these accounting regulations see *infra* notes 243-47 and accompanying text.

170. Under Generally Accepted Accounting Principles (GAAP), a bank's loan portfolio should be carried at amortized historical cost less loan write-offs and the allowance for loan losses, as long as the bank has the ability and intent to hold the loans until their maturity. Allowances are established and write-offs taken based on management's judgment regarding ultimate collectability of the loans in the normal course of business. The amount of loan losses, over time, is important for stockholders and other users of financial statements as such data provide insights into the overall quality of a bank's credit portfolio and its ability to control credit risk.

After Citicorp added a staggering \$3 billion to its reserves against losses on loans to developing countries, raising the reserves to \$3.5 billion and representing 26% of its questionable loans, a \$2.5 billion quarterly loss resulted — the biggest bank loss in memory — although Citicorp's stock price increased the following day. A few weeks later, Norwest Corp. of Minneapolis, the United States' 24th largest bank, raised its reserves against Third World loans by \$200 million, suffering a \$160-million quarterly loss. The next day, Chase Manhattan, the United States third largest bank, increased its reserves by \$1.6 billion. Fierman, *supra* note 153. On December 14, 1987, the Bank of Boston became the first major American bank to acknowledge that a significant portion of its Latin American loans was worthless by writing off \$200 million of its \$1 billion portfolio. Berg, *Bank of Boston In Big Write-Off Of Latin Loans*, N.Y. Times, Dec. 15, 1987, at 1, col. 1 (nat'l ed.). The write-offs do not directly affect the earnings reported to shareholders because they are charged against loan loss reserves, but may affect taxable income. See *supra* note 29. This move could lead to pressure for similar steps by other global banking companies. The other major money center banks now find themselves in a no-win situation. If they do not build up their own reserves, their stock price may erode further; if they increase their reserves from the average 25% for Latin American debt towards an estimated necessary 50%, their already thin shareholders' equity could be reduced further, and they could invite even greater ills, such as higher financing costs. Banks cannot set aside equally large reserves and expect to recover this lost capital through share offerings because of the November 1987 stock market crash. Berg, *Banks' Reserves and Latin Loans*, N.Y. Times, Dec. 16, 1987, at D10, col. 3 (nat'l ed.).

Some analysts see the higher level of reserves at the regional banks as a form of muscle-flexing to show their investors the banks can sustain big hits in stockholders' equity, but the banks defend the move as realistic and necessary in dealing in the international arena. Bennett, *Major Banks Are Divided On Reserves*, N.Y. Times, Jan. 20, 1988, at D1, col. 6 (nat'l ed.). Because of these mixed reasons, the Federal Reserve Board (FRB) entered the scene to offer its quiet guidance that other banks need not correspondingly follow suit, but should make their own decisions. One New York FRB spokesman said "we continue to stress the importance of banks' strengthening their capital and reserve positions over time, taking into account the condition of the organization as a whole." Bennett, *Fed Urged Caution On Reserves*, N.Y. Times, Jan. 22, 1988, at D1, col. 6 (nat'l ed.).

undesirable precedent for other loans to the same or other countries.¹⁷¹

Because interest paid in the form of equity would not necessarily be treated on a non-accrual basis, this option might have a somewhat less adverse impact on banks' balance sheets and income statements than those, for example, linking payments to exports.¹⁷² Banks would need to have assurances about the future treatment of profit remittances to be able to convert debt to local equity without a potential loss of value.¹⁷³ Moreover, some banks would consider this option to imply that a private sector borrower was unable to service its debt even in local currency.¹⁷⁴ Considering that payment in local currency would always make the purchase of the equity in question a possibility, whereas the reverse would not necessarily be true, banks might prefer payment in local currency; payment in equity might be a less favorable alternative forced by the financial weakness of the borrower.¹⁷⁵

Another concern is that smaller Latin American countries may never generate enough foreign exchange to allow the banks to convert their holdings back into dollars.¹⁷⁶ This concern would effectively destroy the benefits of debt-equity swaps and deter creditors from considering them as a debt reduction mechanism.

Frequently restrictions exist on the pace at which dividends can be remitted.¹⁷⁷ As investors, however, the banks might try to protect their investments through such measures as making dividends mandatorily payable once the venture has made sufficient profits, establishing and controlling a sinking fund from which to pay dividends, or protecting against possible devaluation of the local currency by indexing the dividends and redemption payments to reflect any inflationary or exchange rate changes.¹⁷⁸ Dividend remittances might also be arbitrarily frozen by a foreign debtor nation some time in the future, although exchange inconvertibility risk insurance could be obtained to offset against such risks.¹⁷⁹

171. Ganitsky & Lema, *supra* note 13, at 24.

172. See BERGSTEN, CLINE & WILLIAMSON, *supra* note 56, at 173.

173. *Id.*

174. *Id.*

175. *Id.*

176. Evans, *supra* note 59, at 97.

177. For a discussion on restrictions of foreign remittances, see *supra* notes 122-28 and accompanying text.

178. Evans, *supra* note 59, at 97.

179. For a discussion on the availability of risk insurance to participants in debt-equity

Finally, if too many banks suffer massive write-offs, interest rates would rise as loans became scarce resulting in a possible recession.¹⁸⁰

2. Investor

One disadvantage to the foreign investor is that increased participation in foreign investment activities increases exposure to foreign, political, and economic risks. As commentators have stated, "Investors expose themselves to the transfer risk related to the remittance of capital dividends, particularly foreign exchange inconvertibility, and to political risks normally associated with an investment for ten years or more in a developing country."¹⁸¹ As one analyst has noted:

Debt-equity swap risks and the environmental threats magnify the vulnerability of the firm. Nationalist sentiments, rampant inflation partially fueled by other swaps, currency swings, and uncertainty about how the host government will manage its economy in the future are a few of the risks to be evaluated by decision makers before any swap is approved.¹⁸²

Additionally, in the absence of an existing subsidiary in the foreign country to invest the local currency, the investor would have to adjust its policies and administrative systems and adapt its organization to the country's legal, political, cultural, and ethical frameworks.¹⁸³

3. Debtor Country

Because the host government will have to finance the repurchase of its debt from the foreign investor, economists fear that a poorly structured debt-equity swap program could increase the monetary aggregates in the debtor country and, if not properly managed, lead to inflation.¹⁸⁴ This inflationary pressure would oc-

transactions, see *infra* notes 270-86 and accompanying text.

180. Satterfield, *Latin American Debt Pile Weighs Heavily on U.S. Banks*, J. Com., Aug. 20, 1987, at 7A, col. 4.

181. Hannon & Haugen, *supra* note 72, at 3. But see *infra* text and accompanying notes 272-79 for a discussion on the availability of risk insurance which can be purchased by reluctant investors to reduce these risks.

182. Ganitsky & Lema, *supra* note 13.

183. *Id.* at 24.

184. Economists more specifically seem to be saying that debt-equity swaps are not

cur when a debtor country's central bank redeems the external debt in the conversion, causing it to print local currency to pay off the creditor bank. This redemption would pump more money into the domestic economy, which would tend to be inflationary unless the local government neutralizes its monetary impact.¹⁸⁵ However, this fear could be curbed by issuing debt instruments to limit the amount of debt converted.¹⁸⁶ A further dilemma, regardless of the possible neutralizing effects, is that the net effect of a debt-equity swap is an increased internal debt and a reduced foreign debt.¹⁸⁷ Accordingly, the country swaps bad debt for good capital and the government swaps low interest (i.e., external debt) for expensive domestic debt.¹⁸⁸

A host government cannot simply swap a debt obligation for an investment. The debt servicing costs rise considerably when the central bank repurchases the debt in local currency from a foreign investor since local borrowing typically involves high interest rates in most severely indebted nations.¹⁸⁹ A country's domestic interest rates may also increase as competition arises between swaps and government borrowing of domestic currency.¹⁹⁰ Finally, because

capable of extinguishing large portions of a country's external debt without generating inflation. The national money supply must increase as local currency is exchanged for debt instruments unless proper sterilization measures, i.e., the sale of additional government bonds to soak up local currency from the public, are instituted. Therefore, bearing in mind the size of the external debt as compared to the domestic money supply, any large scale redemption will inevitably cause difficulty in sterilization. See MOBILIZING, *supra* note 36, at 45.

185. This "neutralization" of the increase in the domestic money supply is technically referred to as "sterilization." Debtor countries would most likely sterilize the increase through the sale of domestic bonds to the public, the object being to prevent the creation of local currency needed to redeem the external debt. This sterilization procedure, however, is not without its problems. First, the domestic credit markets of the developing countries are most likely to be incapable of sustaining additional demands from governments which for the most part have already absorbed the majority of available credit. Second, sterilization may be undesirable in that it may substitute an external debt at a lower interest rate with a domestic debt that may carry a higher rate of interest. See MOBILIZING, *supra* note 36, at 45-46; Evans, *supra* note 59, at 94. Some believe that the last thing an illiquid country should do is pay off its debts, particularly if this involves creating inflationary pressures in the economy. Some would argue even if the money were available to cancel the debt, the funds would be better spent on other things such as roads, pensions, and health care. Marton, *supra* note 138. The creditor banks, however, believe that if the new local currency is directed toward productive investment and new productive capacity, it is difficult to visualize an inflationary impact on a present value basis. Evans, *supra* note 59, at 94.

186. MOBILIZING, *supra* note 36, at 46; Hayes, *supra* note 138, at 13, col. E.

187. Dornbusch, *supra* note 154, at 80.

188. *Id.*

189. Curtis, *supra* note 138, at 573. See also Dornbusch, *supra* note 154, at 81.

190. "While the switch from foreign to domestic government debt is desirable from the standpoint of external transfer risk, it can be costly in real terms given the fact that real

regulators want banks to maintain their own capital as a certain percentage of their overall assets,¹⁹¹ banks suffering massive write-offs may cause interest rates to rise as loans become scarce and thus promote a possible recession.¹⁹²

Debt-equity swaps raise additional concerns in that debtor countries might be providing subsidies to foreign investors who would make such investments anyway.¹⁹³ Companies that already have facilities in the debtor countries are the major users of swaps, employing them as an inexpensive way to expand their operations.¹⁹⁴ Thus, if the foreign investor would have made the investment without the discount, the host country would have received a direct infusion of foreign exchange in payment for such investment. If the discount occurs, the country will be placed in a more unfavorable foreign exchange position than before since the converted proceeds came into the country at the discounted amount and not at 100 percent.¹⁹⁵ Also, the nation's debt is merely cancelled, as opposed to it having been rescheduled over the next ten to twenty years and, conceivably, not repaid even then. Therefore, countries may not see additional foreign investment as a result of the debt swap. Currently these countries may be providing an unnecessary incentive to foreign investors and using up valuable foreign exchange hurting their balance of payments position.¹⁹⁶

The concept of "round-tripping" also concerns most countries contemplating a debt-equity program. Round-tripping occurs when an investor brings money into the debtor country and converts it to local currency, takes it back out on the black market or parallel market, exchanges it again for dollars, and takes it out with no net benefit to the foreign country.¹⁹⁷

Conversion of debt to equity may also cause a host of political

interest rates in some of the major debtor countries have been extremely high." MOBILIZING, *supra* note 36, at 46-47.

191. See *supra* note 29.

192. Satterfield, *supra* note 180.

193. Professor Dornbusch argues that most swaps are "rip-offs" for this reason; in his view, when involved with a swap, the central bank, in providing the local currency, is saddled with an unnecessary subsidy. Marton, *supra* note 138.

194. *Id.*

195. MOBILIZING, *supra* note 36. For a discussion on "additionality," see *supra* note 36.

196. Hannon & Haugen, *supra* note 72, at 3. Although it could be argued that the government could direct the converted proceeds into new, additional investment, and not into existing assets which do not have as much benefit to the country, critics doubt this probability. Dornbusch, *supra* note 154, at 81-82.

197. Roberts & Remolona, *supra* note 5, at 35-36.

problems. The debtor countries might object to the removal of their debt from the hands of the highly visible commercial banks to anonymous investors, raising serious issues about the control of national resources.¹⁹⁸ As has been noted, “[D]eveloping-country opponents, particularly those on the political left, argue further that swaps allow foreigners to exchange nonperforming debt for control of viable domestic assets and at a discount.”¹⁹⁹ In the state sector, there would be the question of whether the government would be willing to convert sovereign debt into foreign holdings of state enterprises.²⁰⁰ In the private sector, a foreign bank that has lent money over the years to a private firm might acquire an equity interest in that firm without causing political reaction in the debtor country; however, a direct acquisition of equity in the private sector through a debt-equity swap could raise political problems on a large scale.²⁰¹

Debt-equity programs also run the risk of misallocating valuable resources. First, as noted, to the extent that the redemption of the discounted debt effectively creates a preferential exchange rate, investments arising under the program may be unwisely encouraged. Second, the use of foreign funds to retire the country’s external debt denies other uses of these funds. The more the program directs swap proceeds to a specific use, the greater the degree of preference that is exhibited for that particular use.²⁰²

The potential moral hazard²⁰³ created by the advent of debt-

198. Evans, *supra* note 59, at 85. Political scientists also fear that swaps could lead to heightened domestic violence because of increased foreign ownership of industry. However, this fear could be curbed somewhat by allowing local employee ownership through Employee Stock Ownership Plans (ESOPs) in privatized state-owned enterprises. For a further discussion of ESOPs in Latin America, see *supra* note 55.

Moreover, the “investment” is often purely financial; a U.S. investor buys out a local investor, but no new assets are created. Kuttner, *supra* note 138. This results in net capital inflows remaining constant while foreign companies gain an increasing stake in local operations. Curtis, *supra* note 138, at 573. For a definition of “additionality,” see *supra* note 36.

199. Marton, *supra* note 138. See also MOBILIZING, *supra* note 36, at 48; Dornbusch, *supra* note 154.

200. BERGSTEN, CLINE & WILLIAMSON, *supra* note 56, at 172. If it decided to convert sovereign debt into foreign holdings of state enterprises, the debtor country would lose considerable control of state-owned companies. Ganitsky & Lema, *supra* note 13, at 24.

201. BERGSTEN, CLINE & WILLIAMSON, *supra* note 56, at 172. With respect to the narrower issue of conversion of debt to equity, from a political-economic standpoint this measure could be counterproductive if pursued on a large scale. In some countries the result could be a whole new sphere for conflict between nationalism and the interests of foreign capital. *Id.* at 175.

202. Roberts & Remolona, *supra* note 5, at 33-34.

203. “Moral Hazard” has been defined as:

equity regimes also raises questions about the programs' desirability. To the extent that declining conditions within the debtor country result in declining prices of that country's debt in the secondary market, it is possible countries might deliberately enact unwise measures or take unpopular positions regarding repayment so that they may take advantage of the reduction. This moral hazard concern is more likely to appear where the debtor country is itself repurchasing its debt on the secondary market. The risk is less likely to occur in the debt-equity or debt-home currency swaps.²⁰⁴

Finally, it has been argued that debt-equity swaps might result in a future decrease in commercial bank loans. Specifically, debt-equity and debt-home currency swaps might serve to reduce the supply of deposits that are currently held in money center banks, as capital flight currency is repatriated and U.S. investors participate in the debt-equity programs. This would diminish the supply of funds in the banks that could be used for future loans.²⁰⁵

4. Broker

The main disadvantage for brokers seeking to enter the business of facilitating debt-equity swaps is that they risk credibility if they fail to solve conflicts of interest among the participants, the country, the bank, and the investor, which would create adverse precedential effects for established companies not benefitting from new debt-equity swaps.²⁰⁶ Furthermore, there is the possibility that brokers might strain managerial resources if they underestimate the demands of the swap.²⁰⁷ However, on balance, these are not significant disadvantages because of the high commissions paid

The effect of certain types of insurance systems in causing a divergence between the private marginal cost of some action and the marginal social cost of that action thus resulting in an allocation of resources which is not optimal. For example, a person may be insured against illness in such a manner that the cost to him of consuming more medical care is less than the cost to society. Consequently, he may increase his use of medical facilities beyond the socially optimal level

THE MIT DICTIONARY OF MODERN ECONOMICS 257 (3d ed. 1986).

204. Roberts & Remolona, *supra* note 5, at 32.

205. *Id.* at 27-28. These authors, however, note that debt-debt swaps might actually increase future lending in that they would transfer debt exposure to banks more willing to assume risk of a particular country repaying its loans and, hence, more willing to renegotiate old loans. Debt-equity swaps would also provide an exit mechanism for pessimistic creditors possibly generating more flexibility of the loan rescheduling. *Id.* at 28.

206. Ganitsky & Lema, *supra* note 13, at 24.

207. *Id.*

for arranging the swap transactions.

VI. THE U.S. REGULATORY ENVIRONMENT

From the perspective of the U.S. policy-maker, the promotion of debt-equity swaps requires that attention be directed at four regulatory areas: (1) bank regulation; (2) accounting regulation; (3) tax regulation; and (4) the availability of risk insurance. Financial institutions which seek to invest directly in Latin American enterprises are governed by banking regulations which limit both the size and type of their investment. Similarly, accounting and tax regulations may facilitate or retard the willingness of banks and private investors to trade in Latin American debt on the secondary market. Finally, the availability of risk insurance, either through public or private channels, may generate greater demand for the debt-equity swaps by eliminating investment risks which may otherwise discourage investors who are unfamiliar with the political and economic climate in Latin America.

A. Bank Regulations

The Federal Reserve Board (FRB) regulations, and specifically Regulation K,²⁰⁸ closely control the investment activities of national banks in foreign countries. Regulation K limits such investments by U.S. member banks and bank holding companies to investments "of a banking or financial nature and those that are necessary to carry on such activities."²⁰⁹

Until recently, these regulations resembled domestic restrictions on investment, and limited direct investment to traditional banking areas. Banks which were interested in swapping debt for equity in a Latin American country were thus limited in their in-

208. Federal Reserve System Regulation K, 12 C.F.R. § 211 (1987).

It must be noted, however, that Regulation K is not the exclusive mechanism for allowing banks to assume equity positions in non-financial ventures. The traditional principle of "debt previously contracted" derived from both 12 U.S.C. § 29 and 12 U.S.C. § 24, also may allow for such transactions. See generally Lucio, *Debt-equity Swaps and U.S. Banks: Alternatives to Regulation K*, in THE FLORIDA BAR, LEGAL ASPECTS OF DOING BUSINESS IN LATIN AMERICA: CREATIVE SOLUTIONS TO INTER-AMERICAN LEGAL PROBLEMS 5.1 (1989) (lecture outlines of presentations delivered at continuing legal education seminar held in Miami, Florida, Feb. 2-3, 1989) (copy on file at the offices of the University of Miami Inter-American Law Review).

209. 12 C.F.R. § 211.5(a) (1987).

vestment opportunities.²¹⁰ Although recent relaxation of these regulatory standards has set the stage for expanded activity by large money-center banks, preliminary enthusiasm for flexible regulations governing investment through debt-equity swaps should be tempered by a closer examination of the amended regulations.

Regulation K originally limited the ability of national banks to engage in debt-equity swaps by both delineating the range of activities in which banks could invest and restricting the percentage of equity that the bank could hold in a foreign company.²¹¹ With some minor exceptions, national banks could hold up to 20% of the shares of a nonfinancial company and up to 100% of the shares of a financial company.²¹² Regulators carried over the financial/nonfinancial distinction from the domestic bank holding company regulations, and generally allowed investments which would have been permissible under an analysis of Regulation Y.²¹³

Recognizing that greater liberalization of Regulation K would be required to promote debt-equity swaps in heavily indebted countries, the FRB amended Regulation K in August 1987.²¹⁴ The Board's amended regulation made it easier for banks to participate in debt-equity swaps by allowing U.S. banking organizations to acquire as much as 100% of the shares of, or other ownership interest in,²¹⁵ a foreign nonfinancial company in an eligible country²¹⁶ if

210. For example, until it was recently amended, Regulation K made it difficult for banks to invest in nonfinancial activities such as "hotels in Mexico or fish farms in Chile." Evans, *supra* note 59, at 89.

211. Before Regulation K was amended in 1987, the FRB's position was that the regulation would be applied to an equity investment acquired through a debt-equity conversion in the same fashion as any other investment. See Quale, *Legal and Accounting Considerations Relating to Debt Equity Conversions*, in Euromoney Conference, *supra* note 69, at 58.

212. The financial sector in most Latin American countries is severely under-capitalized and desperately needs foreign investment. The awareness of this need is causing some governments to open such sectors to greater foreign investment in spite of the politically sensitive nature of the sector. *Id.*

213. Federal Reserve System Regulation Y, 12 C.F.R. § 225 (1987).

214. See 12 C.F.R. § 211.5(f) (1988) [hereinafter 1987 Regulations]. The FRB's commentary stressed that the policy of the amended regulation was to provide to U.S. banking organizations flexibility in managing their portfolios of loans to heavily indebted countries, and not to permit permanent investments in nonfinancial companies. *Id.* For a useful summary of the 1987 revisions, see Spencer, *Regulation K Allows 100 Per Cent Ownership*, INT'L FIN. L. REV., Oct. 1987, at 13.

215. This provision would allow bank holding companies to own an interest in a business entity which under the respective foreign law does not issue shares.

216. An "eligible country" is defined as "a country that, since 1980, has restructured debt held by foreign creditors." 12 C.F.R. § 211.5(f)(2)(i) (1987). Although neither the amended Regulation K nor the commentary identifies which countries meet this condition, the FRB commentary refers in a footnote to Section 1201(e)(2)(H) of the Tax Reform Act of

the following conditions are met:

- 1) the nonfinancial company is in the process of being transferred from public to private ownership;²¹⁷
- 2) the country in which the company is located is a heavily indebted developing country;
- 3) the shares are acquired through a debt-equity swap;²¹⁸
- 4) the shares are held by the bank holding company or its subsidiaries,²¹⁹ provided, however, that such shares are not held by a U.S. insured bank or its subsidiaries;²²⁰
- 5) the ownership interest is divested within five years from the date of acquisition,²²¹ unless the FRB extends the time for good cause but in no event longer than a total of ten years; and
- 6) an investment is made in accordance with the investment

1986, which lists the following: Argentina; Bolivia; Brazil; Chile; Colombia; Costa Rica; Dominican Republic; Ecuador; Guyana; Honduras; Ivory Coast; Jamaica; Liberia; Madagascar; Malawi; Mexico; Morocco; Mozambique; Niger; Nigeria; Panama; Peru; Philippines; Romania; Senegal; Sierra Leone; Sudan; Togo; Uruguay; Venezuela; Yugoslavia; Zaire; and Zambia.

217. The FRB commentary to the revisions makes it clear that the foreign government must have owned the shares in the foreign nonfinancial company; it would not be sufficient for the foreign government, solely for purposes of the debt-for-equity conversion process, to acquire the shares in the foreign nonfinancial company and then transfer those shares to the bank holding company. The commentary also states that "private investment in such companies [that are currently state-owned] may provide some benefit to the countries by reducing economic inefficiencies and governmental subsidies." 1987 Regulations, *supra* note 214.

218. 12 C.F.R. § 211.5(f)(1)(ii) (1988) states that "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." The debt-equity conversion procedures in the eligible country would have to be reviewed to ensure that they comply with this requirement. The FRB will consider investments in countries requiring that new money be invested in addition to the proceeds of the debt obligation being swapped on a case-by-case basis. 1987 Regulations, *supra* note 214.

219. The purpose of this is to "erect an effective barrier between the bank and the commercial and industrial activities of the companies to be acquired." Thus, ownership through the bank holding company will further isolate the nonbanking activity from the banks and will indicate that the nonfinancial company is not protected by the federal safety net available to banks. Further, the restrictions of Section 23A of the Federal Reserve Act (12 USC § 371c) will apply as a matter of law to transactions between the bank and affiliated companies such as the foreign nonfinancial company. *See* 1987 Regulations, *supra* note 214.

220. The transfer of an asset from a bank to its holding company or to another subsidiary of the holding company, and the conversion of the asset from debt to equity, could result in the recognition of loss for U.S. tax and regulatory reporting purposes. Furthermore, such a debt-for-equity conversion would raise portfolio valuation issues. *Id.*

221. This is consistent with the dividend and capital repatriation restrictions present in many debt conversion programs. *Id.*

procedures as set forth in the appropriate section of the Code of Federal Regulations.²²²

In order to address the potential problems of possible conflicts of interest, unsound banking practices, and the financial markets viewing the U.S. banking organization and the nonfinancial affiliate as one entity, the amended regulation specified that two additional conditions be met. First, the acquired foreign company can not have a name similar to the name of the acquiring bank holding company or any of its affiliates.²²³ Second, neither the bank holding company nor its affiliates can transmit any confidential business information or other information regarding customers that were engaged in similar businesses as the acquired company.²²⁴ Furthermore, the commentary stipulated that U.S. banking organizations maintain few interlocks of officers and directors between the banking organizations and the nonbank affiliate. In the event such interlocks are required, they would be allowed only to the extent that they are "administratively necessary."²²⁵ "As an additional precaution, the foreign company could not as a general rule engage directly or indirectly in trade or business in the United States which is prohibited to Edge Act corporations."²²⁶

The reaction to the August 1987 FRB ruling was mixed. Some members of the banking community cautiously approved of the ruling's liberalization of the regulations, while others expressed doubts that the ruling would have much of an impact on the swap market.²²⁷ There were also suggestions that bankers could easily

222. From a procedural standpoint, the amended Regulation K provides that any debt-equity swap under § 211.5(f) will be treated like any other investment under Regulation K and will be subject to the standard approval requirements of that Regulation. 1987 Regulations, *supra* note 214.

223. 12 C.F.R. § 211.5(f)(3) (1988). The commentary states:

The restrictions on the sharing of a similar name by the U.S. banking organization and its nonbank affiliate would reduce the likelihood that a bank would be identified with the nonbank company and thereby reduce the pressures on a banking organization to support the affiliate in the case of losses.

Id.

224. 12 C.F.R. § 211.5(f)(3)(ii) (1988).

225. 1987 Regulations, *supra* note 214.

226. See 12 C.F.R. § 211.5(f)(1)(v) (1988) and 12 C.F.R. § 211.5(b)(3)(A), (B) (1988).

227. Compare the comments of Neil Allen, head of the LDC asset trading division of Bankers Trust in New York ("Of course we welcome the move. But this is only one step; further liberalisation is needed.") with those of Antonio Angotti of Security Pacific Bank ("The Fed's decision doesn't change much. Most countries, when they privatise, want cash, not debt. It's useless interference."). Evans, *supra* note 59, at 89. For additional commentary on the FRB's decision, see Commins, *Fed Ruling May Sour Some Debt Swaps*, J. Com., Aug. 20, 1987, at 7A, col. 2; Wolfson, *Fed Ruling on Swaps Fails to Stir Debt Mart*, J. Com.,

avoid the regulations by acquiring preferred, non-voting stock or obtaining equity interests in exchange for debt previously contracted.²²⁸

Although the August 1987 amendment to Regulation K was issued as a final rule and was thus effective upon issuance, the FRB did request comments from concerned parties as part of a continuous examination of the rules governing debt-equity swaps. The FRB received twenty-three public comments and made the decision to further amend Regulation K to take into account these public suggestions. On February 18, 1988, the FRB announced its most recent amendment of Regulation K's rules on debt-equity swaps, taking effect on February 24, 1988.²²⁹

Six major revisions were made to Regulation K in early 1988. First, the amendment allows a U.S. banking organization to invest in up to forty percent of the shares of a private sector nonfinancial company through the use of a debt-equity swap.²³⁰ In contrast, the 1987 amendment only concerned itself with investments in public sector companies that were being privatized by the government of the foreign country.²³¹ Other provisions of Regulation K, however, limited investment in the nonfinancial sector to 20% of the shares of the company, so that the recent 1988 regulations reflect a significant liberalization of the rules.²³²

Aug. 18, 1987, at 2A, col. 1; Truell & Yang, *Fed Agrees to Let U.S. Banks Acquire Nonfinancial Firms in Debtor Nations*, Wall St. J., Aug. 13, 1987, at 3, col. 2.

228. See Evans, *supra* note 59, at 89, 91.

229. See 53 Fed. Reg. 5358 (1988) (codified at 12 C.F.R. § 211.5(f)) [hereinafter 1988 Regulations].

230. 12 C.F.R. § 211.5(f)(2)(ii) (1988) states in part: "*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. . . ."

For the conditions imposed on this ownership interest, see *infra* notes 233-36 and accompanying text.

231. See 12 C.F.R. § 211.5(f)(2)(i) (1988).

232. Although the August 1987 and February 1988 Regulations frequently refer to the 20% ownership in non-financial companies previously allowed under Regulation K, there is little reference to how this figure was determined, thus generating a great deal of confusion among many bankers before the 1988 Regulations specifically raised the ownership limit in § 211.5(f)(2)(ii). Under § 211.5(c), however, an investor (defined as an "[e]dge corporation, agreement corporation, bank holding corporation, or member bank" in § 211.2(j)) could make "portfolio investments" in a corporation subject to certain restrictions. The term "portfolio investment" is defined in § 211.2(n) as "an investment in an organization other than a subsidiary or joint venture." Since a "joint venture" is defined in § 211.2(k) as "an organization that has 20 percent or more of its voting shares held directly or indirectly by the investor or by an affiliate of the investor," and since a "subsidiary" is defined by § 211.2(p) as "an organization that has 50 percent or more of its voting shares held directly or

Second, the new regulation requires that another shareholder, or a control group of shareholders, own a larger block of shares than the U.S. banking organization if it acquires more than 25% of the voting shares of a nonfinancial company.²³³ According to the FRB, this requirement demonstrates that there is another equity holder with substantial capital at risk and ensures that the bank holding company would not have to shoulder sole operational responsibility for the company. Not only would the investor not be put in a position where additional investments would have to be made to prop up a failing enterprise, but it would also become far less likely that the host country would place responsibility for the failure of the nonfinancial company on the U.S. organization.²³⁴

Third, any U.S. banking organization which makes an investment in a company under the revised Regulation K guidelines is also permitted to provide loans or other financing in an amount up to 50% of the total loans and extensions of credit to the affiliated company.²³⁵ Since at least one-half of the company's credit must be obtained through the marketplace, the FRB intends to ensure that the company is creditworthy and will not be allowed to rely on its U.S. affiliates for all of its funding. As such, the provision is similar in nature to the limitation on share ownership.²³⁶

Fourth, the new regulations extend the period for which the U.S. bank may hold the debt-equity investments in nonbank companies. Under the 1987 revisions, the investment could be held for five years with the possibility of a five-year extension.²³⁷ The new regulations allow investments made under the new guidelines to be held for the lesser of 15 years or two years beyond the end of the period established by the country restricting repatriation of the investment. It applies to both privatized and private sector companies.²³⁸

Fifth, unless the FRB permits a bank to hold it, the invest-

indirectly by the investor or by an affiliate of the investor," the conclusion was that the term "portfolio investment" limited investment in nonfinancial organizations to 20 percent. For a rather indirect treatment of this analysis, see Mortimer & Slade, *Foreign Securities Activities of U.S. Banks*, INT'L FIN. L. REV., June 1987, at 17.

233. 1988 Regulations, *supra* note 229 (codified at 12 C.F.R. § 211.5(f)(2)(ii)(A)) (1988)).

234. *Id.*

235. *Id.* at § 211.5(f)(2)(ii)(B).

236. *Id.* at § 211.5(f)(2)(ii)(A).

237. 12 C.F.R. § 211.5(f)(1)(iv) (1988).

238. *Id.* at § 211.5(f)(4).

ment is required to be held through a bank holding company and not its bank or subsidiary.²³⁹ The FRB, however, will consider these exemptions on a case-by-case basis and will require that the applicant show a special need to hold the nonfinancial investment through the bank. One such need, for example, would be a local legal requirement that would require that the investment be held by the bank.²⁴⁰

Finally, the new regulations increase the general consent limit of Regulation K to the greater of \$15 million or one percent of the investor's equity capital.²⁴¹ This limit represents the fact that an organization may invest without giving prior notice to the FRB, and would also apply to investments made in public sector companies.²⁴²

The most recent amendments to Regulation K are a substantial liberalization of the rules governing investments made by banks through debt-equity conversions. However, they fail to reach as far as some banks would have liked. Private debt, for example, is still not eligible for conversion under the FRB's regulations. Many banks would prefer to have the nonfinancial investments held by the bank and not the holding company. In addition, many commentators also feel that the 40% share allowance is still too low. Nevertheless, the new regulations reflect a sensitivity on the part of the FRB to the requirements of the participants in debt-equity transactions, which suggest that future needs will also be considered as they arise.

B. Accounting Regulations

Until recently, accounting regulations, which discouraged banks from selling foreign debt through debt conversion programs, have played an important part in limiting the supply of debt that is traded on the secondary market. When a bank creditor sells a portion of its foreign debt at a significant discount, it recognizes that the carrying value of the debt exceeds its sales price. A question is raised whether the remaining portfolio of that obligor should be written down to market value,²⁴³ to more accurately re-

239. *Id.* For a definition of "a bank holding company" see 12 C.F.R. § 211.5(f)(2)(ii).

240. *Id.* at § 211.5(f)(3).

241. *Id.* at § 211.5(f)(5).

242. *Id.*

243. Note that European, Japanese, and Canadian banks are required by law to write

fect its actual value.²⁴⁴ Former U.S. accounting standards followed this logic.²⁴⁵ This long-running debate also applies to banks selling debt in debt-equity swaps. For large money center banks holding sizeable amounts of debt in one country, an "all or nothing" mentality would be created. Unless the bank could simultaneously release all of its debt on to the secondary market, the bank would refrain from selling any part of the debt in order to prevent reporting significant book losses, even if the bank subsequently increases stockholders' equity.²⁴⁶ These concerns destroy all incentives to extend further credit to Latin America and other financially troubled countries.²⁴⁷

It is critical to the expanded use of debt-equity conversions that no write-down be required.²⁴⁸ The promotion of debt-equity swaps could best be achieved by accounting regulations limiting the write-down of the bank's foreign loan portfolio only to debt sold at a discount. The collectability of loans should not be related to the write-down resulting from swaps. The American Institute of Certified Public Accountants (AICPA) is currently considering new guidelines reflecting this logic. With banks following Citicorp's de-

all investment down to market. Hayes, *supra* note 138, at 1D, col. E.

244. Some bankers are discouraged from selling debt at a discount, whether through a debt-equity swap or outright sale, because they fear that it might spread a "contagion to the rest of their portfolio." Curtis, *supra* note 138, at 572. Some view contamination as a serious problem, although issues affecting trading of debts of financially troubled nations are viewed differently by major accounting firms. One firm, Arthur Young & Co., P.A., does not view contamination as a problem because it splits the portfolio into an investment and a trading portfolio, keeping the loans in the investment portfolio *at par*. Price Waterhouse & Co., C.P.A., on the other hand, believes that if any part of a portfolio is traded, all the loans must be marked to market. Evans, *supra* note 59, at 92-93.

245. Although the former method of accounting for the sale of debt did not specifically mandate the write-down of the remaining loan portfolio of a specific country, such accounting procedures were generally understood to be preferred. In 1985, the American Institute of Certified Public Accountants (AICPA) counseled banks to review their loan portfolios to determine the adequacy of their loan loss allowance. When read in conjunction with the AICPA recommendation that swaps should be recorded at "current fair value," many banks believed that the sale of debt at a discount required a write-down of the remaining portfolio. Additionally, the Comptroller of Currency issued a circular which supported this position. Comptroller of the Currency Banking Circular 200, May 22, 1985. See Roberts & Remolona, *supra* note 5, at 25. Sales of public sector debt raise difficult questions concerning the attribution of the loss. For example, it is unclear whether loans to a government corporation should be cumulated with loans to the government. *Id.* at 26.

246. Curtis, *supra* note 138, at 572. See *supra* note 170.

247. Curtis, *supra* note 138, at 571.

248. Unfortunately, accountants and regulators are leaning toward recording the equity part of the swap at the fair market value of the debt, as with debt-for-debt swaps. The result is that the banks would suffer damage. Marton, *supra* note 138, at 178.

cision to add to its loan loss reserves²⁴⁹ the interests of both the bank and the borrowing country would best be served by encouraging avoidance of some of these loans through the substitution of equity, even if acquired at a discount.

The accounting issue regarding the proper handling of the translation of earnings into dollar equivalents arises from the generation of local currency earnings by equity assets through a debt-equity swap. The "Emerging Issues Task Force Issue Summary" No. 87-12 illustrates the problem of accounting in consolidated financial statements for the credit²⁵⁰ resulting from a parent participating in a debt-equity swap and the reinvestment of the proceeds in the parent's foreign subsidiary. Assuming that a parent invested \$75 million for \$100 million of local debt (redeemable at 95% of face value) in a debt-equity swap, thereby increasing the net assets of its subsidiary in the foreign country by \$95 million in local currency, a \$20 million credit arises in the parent's consolidated financial statements. The credit appears to be neither a "transaction gain or loss," nor a "translation adjustment" as described by FASB No. 52 because the amount does not result from a change in the exchange rate.²⁵¹ Issue Summary No. 87-12 proposes the following alternatives in handling the credit on financial statements:²⁵² (1) no income recognition;²⁵³ (2) classification as a deferred credit;²⁵⁴

249. See *supra* note 170.

250. No authoritative literature exists which specifically addresses this issue, although the Financial Accounting Standards Board has provided some guidance. See FINANCIAL ACCOUNTING STANDARDS BOARD, FOREIGN CURRENCY TRANSLATION STATEMENT No. 52 [hereinafter FASB No. 52].

251. *Id.*

252. AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, EMERGING ISSUES TASK FORCE ISSUE SUMMARY: ACCOUNTING FOR FOREIGN DEBT FOR EQUITY SWAPS, ISSUE No. 87-12 (1987) [hereinafter ISSUE SUMMARY].

253. Proponents of this view argue that the foreign exchange rate used to remeasure the subsidiary's financial statements should be discounted to properly reflect the effects of the restrictions on the local currency's fair value. This discount is believed to equal the amount the investor paid for the foreign loan in the secondary market. Consequently, by discounting the exchange rate, the recorded value of the subsidiary's net assets would equal the parent's investment in the subsidiary; therefore, no elimination of credit in consolidation would be necessary. However, such a view appears inconsistent with FASB No. 52, *supra* note 250. See also ISSUE SUMMARY, *supra* note 252, at 2.

254. Advocates of this view believe that the credit should be classified as a deferred credit on the balance sheet due to the remoteness of ultimate distribution of the credit to the parent based on the subsidiary's capital stock restrictions and the foreign economy's instability. However, the deferred credit would be recognized as income when the parent either sells its investment in the subsidiary or when the subsidiary distributes the amount to the parent. Note that the deferred credit could also be classified as a component of stockholders' equity, similar to the classification of translation adjustments under FASB No. 52,

(3) treatment as a credit excess associated with a consolidated subsidiary or an equity method investee;²⁵⁵ (4) recognition as current income;²⁵⁶ or (5) recognition as income similar to local currency used in that foreign subsidiary.²⁵⁷

C. Tax Considerations

United States Internal Revenue Service Revenue Ruling 87-124 addresses the U.S. federal income tax consequences of a United States commercial bank entering into debt-equity conversions as part of a foreign country's program to reduce the amount of its outstanding U.S. dollar-denominated debt.²⁵⁸ The following example illustrates the federal income tax consequences of a typical debt-equity swap when a foreign firm ("Investor") purchases U.S. dollar denominated debt ("Obligation") from a commercial bank creditor ("Creditor").²⁵⁹ Assume Investor purchased Creditor's \$100 million Obligation for \$75 million (fair market value in the secondary market outside the foreign country in question)

supra note 250. See also ISSUE SUMMARY, *supra* note 252, at 2.

255. Based on this view, the credit would not be recognized currently as income because it is effectively a capital contribution made by the parent to the subsidiary. The credit would be accounted for according to its nature in the parent's consolidated financial statements (e.g., the parent could allocate the credit as a component of specific accounts within the financial statements, or account for it as if it were an unallocated credit excess that arises in a purchase business combination if the credit could not be specifically identified). ISSUE SUMMARY, *supra* note 252, at 3.

256. Those who advocate this method believe that the credit has been realized by the consolidated entity upon the consummation of the debt-equity swap because the local currency contribution by the foreign government results in an increase in the subsidiary's cash flow and net worth. *Id.*

257. Based on this view, the credit would be recognized according to the nature in which the local currency ("LC") is required to be used by the foreign subsidiary. For example, if the agreement requires the subsidiary to make a capital expenditure, the difference would be amortized to income over the expected useful life of the acquired asset; likewise, if the LCs are used to pay a portion of the subsidiary's debt, the credit should be recognized as a gain from extinguishment of debt in the company's consolidated financial statements. Supporters of this method believe the concepts in the AICPA's Issues Paper, *Accounting for Grants from Governments*, are applicable to accounting for this credit. *Id.*

258. Rev. Rul. 87-124, 1987-47 I.R.B. 5.

259. *United States: Revenue Ruling on Debt/Equity*, INT'L FIN. L. REV., JAN. 1988, at 44-45. The Ruling does not intend to cover all variations in the debt-equity swap procedures; therefore, the specific procedures of each foreign country's capitalization program would have to be individually reviewed when considering the U.S. income tax treatment for U.S. banks and other U.S. taxpayers participating in such programs. Also, the Ruling does not deal with any U.S. income tax consequences for transfers of the stock in the local corporation by the U.S. bank to its bank holding company, if required by the recently amended Regulation K. See Spencer, *supra* note 214, at 45.

which was redeemed at the central bank for \$95 million in local currency ("LC"). The central bank then credits the account of a local corporation with the local currency and the local corporation issues all of its capital stock to Investor. According to the Ruling, Creditor will recognize a loss on the sale of the Obligation to Investor for \$25 million, equal to the excess of the property's adjusted basis of \$100 million over the amount realized of \$75 million.²⁶⁰

The Investor has an adjusted basis in the Obligation of \$75 million, its purchase price.²⁶¹ The remainder of the transaction will be treated for federal income tax purposes as if Investor received \$95 LC from the central bank in exchange for the Obligation, and then contributed the \$95 LC to a corporation organized in the foreign country in exchange for its stock. Because the LC is considered property,²⁶² Investor realizes a gain on the exchange of the Obligation with the Central bank to the extent the fair market value of the \$95 LC²⁶³ exceeds Investor's adjusted basis of \$75 million.²⁶⁴ Investor's basis on the \$95 LC is \$75 million plus the gain, if any, recognized on the exchange. As the fair market value of the stock received from the corporation in the foreign country is presumed to equal the fair market value of the \$95 LC,²⁶⁵ then Inves-

260. See I.R.C. § 1001(a) (1987). Note that although no tax effects exist for the remaining portfolio because no sale or exchange has taken place, management should theoretically adjust its loan loss reserves to reflect market value according to GAAP. See *supra* note 170.

261. See I.R.C. § 1011 (1987).

262. See Rev. Rul. 74-7, 1974-1 C.B. 198.

263. Until recently the accounting profession insisted that equity interests received in exchange for debt should be accounted for at the fair value of the debt exchanged. In June 1987, the I.R.S. modified its position and decided that the fair market value of the local currency for purposes of debt-equity conversions is determined by taking into account all the facts and circumstances of the exchange. This includes taking into consideration the limitations imposed by the foreign government on Investor's use of the local currency, and despite a free market for exchanging the local currency into U.S. dollars in transactions unrelated to the debt conversion program. See Rev. Rul. 87-124, *supra* note 258; Evans, *supra* note 59, at 91. The I.R.S., however, did not explain the circumstances in which the value of the converted local proceeds exceeds the purchase price of the debt, leaving this determination uncertain. *How U.S. Corporations Can Make A Case For Tax-Free Debt Swaps*, 1988 BUS. LAT. AM. 110, 111 (based on interviews with Richard Hammer, National Director of International Taxation, Price Waterhouse, and Dale Johnson, Chairman, International Department, Widett, Slater & Goldman) [hereinafter *Tax-Free Swaps*].

264. This may provide some disincentive to some Investors who may decide that their basis in the stock of the corporation in the foreign country should be limited to the cost of the Obligation because of the repatriation restrictions (i.e., the converted U.S. dollar-denominated debt into local currency cannot be used outside that country). However, this merely would postpone the gain on the subsequent sale of the corporate stock.

265. Two theories have been advanced supporting the proposition that no taxable gain should arise when participating in a debt-equity swap. First, under the "fair market value theory," the value of the converted local currency (e.g., \$95 LC) approximates the price paid

tor's basis in this stock in exchange for the \$95 LC equals the fair market value of the \$95 LC and no gain or loss is recognized.

The Revenue Ruling also describes a second fact situation. Assume that, instead of crediting the account of the local corporation, Creditor sells the Obligation to a domestic corporation (which is not affiliated with Creditor) for \$75 million. The Creditor, on behalf of Investor, then delivers the Obligation to the foreign country's central bank. The central bank credits the account of the local corporation at the central bank with the \$95 LC, and the local corporation issues all its capital stock to Investor. The same analysis as in the first situation applies, except that Investor will be treated as if it received \$95 LC from the central bank in exchange for the Obligation and then contributed the \$95 LC to the local corporation in exchange for its stock. According to the Ruling, Creditor has a taxable loss of \$25 million, equal to the difference between its adjusted basis and the amount realized. The transaction is treated as if the U.S. corporation transferred the Obligation to the central bank, in exchange for the local currency, and then the U.S. corporation transferred the local currency to the local corporation in exchange for all of the stock of the local corporation. The U.S. corporation recognizes a loss on the exchange of the Obligation equal to the excess of Investor's adjusted basis (\$100 million) over the fair market value of the \$95 LC received from the central bank.²⁶⁶ Assuming that the U.S. corporation's basis for tax purposes in the local currency equals the fair market value of the stock issued by the local corporation, the U.S. corporation does not recognize gain or loss on the exchange of the local currency for the

for the debt obligation (e.g., \$75 million) because of the restrictions on the local currency. Furthermore, proponents of this theory argue that no gain arises at the parent level because a prudent investor would simply purchase the same debt on the secondary market if forced to pay more than \$75 million for the restricted \$95 LC. Second, under the "subsidy theory," the currency gain (e.g., the subsidiary receives 95% of the debt redemption price in local currency for an investment of 75% of the face value by the parent) realized by the subsidiary is treated as a "subsidy, or inducement, by the government to invest." Although this subsidy accrues to the subsidiary as a result of the favorable exchange rate, the increase in capital (i.e., contributions from government entities to induce local investment) is not taxable under U.S. tax rules. The subsidy theory thus allows the Investor to avoid Subpart F tax liabilities, which subjects passive income (such as foreign currency gains) earned by a controlled foreign corporation at the subsidiary level to tax liability. This theory is supported by *Edwards v. The Cuba R.R. Co.*, 268 U.S. 628 (1925), which held that a foreign government providing a subsidy that does not require services in exchange is not taxable to the U.S. corporation or its foreign subsidiary. See *Tax-Free Swaps*, *supra* note 263, at 110-11.

266. ISSUE SUMMARY, *supra* note 252, at 2.

stock of the local corporation.²⁶⁷

A third and final fact situation is presented in Revenue Ruling 87-124, which is a variation of the second situation. Instead of crediting an account of the foreign corporation, the central bank credits an account of a U.S. corporation having the status of a charitable organization pursuant to I.R.C. § 170(c)(2) (1988) and which can use the converted local currency for charitable purposes. Although contributors generally receive a charitable deduction equal to the fair market value of the property on the date of the contribution (the amount that is available for charitable use by the donee) this ruling allows the U.S. commercial bank donor to claim a charitable contribution deduction equal to the fair market value of the local currency.²⁶⁸ Investor also recognizes a loss on the exchange of the Obligation for \$95 LC equal to the excess of its adjusted basis in the Obligation, \$100 million, over the fair market value of the \$95 LC. This interpretation should help to encourage creditor banks engaging in debt-equity swaps to donate the converted proceeds to U.S. charitable organizations operating in the developing country.

The Internal Revenue Service (IRS) has determined that in certain circumstances U.S. banks must reduce foreign tax credits by the amount paid by the host country. For example, in technical advice memorandum No. 87-18010, the IRS held that the foreign tax credit allowable to the U.S. bank creditors to Brazil must be reduced by the amount of the subsidy received by the Brazilian bank even though the subsidy is passed on to Brazilian companies. The Brazilian bank receives an interest subsidy from the Govern-

267. *Id.*

268. This ruling allows taxpayers to obtain the full benefit of their basis in property by selling the property and contributing the proceeds. For example, under existing rules, if a taxpayer contributes property with a basis exceeding its fair market value, the taxpayer is not permitted to deduct the excess as a deduction or a loss. However, if the taxpayer sells the property for less than its basis, the taxpayer is allowed a corresponding loss deduction, thus obtaining the full benefit of its basis. Rev. Rul. 87-124 allows taxpayers to contribute debt instruments issued by the foreign country (with a basis exceeding fair market value) and receive a charitable deduction for the fair market value of the local currency, thereby achieving this objective. The I.R.S. reaches this result by viewing the transaction as if the bank creditor converts its external debt into a domestic obligation, and contributes the local currency it receives from the host country's central bank to a charitable organization in the foreign country. See *Certain Charitable Contributions of Developing Nation Debts: Hearings on S. 1781, Department of the Treasury Before the Subcommittee on Taxation and Debt Management Senate Finance Committee*, 100th Cong., 1st Sess. 14-17 (statement of C. Eugene Steuerle, Deputy Assistant Secretary of the Treasury).

ment for a portion of the Brazilian withholding tax.²⁶⁹

D. Risk Insurance

Direct foreign investment always carries with it a degree of risk exceeding that of domestic investment. Information barriers, particularly the inability to foresee the future investment climate of a country that may have a volatile political history,²⁷⁰ produce a hesitancy among many possible investors fearful of possible expropriation or loss of their investment. This hesitancy cannot help but deter direct investment through debt-equity swaps.

Risk insurance can be purchased by fearful investors to protect against many of these uncertainties associated with investment in financially troubled Latin American debtor nations. Two mechanisms are of particular importance for American investors, although they have at this point been limited for different reasons. First, the Overseas Private Investment Corporation (OPIC), which has served as the key federal agency for encouraging mutually-beneficial American business investment in the world's developing nations, provides risk insurance for "new investment" that meets its statutory conditions. Second, the Multilateral Investment Guarantee Agency (MIGA) represents a multinational attempt to encourage investment among its members through similar insurance guaranties. However, the United States Senate has not yet ratified American membership in the Agency. Both of these programs will assist in fostering foreign investment flows to developing countries for productive purposes. They are expected to help close confidence gaps between investors and developing host countries, and reduce barriers to investment, and thus to stimulate the flow of resources to developing countries far beyond the volume of the investments they actually guarantee.²⁷¹

OPIC performs two functions related to the facilitation of direct investment in developing countries. Not only does it insure U.S. investments against the political risks of inconvertibility, ex-

269. *Memorandum on Brazilian Loans*, 1987 INT'L FIN. L. REV., Oct. 1987, at 41, 42.

270. For a useful survey of the techniques by which one may attempt to manage political and investment risk, see Stobaugh, *How To Analyze Foreign Investment Climates*, HARV. BUS. REV. 100 (Sept.-Oct. 1969).

271. For a survey of the MIGA plan, see Shihata, *Factors Influencing the Flow of Foreign Investment and the Relevance of a Multilateral Guarantee Scheme*, 21 INT'L LAW. 671 (1987); Voss, *The Multilateral Investment Guarantee Agency: Status, Mandate, Concept, Features, Implications*, 21 J. WORLD TRADE L. 5 (1987).

propriation, and war, but it also provides credit facilities that include direct lending and a loan guarantee program.²⁷² OPIC's credit facilities have been very active in Latin America, lending close to 40% of their funds to the region.²⁷³

On the insurance side, OPIC only issues insurance to "eligible investors," defined as U.S. citizens, corporations, partnerships, business partnerships with at least 50% U.S. ownership, or foreign corporations, partnerships, or business associations which are at least 95% owned by other forms of "eligible investors." It will also cover no more than 90% of an investment plus attributable earnings, placing the burden on the investor to bear the risk of at least 10% of the investment. Investors must secure the insurance from OPIC before the investment has been made but there is no fixed form the investment must take in order to be eligible for OPIC; equity investment loans, and goods and services under contract, for example, are all eligible for insurance.²⁷⁴

OPIC's credit facilities, as noted, include direct loans and loan guarantees. Direct loans are issued only for investment projects sponsored by, or including, U.S. small businesses, with a maximum loan amount of \$6 million, and terms ranging from five to 12 years.²⁷⁵ OPIC's loan guaranties, under which OPIC guarantees third party loans, are issued to either U.S. lenders having over 50% U.S. ownership or to foreign lending institutions that are at least 95% U.S. owned.²⁷⁶ Corporations which may not be eligible for direct loans may utilize these guaranties, which may go as high as \$50 million per project. OPIC works with the lender in structuring the financing and charges the borrower an annual guarantee fee of 1.5 percent to 2.5 percent on the outstanding balance.²⁷⁷

Before one can participate in either program, however, OPIC requires that the following five conditions be met:²⁷⁸

- 1) the investor's project be a new venture or an expansion of an existing enterprise;

272. See generally Overseas Private Investment Corporation (information guide published by OPIC) [hereinafter OPIC Guide]; Keslar, *OPIC's Brave But Risky New World*, *EUROMONEY*, Aug. 1987, at 157; *OPIC Financing Programs Offer Loans and Guarantees for Hard-to-Fund Projects*, 1987 *BUS. LAT. AM.* 91 [hereinafter *Loans and Guarantees*].

273. See *Loans and Guarantees*, *supra* note 272.

274. OPIC Guide, *supra* note 272, at 10.

275. *Loans and Guarantees*, *supra* note 273.

276. OPIC Guide, *supra* note 272, at 10.

277. *Loans and Guarantees*, *supra* note 273.

278. OPIC Guide, *supra* note 272, at 10.

- 2) the project be located in a developing country where OPIC operates;
- 3) the project assist in the social and economic development of the host country;
- 4) the project be approved by the host government; and
- 5) the project be consistent with the economic interests of the United States and not have a significant adverse effect on the U.S. economy or U.S. employment.

These overall eligibility criteria, especially the first requirement of a "new venture," add some uncertainty regarding OPIC participation in debt-equity swaps that has yet to be resolved. Without any planned expansion after the initial investment is made, it becomes very unclear whether OPIC would support investment in an existing plant through a debt-equity swap.

MIGA is designed to foster the flow of investments to and among its developing member countries by according foreign investors guarantee protection against non-commercial risks, by providing technical and advisory services to requesting member governments, and by facilitating policy cooperation among its member governments to improve and stabilize investment climates.²⁷⁹ MIGA's role is to alleviate perceptions of non-commercial risk as barriers to the flow of capital and technology to developing countries.²⁸⁰ The ultimate objective is to facilitate consideration of investments in developing countries on the same footing as investments in developed countries, i.e., to encourage investors to allocate investment resources solely on the basis of relative rates of return.²⁸¹ "The critical distinction between MIGA and existing public or private insurance schemes is that it would provide a mechanism for monitoring agreements and imposing sanctions in cases of violations by contracting parties."²⁸²

Eligible investments include new²⁸³ equity investments and non-equity forms of direct investment having terms of at least three years. The investor's return depends substantially on the

279. Voss, *supra* note 271, at 5.

280. *Id.* at 8.

281. *Id.* at 8-9.

282. LESSARD & WILLIAMSON, *supra* note 12, at 39.

283. Only new investment will qualify for coverage, i.e., investment that has been made or irrevocably committed before registration with MIGA of an application for a guarantee. Voss, *supra* note 271, at 11.

production, revenue, or profits of the investment project.²⁸⁴ Eligible investors include member countries and investors from member countries.²⁸⁵

Any coordinated effort by the U.S. policymakers to encourage direct investment in lesser developed nations and reduce their countries' indebtedness must make every attempt to make risk insurance available to potential investors at a reasonable price. Toward this end, OPIC's revaluation must be amended to specifically include debt-equity swaps within the definition of "new investment." U.S. participation in MIGA should also be made an immediate priority.²⁸⁶

VII. CONCLUSION

Two undisputed propositions emerge from the vast literature discussing the Latin American debt crisis. First, no real solution can neglect the role that domestic growth must play in the rejuvenation of the financially troubled Latin American countries. Second, a major commitment must be made by the developing countries to both promote this growth in the debtor countries and to reduce the debt which saddles the debtors and threatens the financial community within the developed country.

Debt-equity swaps will not, on their own, produce a miraculous turnaround in the economies of the Latin American debtor nations. Although debt-equity swaps have surged in popularity as the most palatable choice within the debtor bank's menu of debt restructuring options, they fail to squarely address the central problem of generating new investment in Latin America. To the extent that they may generate some direct investment in Latin America, however, their use should be encouraged by U.S. policymakers, who must be particularly mindful of the developed countries' prominent role in the search for a solution to the debt crisis. This plea to American policymakers should in no way be construed

284. Voss, *supra* note 271, at 10-11. These conditions reflect MIGA's focus on investment capable of generating its own dividend and service payments.

285. Investments must be made in the territory of a developing member country and an investor must be a national of a member country or, in the case of a corporate investor, either be incorporated in and have its principal place of business in a member country, or the majority of its capital must be owned by nationals of member countries. *Id.*

286. The U.S. still has not joined MIGA. However, as of late April 1988 it had finally received enough signatures from participating countries to make it operational. See *Management Alert*, 1988 Bus. LAT. AM. 136.

as being blind to the crucial role that the debtor countries themselves play in the promotion of growth. In no instance is this role better exhibited than by the willingness of some countries to design debt-equity swap programs and investment regimes that encourage investment by recognizing the demands of the marketplace. It cannot be stated strongly enough that both sides must be willing to work together to fashion relief that is in the best interests of the debtor country; these "best interests" have a tendency to produce beneficial results among both debtor and creditor.

On balance, properly structured debt-equity swaps are beneficial to debtor nations, bank creditors, and investors, and should thus be encouraged. They are the most important means yet developed for liquidating debt and stimulating new investment, both of which are needed to revive economic growth. United States accounting and banking regulators should promote these debt-equity swaps by encouraging U.S. banks, which hold the majority of the Latin American financially troubled loans, to sell their debt in these swap transactions. Regulators should also continue to liberalize regulations which may discourage banks from directly engaging in debt-equity swaps through direct investment. Debt-equity swaps are not a panacea; however, they are capable of eliminating an estimated ten percent of Latin America's debt and, along with other debt reduction alternatives, can only help to ease and eventually cure the unabated debt crisis.