American University International Law Review

Volume 2 | Issue 2 Article 7

1987

The International Leading Supervision Act of 1983: Has It Had an Effect on the Latin American Debt Crisis?

Lyle B. Vander Schaaf

THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983: HAS IT HAD AN EFFECT ON THE LATIN AMERICAN DEBT CRISIS?

Lyle B. Vander Schaaf*

INTRODUCTION

The United States Congress enacted the International Lending Supervision Act (the "Act" or "ILSA") in 1983.[1] This legislation was designed to decrease the risk associated with bank loans to foreign borrowers experiencing difficulty servicing their debts.[2] The Act attempted to force banks to lend more responsibly in an effort to halt the international debt crisis, particularly the crisis associated with Latin American debtors.[3] The Act also attempted to prevent a strangulation of loans to the debtor countries.[4] If the legislators had required banks to entirely discontinue lending to foreign debtors, an international economic crisis would have resulted, which is something neither the legislators nor the banks and debtor countries desired.[5] Despite the enactment of ILSA,

---

* J.D. Candidate, 1988, Washington College of Law, The American University.

1. International Lending Supervision Act of 1983, Pub. L. No. 98-181, 97 Stat. 1278 (1983) (codified as amended at 12 U.S.C. §§ 3901-3912 (West Supp. 1986)) [hereinafter ILSA]; *cf., e.g.*, Comment, *New Controls on Global Debt: The International Lending Supervision Act of 1983*, 17 CORNELL INT'L L.J. 425 (1984) [hereinafter *New Controls on Debt*] (analyzing the legislation directly after enactment); Recent Development, *New Limits on Banks Lending to Foreign Nations*, 17 VAND. J. TRANSNAT'L L. 711 (1984) [hereinafter *Lending to Foreign Nations*] (providing the history of ILSA and its provisions); Mitchell, *New Rules for International Lending*, N.Y.L.J., Apr. 25, 1984, at 1, col. 1; Comment, *The International Lending Supervision Act of 1983: A First Step Toward Responsible Foreign Lending*, 42 WASH. & LEE L. REV. 193 (1985) [hereinafter *Responsible Foreign Lending*] (describing ILSA and some of the regulations promulgated under it).

2. *Review of the International Lending Supervision Act of 1983: Hearing Before the Subcomm. on International Finance and Monetary Policy of the Comm. on Banking, Housing, and Urban Affairs, United States Senate*, 99th Cong., 2d Sess. 1, 9 (1986) [hereinafter *Review of ILSA*].

3. *See id.* at 1, 8-9, 11 (noting the purpose and intent of ILSA).

4. *See infra* note 28 and accompanying text (discussing the effect that a cessation of loans would have on the economics of the debtor nations).

5. *See Proposal for Legislation to Increase the Resources of the International Monetary Fund: Hearings Before the Subcomm. on International Finance and Monetary Policy of the Senate Comm. on Banking, Housing and Urban Affairs*, 98th Cong., 1st Sess. 140 (1983) [hereinafter *Senate Hearings on International Debt*] (remarks of Lionell Olmer, Under Secretary for International Trade) (cautioning against establishing regulations that would send negative signals to banks and provide disincentives for lending); *id.* at 199 (statement of George J. Clark, Executive Vice President of Ci-

the Latin American debt crisis has not dissipated. As a consequence, banks continue to seek investment and accounting solutions for debtor countries that show little opportunity for repayment of their loans, and Congress continues to observe closely the United States banking industry.[6]

It is important to understand the extent of the crisis before analyzing the statutes and regulations promulgated to deal with it. Part I of this Comment examines the Latin American debt crisis. Part II analyzes the effect of ILSA to determine whether it has forced banks to lend more responsibly to Latin American debtor nations and whether the regulations have alleviated the Latin American debt crisis. This section concludes that ILSA has not solved the crisis. Part III of this Comment analyzes other measures that banks employ, including establishing increased loan loss reserves, rescheduling existing loans, syndicating existing loans, selling and swapping loans, and participating in debt-equity swaps. These innovations reflect the struggle banks experience while coping with ILSA and the continuing Latin American debt crisis. This Comment concludes that many of these independent accounting measures and investment transactions, rather than ILSA, have reduced some of the risks associated with the Latin American debt crisis.

I. ANALYSIS OF THE LATIN AMERICAN DEBT CRISIS

Many economists and officials who have studied the Latin American debt crisis are concerned over the increasingly large debts that Latin American countries owe to United States lenders. Although many factors contributed to the Latin American debt crisis,[7] most economists

tibank) (noting that a low interest rate requirement would drive banks away from providing loans at a time when they are most needed); *id.* at 13 (showing Senator Heinz's concern for the adverse impact that increased regulations could create).

6. *See Review of ILSA, supra* note 2 (examining whether ILSA has had a positive impact on the international lending practices of banks and the international debt crisis).

7. *See, e.g.*, Meissner, *Crisis as an Opportunity for Change: A Commentary on the Debt Restructuring Process*, 17 N.Y.U.J. INT'L L. & POL. 613, 614 (1985) (charging that the Federal Reserve Bank's change in interest rate policy in the fall of 1979 caused severe recessions in industrialized nations); Friesen, *The Regulation and Supervision of International Lending: Part I*, 19 INT'L LAW. 1059, 1090-2064 (1985) (stating that in 1984 over 30 developing countries had a debt of $400 billion and that recession, inflation, and regulation caused the debt crisis); *see* Bradley, *Defusing the Latin Debt Bomb: Squeezing the Debtors Will Make Things Worse for Them and Us*, Wash. Post, Oct. 5, 1986, at C2, col. 1 (arguing that capital flight outstripped incoming investment or foreign loans and contributed to the debt crisis); Brown, *The Behavior of Transnational Banks and the Debt Crisis*, 21 C.T.C REP. 24, 27 (1986) (stating that inadequate volumes of non-ancessional external capital flows contributed to the debt crisis); Avittey, *The Truth in Lending to Third World Governments*, Wall St. J.,

and officials generally agree that a major cause was the recycling of petro-dollars in the early 1970s.[8]

Debtor countries continue to struggle to service their external loans from United States banks.[9] Meeting these payments places severe hardships on the domestic economic,[10] political,[11] and social[12] environ-

---

Oct. 11, 1984, at 32, col. 3 (recognizing systematic corruption and waste in less developed countries as causes of the debt crisis); Gall, *Games Bankers Play*, FORBES, Dec. 5, 1983, at 172 (stating that printing money simply to monetize the debt exacerbates other economic problems and contributes to the crisis); Sargen, *Managed Lending: An Assessment of the Current Strategy Toward LDC Debt*, 17 N.Y.U.J. INT'L L. & POL. 533, 535 (1985) (citing poor government policies of overly expansionary demand, inappropriate exchange rates, and development strategies that shifted production away from export sectors as causes of the debt crisis); *cf., e.g.*, Meissner, *supra*, at 613-14 (noting the shift in emphasis in lending from trade and project financing to balance of payments support as the debt crisis developed); Lowenfield, *Foreword*, 17 N.Y.U.J. INT'L L. & POL. 485, 487-89 (1985) (describing the crisis as so broad that Dante could have filled an additional canto in the *Inferno*); Brown, *supra*, at 24 (noting reduced bank lending and a sharp decline in foreign direct investment as obstacles to debtor nations using project loan financing to pay off their debts); Clark, *Who's Fouling Up International Finance? Everybody*, Wall St. J., Nov. 20, 1984, at 31, col. 3 (describing the inability of developing nations to manage their governments, the weakness of the dollar, and the long recession as causes of the debt crisis).

8. *See* Meissner, *supra* note 7, at 613 (attributing the origins of the debt crisis to the recycling of petro-dollars following the 1973 oil price increases); *New Controls on Debt*, *supra* note 1, at 426 (stating that the oil price increases during 1973 and 1974 increased bank lending to developing countries); *Responsible Foreign Lending*, *supra* note 1, at 193 (stating that the recycling of petro-dollars in the 1970s led to increased lending to lesser developed countries); *cf.* Friesen, *supra* note 7, at 1060-64 (observing that the outstanding debt of developing countries expanded tenfold between 1979 and 1984); *New Controls on Debt*, *supra* note 1, at 406 (stating that commercial lending to developing countries increased at an annual rate of approximately 20% between the mid-1970s and the early 1980s).

9. Bogdanowicz-Bindert, *The Debt Crisis: The Case of the Small and Medium Size Debtors*, 17 N.Y.U.J. INT'L L. & POL. 527, 529 (1985). To participate in any United States bank, World Bank, or International Monetary Fund (IMF) loan restructuring plan, debtor countries must enact "austerity programs" that usually have an adverse impact on their domestic economies. *Id.*

To make payments on these large debts most Latin American countries must use up to 50% of their export receipts. Donaldson, Lufkin & Jenrette, Bank Stock Q., Nov. 5, 1984, at 64; Table 19 Debt Service Ratio 1983, Thirteen Selected Developing Countries in Latin America and Asia, *cited in* Bogdanowicz-Bindert, *supra*, at 531; *cf.* B. BALASSA, G. BUENO, P. KUCZYNSKI & M. SIMONSEN, TOWARD RENEWED GROWTH IN LATIN AMERICA 16, 70 (Institute for International Economics 1986) [hereinafter B. BALASSA] (indicating that interest payments comprised one-third of the exports from Latin American countries in 1985).

10. *See* WORLD BANK, THE WORLD BANK ANNUAL REPORT 1986 111-14 (1986) (indicating that gross domestic product is increasing at a slower pace in all Latin American countries, except Brazil, in part because of the global debt); World Bank, *Development and Debt Service: Dilemma of the 1980s*, in INTRODUCTION, WORLD DEBT TABLES 1985-86 (1986), *reprinted in* 25 I.L.M. 472 [hereinafter WORLD DEBT TABLES] (showing that the gross domestic product figures of Latin American countries are growing slowly in the 1980s); B. BALASSA, *supra* note 9, at 16, 52-53 (indicating that per capita income and the gross domestic product of Latin American nations are

ment of most debtor countries. The effects of the international debt crisis harm the United States and other industrial countries as much as they harm the indebted developing countries.[13] The United States banks and officials from the Treasury Department insist that although

low because of the global recession).

To repay their loans, debtor countries have slowed their economies, slashed imports, and created massive trade surpluses. Samuelson, *It's Time for the U.S. Banks to Write Down Latin Loans*, L.A. Times, Mar. 26, 1986, part II, at 5, col. 1 [hereinafter *Time for Banks to Write Down Loans*]; *cf.* Bradley, *supra* note 7, at C2, col. 1 (stating that Latin American countries have boosted exports to service their debts). The trade surplus of Argentina was 7.9% of its total output in 1985. *Time for Banks to Write Down Loans*, *supra*, part II, at 5, col. 1. Brazil and Mexico had trade surpluses of 5.7% and 4.8% of total output respectively. *Id.* Furthermore, austerity measures have severely limited the domestic consumption and investment in many debtor countries. Bradley, *supra* note 7, at C2, col. 1.

According to Senator Bill Bradley (D-N.J.), the loss of exports to Latin America since the onset of the debt crisis caused the loss of 800,000 United States jobs. *Id.* Moreover, increased imports from Latin America caused additional unemployment in the United States. *Id.*

The GNP of Latin American countries also decreased because of the debt crisis. WORLD DEBT TABLES, *supra*, at 464; *cf.* Sargen, *supra* note 7, at 538 (citing an average loss of two percent in real GNP in the region between 1981 and 1983).

11. Lekachman, *Banks Deserve a Penalty for Folly*, L.A. Times, June 19, 1984, part IV, at 3, col. 3. Raul Alfonsin, President of Argentina, asserted that IMF restructuring conditions for his country threaten its fragile hopes for democracy. *Id.* Attempts of the Dominican Republic to meet stiff IMF measures outlined in an IMF loan package resulted in riots. *Id.*; *see also* Rout, *Postponement of Third World Debts Threatens Upheaval, Financial Collapse*, Wall St. J., June 22, 1984, at 35, col. 2 [hereinafter Rout, *Postponement of Third World Debts*] (quoting Brazilian economist Edmar Bacha's fears that unless the economy of his country begins to grow, the government could become fascist).

12. *See* Lekachman, *supra* note 11, part IV, at 3, col. 3 (indicating that the standard of living in Brazil decreased by 15% as its government attempted to meet its debt obligations). The Brazilian economy would need to grow 6.5% a year in real terms between 1984 and 1989 simply to return to the 1980 standard of living. Rout, *supra* note 11, at 35 (citing a 12% decline in per capita income between 1979 and 1982); *see also* Bradley, *supra* note 7, at C2, col. 1 (noting that Latin American nations paid $100 billion to the creditor countries in the past four years, even though some of these debtors experienced recessions and could neither feed their poor nor invest in their own economic development).

13. Bradley, *supra* note 7, at C2, col. 1; *see also* Rowen, *Trade Deficits Inexorably Tied to Debt Crisis*, Wash. Post, Nov. 30, 1986, at H1, col. 1 [hereinafter *Trade Deficits Tied to Debt Crisis*] (stating that the Third World debt has curtailed the ability of Latin American countries to purchase United States products); *Review of ILSA*, *supra* note 2, at 2 (opening statement of Senator Heinz) (noting that less developed countries account for nearly two-thirds of United States exports, and likening the United States trade recovery to LDC recovery). Senator Bradley provides several examples of ways the Latin American debt directly harms the United States, including economic damage, damage communist insurgencies impose on Latin America, and waves of illegal immigration. Bradley, *supra* note 7, at C2, col. 1. Senator Bradley further demonstrates that Latin American countries' fulfillment of debt payments through 1985 created disastrous consequences for United States farmers, factory workers, and exporters. *Id.*

the actual debt is increasing,[14] the international debt crisis is stabilizing.[15] A more realistic appraisal of the situation indicates that the debt crisis is a long-term problem that will burden the world economy throughout the 1990s and perhaps beyond.[16]

Although United States banks claim that the crisis is abating, they have become reluctant to lend additional money to Latin American

---

14. *See* WORLD DEBT TABLES, *supra* note 10, at 459-63, 472 (providing graphs and analysis indicating that the debt of Latin American countries is increasing); Wall St. J., Mar. 27, 1986, at 64, col. 2 (citing a World Bank prediction that the total external debt of developing countries to both public and private creditors would continue to increase in the future).

15. *See* James A. Baker, III, Statement Before the Meetings of the Interim Committee of the International Monetary Fund (IMF) and Development Committee of the World Bank and the IMF, TREASURY NEWS, Department of Treasury, Washington, D.C., Apr. 9-11, 1986, at 2-3 [hereinafter Statement Before IMF] (stating that progress on the debt situation suggests that debtor nations will eventually realize their aspirations of development); *Review of ILSA*, *supra* note 2, at 78-79 (written response of William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve Board) (claiming that Latin American countries have made sufficient progress and concluding that loans to them are not uncollectible); *see also* Bennett, *The Intricacies of Bank Accounting*, N.Y. Times, July 2, 1984, at D10, col. 1 [hereinafter Bennett, *The Intricacies of Bank Accounting*] (stating that banks continue to believe that they will eventually recoup their earnings, that debtor countries will repay, and that the government would never allow major banks to fail).

Progress occurred primarily because the developing countries expressed a willingness to establish adjustment programs and the United States economy improved substantially. *Id.* Secretary Baker further stated that debtor countries could meet their obligations if they strictly followed a recovery plan. *Id.* Baker also indicated that substantial reductions in both short- and longer-term interest rates since early 1985 should reduce debt service payments for developing countries by $11 billion or more annually. *Id.* Secretary Baker also noted that during 1986 and 1987 developing nations would face the best external economic environment since the early 1970s, providing a solid foundation for their own efforts to strengthen growth. *Id.*

Other statistics demonstrate that trade positions of developing countries have been improving sharply. Statement of James A. Baker, III, Before the Joint Annual Meeting of the International Monetary Fund and the World Bank, TREASURY NEWS, Department of Treasury, Washington, D.C., Oct. 8, 1985, at 2, *reprinted in Documentation Concerning Development and International Debt Issues*, 25 I.L.M. 412, 413-14 (1986) [hereinafter Statement of James A. Baker, Oct. 8, 1985] (emphasizing increased exports, economic growth, and reduced aggregate current account deficits in developing nations).

Other commentators, however, contend that the trade positions of developing countries will decline due to external developments including an increase in United States interest rates, a slowing of the United States economy, or continued low oil prices. Sargen, *supra* note 7, at 542; *see also Review of ILSA*, *supra* note 2, at 14-15, 20 (noting that oil price decreases from 1982 to 1985 harmed Mexico and other oil exporting countries); Asman, *Free Market Theories Become Public Policy in Ecuador*, Wall St. J., Apr. 11, 1986, at 27, col. 3, (quoting Victor Eastman, Vice President of the New York Central Bank, as stating that for every one dollar decrease in the price of oil, the annual export revenues of Ecuador decrease $60 million).

16. Meissner, *supra* note 7, at 621 (stating that banks have not resolved the crisis). Rather than solving the crisis, banks learned how to manage it, allowing the debt crisis to remain a problem for a long time. *Id.*

debtor countries.[17] Since 1984, banks have issued additional loans only to enable the debtor nations to repay interest on existing loans.[18] In 1984, for example, the United States Treasury Department, in conjunction with the World Bank and the IMF, found it extremely difficult to arrange a successful loan package between debtors and creditors to prevent Argentina from defaulting on its loans.[19] Some of the same difficulties recurred in 1986 when Mexico needed to reschedule its loans.[20] Therefore, the optimism of the United States Treasury Department and the United States banks in connection with the international debt crisis is not warranted.

---

17. *See* B. BALASSA, *supra* note 9, at 112-16 (showing that United States foreign investment in Latin American countries decreased from $38.8 billion in 1980 to $28.0 billion in 1984 despite a pattern of increased foreign investment in other developing nations since 1978); Sargen, *supra* note 7, at 542 (stating that voluntary lending to Latin American countries has not reached previous levels or levels that are necessary to maintain their economies); Statement of James A. Baker, Oct. 8, 1985, *supra* note 15, at 3 (stating that lending to debtor nations has declined, with very little net new lending anticipated); Statement Before IMF, *supra* note 15, at 8 (asserting that both domestic and foreign investment had fallen significantly in 1986 and 1987, and that foreign direct investment in developing countries declined from 20% of total flows in 1975 to only 11% in 1984); Wall St. J., Sept. 25, 1984, at 33, col. 2, *cited in* Bogdanowicz-Bindert, *supra* note 9, at 531 (noting the statement of the president of the World Bank that new money from commercial banks, including smaller regional banks, is an unlikely prospect); Rowen, *$1 Trillion in Debts*, Wash. Post, Oct. 2, 1986, at A27, col. 1 [hereinafter *$1 Trillion in Debts*] (stating that of the 15 countries on United States Treasury Secretary Baker's list of troubled debtor countries, only Mexico seemed likely to receive significant new private loans in 1986); *Trade Deficits Tied to Debt Crisis*, *supra* note 13, at H7, col. 4 (commenting that loans have fallen far short of the level Treasury Secretary Baker contemplated in his well publicized debt initiative of October 8, 1985).

18. Needham, *Banks Must Acquire Equity in Debtor Countries*, Wall St. J., Sept. 30, 1983, at 31, col. 3 (noting that as long as debtor nations borrow money primarily to repay existing loans, banks will never attain the real solution to the debt crisis, namely capital formation that provides goods and services for international commerce); *cf.* Lekachman, *supra* note 11, part IV, at 3, col. 3 (observing that banks that have overextended assets in irresponsible loans should convert loans debtor nations cannot repay into gifts); Bogdanowicz-Bindert, *supra* note 9, at 529 (citing the increasing reluctance of regional banks in the United States to continue lending to debtor nations).

Banks rarely lend to Latin American countries as a safe investment. *Id.* The nine major United States foreign lending banks have lent 179% of their shareholders' equity and have little choice but to continue lending because without additional funds, countries will default on their existing loans. *See id.* (noting that the major United States banks have already invested too much in these countries to discontinue lending now). Brazil, as a case in point, used 80% of its borrowed money for debt service in 1983. Needham, *supra*, at 31 (showing that Brazil used 80 cents of every dollar it earned to service its $90 billion debt thereby typifying the difficulty of debtor nations when they reconcile economic growth with debt repayment).

19. L.A. Times, June 3, 1984, part IV, at 5, col. 3.

20. *Cf.* Statement Before IMF, *supra* note 15, at 2 (suggesting that if debtor nations acceded to the "Baker Plan" to resolve the debt crisis, the resulting demand exports from debtor nations would reduce nominal and real interest rates, thus alleviating the crisis).

Some experts conclude that the Latin American debtor nations will never repay all their outstanding loans, or at best will repay the loans long into the future.[21] It is unlikely that these countries will continue to impose economic hardships on their nationals to maintain a favorable credit rating with the United States banks.[22] Even if the Latin American countries do experience the miraculous economic recovery that the United States Treasury Department and the banks predict,[23] they will not have enough funds to satisfy all their debt obligations.[24] In light of this pessimistic outlook, United States banks must act to ease the burden of their loans to Latin American countries because legislative and regulatory attempts to solve the Latin American debt crisis have not succeeded.[25]

---

21. *See, e.g.*, Rowen, *Citicorp's Bold Move*, Wash. Post, May 22, 1987, at Fl, col. 5 [hereinafter *Citicorp's Bold Move*] (stating it is unlikely that much of Latin America's $400 billion debt will ever be paid off); Rout, *Postponement of Third World Debts Threatens Upheaval, Financial Collapse*, *supra* note 11, at 35, col. 2 (discussing the continuing threat that heavily indebted countries will simply walk away from their debts); *$1 Trillion in Debts*, *supra* note 17, at A27, col. 1 (quoting French Economy and Finance Minister Edouard Ballador's concern that some debtor countries may collapse).

22. Biggs, *Legal Aspects of the Latin American Public Debt: Relations with the Commercial Banks*, 25 CEPAL REV. 163, 164 (1985). Current Latin American debt is similar to the German debt after World War I in that "there is a limit to the amount of financial resources a country can transfer abroad without seriously upsetting the living standards of its population and its social and political organization." *Id.* at 168. Indeed, the main reason Latin American countries feel obligated to pay their debts is not a legal rule, but their intentions to borrow again. *Id.* (quoting P. EINZING, ROLLOVER CREDITS 49 (1973)).

23. *See* Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D10, col. 1 (indicating the positions and predictions of United States banks); Statement of James A. Baker, Oct. 8, 1985, *supra* note 15, at 3 (indicating that the Treasury Department and the United States banks are optimistic about the resolution of the debt crisis); Statement Before IMF, *supra* note 15, at 3-4 (providing optimistic predictions about the future of Latin American economies). *But see* Wash. Post, Oct. 2, 1986, at E10, col. 1 (noting that finance ministers of several developing countries have limited expectations for the economies in their own countries).

24. Rowe, *Mexico, Banks Agree on Loan Terms*, Wash. Post, Oct. 1, 1986, at G1, col. 2 (stating that positive effects from improved economic conditions take time to yield results). Considering the lag time associated with the recovery of the economies of Latin American countries, it seems unlikely that most debtor countries will soon make interest payments. *Id.*

Current high interest rates make it implausible that the debtor countries will ever repay all of their loans or even a very large fraction of them. Lekachman, *supra* note 11, part IV, at 3, col. 3. Even if debtor nations meet bankers' terms in the 1980s loan restructuring, the same problems probably will recur in the 1990s. *See* Sargen, *supra* note 7, at 542 (observing the increasing importance of past issues as the 1980s debt restructuring leads to a bunching of amortization payments of developing countries in the 1990s); *see also* Gall, *Games Bankers Play*, *supra* note 7, at 172 (documenting the possibility that developing nations may fail to meet their debt obligations and concluding that eventual default is not a "probability" but an "inevitability").

25. *Cf. New Controls on Global Debt*, *supra* note 1, at 437 (stating that the Act

II. THE INTERNATIONAL LENDING SUPERVISION ACT OF 1983 AND THE REGULATIONS ESTABLISHED UNDER ITS AUTHORITY: AN ATTEMPT TO DECREASE THE RISK OF THE INTERNATIONAL DEBT CRISIS

In response to the international and Latin American debt crises, Congress enacted the International Lending Supervision Act of 1983.[26] The legislators who enacted ILSA intended to control, regulate, and supervise loans to developing debtor countries.[27] These legislators also hoped to guarantee a moderate flow of lending to debtor nations, reasoning that a strangulation of lending would doom the development and growth of debtor nations and create an economic crisis.[28] In practice, the regulatory agencies seem more concerned with guaranteeing a flow of capital to the debtor countries than with promoting and enforcing rules of banking conduct.[29]

The Act authorizes the three major bank regulatory agencies, the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC), to increase their supervision and regulation of private banks with international loans.[30] Through ILSA, the United States legislators and regulators intended to increase their control over banks with international loans. The Act contains five provisions to supervise and regulate private lending abroad.[31] These provisions include special risk reserves, accounting rules on loan fees, disclosure rules, capital adequacy requirements, and requirements for special project loans.[32]

---

provides little substantive regulatory reform and even less of a solution to the international debt problem). *But cf. Responsible Foreign Lending*, *supra* note 1, at 208-13 (stating that the Act includes some effective provisions that reduce the risks associated with country default).

26. ILSA, *supra* note 1, §§ 3901-3912

27. *Id.*

28. *See Senate Hearings on International Debt*, *supra* note 5, at 13 (noting Senator Heinz's concern that strict regulations on lending could cause debtor nations to reduce their imports and therefore decrease the exports of other countries); *id.* at 49 (statement of Donald T. Regan, Secretary of the Treasury) (stating that regulations on lending are necessary, but if not instituted in moderation, could compound the adjustment and liquidity problems of debtor nations); *id.* at 241 (statement of Paul A. Volcker, Chairman, Federal Reserve System) (arguing that strict regulations could encourage retreat from lending and leave debtor nations without money to improve their economies and pay back loans).

29. *See Review of ILSA*, *supra* note 2, at 14, 16, 20 (showing the concern among officials from bank regulatory agencies of continuing a flow of capital to Latin American debtors).

30. ILSA, *supra* note 1, §§ 3901-3908.

31. *Id.* §§ 3904-3908.

32. *Id.*

A. Provisions for Special Risk Reserves

Members of Congress and officials of the bank regulatory agencies perceived that banks with large international loans often overstated the value of these loans on their books.[33] ILSA, therefore, requires banks to establish special reserves for foreign loans that experience a high risk of nonrepayment.[34] The Act delegates to the regulatory agencies the authority to promulgate specific reserve requirements.[35] ILSA directs the bank regulators to require banks to establish special reserves whenever a foreign borrower exhibits no definite prospects for restoration of its debt or whenever the quality of the assets of a bank are impaired due to the inability of the debtor to pay its debts.[36] The Act prescribes three factors to determine whether bank assets are impaired from nonpayment of a debtor: (1) the failure of a debtor to make full interest payments; (2) the failure of a debtor to comply with the terms of a restructuring plan; or (3) the failure of a debtor country to comply with an IMF or other adjustment program.[37] Banks may not include these special reserves as either income or capital and surplus for other regulatory and accounting purposes.[38] The Act requires banks to maintain the reserves at levels sufficient to protect against potential loss.[39]

The three federal regulatory agencies simultaneously established identical guidelines to implement the provisions of ILSA for special reserves. To satisfy special reserve requirements banks must create Al-

33. *Senate Hearings on International Debt*, *supra* note 5, at 59 (statement of C. Todd Conover, Comptroller of the Currency). The regulators alleged that banks overstated the value of their foreign loans with protracted repayment difficulties. *Id.* The Comptroller of the Currency stated that banks should decrease the value of such assets rather than carry them on their books at full value. *Id.* The Chairman of the FDIC, William Isaac, agreed and contended that banks should set up reserves against particularly risky loans. *Id.* at 388 (statement of William Isaac). These reserves would make earnings statements, capital accounts, and dividend policies more realistic. *Id.*

34. ILSA, *supra* note 1, § 3904(a)(1), (c).

35. *Id.*

36. *Id.* § 3904(a)(1)(A).

37. *Id.* § 3904(a)(1)(A)(i)-(iii), (B).

38. *Id.* § 3904(a)(2). The regulations promulgated after ILSA retain this language. *See* 12 C.F.R. §§ 20.8(c)(1), 211.43(c)(1), 351.1(b)(3)(I) (1986) (prohibiting banks from including charges to current income as capital or surplus). Along these lines, the Securities and Exchange Commission (SEC) has stated that these rules do not preempt accounting procedures and securities laws requiring other reserves of bank holding companies. *See SEC Staff Says Bank Loan Risk Reserve May Not Satisfy Federal Securities Laws*, 16 Sec. Reg. & L. Rep. (BNA) No. 5, at 247 (Feb. 3, 1984) (reporting that banking institutions may have to establish reserves in excess of present regulatory levels). The regulations also state that banks shall not combine these special reserves with other reserves to meet the requirements. 12 C.F.R. §§ 20.8 (c)(2), 211.43(c)(2), 351.1(b)(3)(ii) (1986).

39. ILSA, *supra* note 1, § 3904(b).

located Transfer Risk Reserves (ATRRs)[40] or alternatively "write-down" the value of the loan.[41] The regulations simply require a bank to set aside a certain amount of money every time it lends to a heavily indebted Latin American country.

The reserves protect the bank in the event a debtor country defaults on its loan. If a debtor nation fails to repay its loans, the special reserves allow a bank to have a sufficient amount of money set aside to prevent the bank from collapsing.[42] The ATRRs affect bank earnings because they require banks to hold money that they otherwise could invest or lend for a profit.[43] The provisions protect stockholders of bank securities and the overall economy more than they protect depositors because depositors are insured through the FDIC or a state banking insurance company.

The regulators retain the authority to determine which loans require the special reserves, the amount of the reserves, and when the banks must establish them.[44] The regulatory agencies use factors the Act prescribes for special reserves[45] to determine whether a bank loan re-

---

40. 12 C.F.R. §§ 20.8, 211.43, 351.1 (1986). The regulations define "transfer risk" as "the possibility that an asset cannot be serviced in the currency of payment because of a lack of, or restraints on the availability of, needed foreign exchange in the country of the obligor." *Id.* §§ 20.7(h), 351.1(a)(4).

In anticipation of these regulations, most banks with loans to countries experiencing protracted debt problems voluntarily established such reserves as of late 1983. Am. Banker, Dec. 19, 1983, at 2, col. 4.

41. 12 C.F.R. §§ 20.8(c)(4), 211.43(c)(4), 351.1(b)(3)(iv) (1986).

42. Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D10, col. 1 (stating that reserves are a necessary safeguard against the uncertainty surrounding banks' huge foreign loan portfolios).

43. *See Review of ILSA*, *supra* note 2, at 13 (statement of William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System) (describing the ATRRs as a prescribed formula to write down loans). The ATRR process "permits an orderly adjustment in carrying value for transfer risk to those countries where economic adjustment has not been followed or has not been successful." *Id.*

44. 12 C.F.R. §§ 20.8(b)(i)-(iii), 351.1(b)(2)(A)-(C) (1986). The amount of the reserves depends on the circumstances of each case. *Id.* § 20.8(b)(2)(ii). Unless special circumstances apply, the reserves will comprise at least 10% of the loan in the first year and 15% in following years. *Id.* §§ 20.8(b)(2)(ii)(B), 211.43(b)(2)(ii)(B), 351.1(b)-(2)(ii)(B)(2). It is also possible to reduce the amount of the reserves. *Id.* The proper level of the loan loss reserves is a subjective judgment that includes, among other factors, a "bank's loan loss history, concentrations within the loan portfolio, management, and economic variables." *Review of ILSA*, *supra* note 2, at 80-81 (written response of William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System). In 1986, the ATRRs varied in amount between 30 and 90% of outstandings to the countries subject to the ATRRs. *Id.* at 91 (written response of Robert R. Bench, Deputy Comptroller of the Currency). The regulators review the ATRR amounts annually and generally increase them 15% per year, but they can decrease them depending on the borrowers' condition. *Id.*

45. *See infra* note 46 and accompanying text (outlining the three factors regulators

quires ATRRs.[46] These legislatively prescribed factors suggest that the regulators could have required several banks with loans to various Latin American countries to set aside money in the ATRRs. The regulatory agencies, however, have required banks to establish ATRRs for loans made only to seven debtor nations.[47]

While Congressional committees debated the Act, officials from the regulatory agencies indicated that the agencies would enforce these provisions rigorously.[48] At that time, many commentators anticipated that these statutes and regulations would have a great impact on the lending practices of United States banks.[49] The banks, however, escaped strict application of these provisions because the regulators have not rigorously required the special reserves.[50] Although all of the Latin American countries experienced severe debt situations, the regulators required ATRRs initially for only Nicaragua and Bolivia.[51] The regulations immediately affected only three non-Latin American countries: Sudan, Poland, and Zaire.[52] Since the initial determinations, the regulators have added only two countries to that list, bringing the total to

---

use when determining if banks must establish special reserves).

46. 12 C.F.R. §§ 20.8(b)(2)(A), (B), 211.43(b)(2)(A), (B), 351.1(b)(2)(ii)(A)(1), (2) (1986). Subsequent conduct of the regulators indicates that they have further defined the three factors. The following factors are now controlling: (1) nonpayment of interest for six months; (2) noncompliance with an IMF program; and (3) failure to satisfy rescheduling terms for over one year. *Review of ILSA supra* note 2, at 91 (written response of Robert R. Bench, Deputy Comptroller of the Currency).

47. *Review of ILSA, supra* note 2, at 91-92 (written response of Robert R. Bench, Deputy Comptroller of the Currency) (stating that as of June 25, 1986, loans to seven countries required ATRRs and that it is illegal for the regulators to publicly disclose the names of these countries).

48. *See Proposed Solutions to International Debt Problems: Hearing on S. 502 Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 32, 56-59 (1983) [hereinafter *Hearing on Proposed Solutions to International Debt Problems*] (statement of C. Todd Conover, Comptroller of the Currency) (setting forth the position of the Office of the Comptroller of the Currency and outlining a five-point program designed to increase the supervision of international lending).

49. *Lending to Foreign Nations, supra* note 1, at 728 (stating that the ATRR provisions would have a marked impact on the lending policies of several United States banks); Am. Banker, Feb. 28, 1984, at 2, col. 2, *cited in* Mitchell, *supra* note 1, at 2 (stating that ATRRs are punitive and would discourage further lending to Third World nations).

50. Wall St. J., Dec. 27, 1983, at 2, col. 3; *see also Review of ILSA, supra* note 2, at 2 (opening statement of Senator Heinz) (noting that Poland obviously needs the reserves).

51. Wall St. J., Dec. 27, 1983, at 2, col. 3; Bennett, *Fed Seeks U.S. Bank Write-Offs*, N.Y. Times, Dec. 23, 1983, at D1, col. 5 [hereinafter *Fed Seeks Write-Offs*]; Rowe, *Fed Rule Allows 3d World Loans to Continue*, Wash. Post, Feb. 3, 1984, at D3, col. 1 [hereinafter *Fed Rule*]; Mitchell, *supra* note 1, at 2, col. 2.

52. Wall St. J., Dec. 27, 1983, at 2, col. 3; Bennett, *Fed Seeks Write-Offs, supra* note 51, at D1, col. 3; *Fed Rule, supra* note 51, at D3, col. 1.

seven.[53] In addition, banks have devised activities that allow them to avoid the requirements.[54] The decisions of the regulators to add additional countries to the list are confidential, but the banks often voluntarily disclose the regulators' decisions. In 1986, the reserves varied from 85 percent of the loans for one country to 15 percent for another.[55] At that time, the reserves increased for some countries, but no reserves had decreased.[56] At year end 1985, these reserves totaled $2.4 billion,[57] and the nine largest banks in the United States held $1.5 billion of this total.[58]

B. ACCOUNTING RULES ON BANK FEES

The Act authorizes regulators to restrict bank service fees in excess of administrative costs for restructuring or rescheduling loans.[59] The Act allows banks to charge such "front-end" fees only if the banks record the fees as income over the life of the loan rather than as income in

53. *Compare supra* note 51 and accompanying text (indicating in 1983 that problem loans from five countries required ATRRs) *with Review of ILSA*, *supra* note 2, at 27 (indicating that in 1986 problem loans from seven countries required ATRRs). At least one commentator indicates that regulators required banks with problem loans from Peru to establish ATRRs for these loans. Sterngold, *Peru May Resume Debt Payments*, N.Y. Times, Mar. 15, 1986, at A36, col. 4. *But cf.* Riding, *Foreign Banks Eager for Debt Talks with Peru*, N.Y. Times, Sept. 2, 1985, at A28, col. 1 (noting that banks could write-off loans from Peru without harming themselves).

54. *See infra* notes 97-226 and accompanying text (discussing the means banks use to manage the current Latin American debt crisis and avoid the regulations promulgated after ILSA). These activities include rescheduling existing loan agreements, syndicating bank loans, swapping international loans, and engaging in debt-equity swaps. *Id.*

55. *Review of ILSA*, *supra* note 2, at 22-23 (statement of Charles Collier, Assistant Director, Division of Bank Supervision, FDIC).

56. *Id.*

57. *Id.*

58. *Id.*

59. ILSA, *supra* note 1, § 3905 (a)(1); *see Hearing on Proposed Solutions to International Debt Problems*, *supra* note 48, at 30, 51-52 (statement of Paul A. Volcker, Chairman, Federal Reserve Board) (describing service fees that act as charges imposed on borrowers in addition to interest charges as "up-front" fees or "front-end" fees); Mendez, *Recent Trends in Commercial Bank Lending to LDCs: Part of the Problem or Part of the Solution?*, 8 YALE J. WORLD PUB. ORD. 173, 186 (1982) (noting that banks usually charge fees in addition to charging interest upon granting new loans or restructuring or rescheduling an existing loan); Mitchell, *supra* note 1, at 2 n.24 (describing these fees as common when banks arrange a loan, increase the yield on a loan, syndicate a loan, or commit funds for a fixed period of time).

A consortium of banks from different countries, including the United States, Japan, and West Germany, usually transacts major loans to developing countries. Ellis, *A Look at What's Behind the Rising Cost of the World's Developing Countries*, Christian Sci. Monitor, Oct. 11, 1983, at 9, col. 1. A lead bank represents and manages the consortium. *Id.* The lead bank charges the borrowing country a management fee to cover costs and earn a profit. *Id.*

full when the loan is created.[60] Prior to the enactment of ILSA, recording these fees as income in full upon creation of the loan was the common method of accounting.[61] The new rule limits the ability of banks that lend to foreign debtors to receive the short-term benefits of including the "front end" fees as immediate income on their books.[62] At first glance, the fees make balance sheets appear profitable, but they hide banks' overexposure and increase the risk that debtors will not repay their loans.[63]

Under the regulatory agencies' guidelines for service fees, banks may continue to record as income their fees for administrative costs of originating, restructuring, or syndicating an international loan.[64] The Act specifically identified these costs with negotiating, processing, and consummating the loan.[65] Included among these costs are legal fees, costs of preparing and processing loan documents, and an allowable portion of salaries.[66] The Act specifically excludes supervisory and administrative expenses as well as occupancy and other similar overhead costs.[67] Banks must amortize these latter fees and expenses over the life of the loan rather than record the fees as income at the beginning of the loan period.[68] Despite the regulatory guidelines, banks could continue to receive substantial fees for their services to debtor countries

---

60. ILSA, *supra* note 1, § 3905(a)(1).

61. *See Hearing on Proposed Solutions to International Debt Problems*, *supra* note 48, at 60 (statement of C. Todd Conover, Comptroller of the Currency) (stating that the accounting method that uses "front-end" fees creates a deceptive short-term appearance of increased income); H.R. REP. NO. 175, 98th Cong., 1st Sess. 43 (1983), *reprinted in* 1983 U.S. CODE CONG. & ADMIN. NEWS 1898, 1925 [hereinafter H.R. REP. NO. 175] (stating that a system spreading the fee over the life of the loan should replace this common accounting method); Mitchell, *supra* note 1, at 2, col. 2 (stating that prior to ILSA, banks often considered "front-end" fees as income in full when received).

62. *See Hearing on Proposed Solutions to International Debt Problems*, *supra* note 48, at 60 (statement of C. Todd Conover, Comptroller of the Currency) (stating that there is an incentive to take advantage of the deceptive short-term appearance of increased income that "front-end" fees can provide); H.R. REP. NO. 175, *supra* note 61, at 1898, 1925 (stating that using the fees as income over the life of the loan is a more realistic accounting approach).

63. Ellis, *supra* note 59, at 9, col. 1.

64. 12 C.F.R. §§ 20.9(c), 211.45(c), 351.2(d) (1986) (requiring banks to account for the administrative costs of an international loan as the costs are incurred). The accounting profession adopted the accounting guidelines "with only modest changes." *Review of ILSA*, *supra* note 2, at 13 (statement of William Taylor). Whereas these fees averaged 1¼% in 1983, they only averaged ½% in 1986. *Id.*

65. 12 C.F.R. §§ 20.9(c)(2), 211.45(c)(2), 351.2(d)(2) (1986).

66. *Id.*

67. *Id.*

68. *See infra* notes 97-225 and accompanying text (observing how banks continue to receive substantial fees for services to debtor nations and continue to avoid ILSA regulations).

because they can classify their services as negotiating, processing, or consummating loans.[69] Indeed, regulatory officials praise the new accounting rules because they are not an impediment to "international loan reschedulings" or "new project loans in certain countries."[70] In addition, the accounting rules have very little effect on banks that already had in place policies similar to the new ILSA provisions.[71]

C. INCREASED DISCLOSURE OF INTERNATIONAL LENDING DATA

The Act requires banks to increase their disclosure of international lending data[72] and authorizes the banking agencies to promulgate regulations regarding disclosure and reporting requirements.[73] The Act also requires banks with foreign country exposure risk to submit quarterly reports to the federal regulatory agencies[74] and make figures on its foreign loans available to the public.[75] Frequent disclosures allow depositors and investors to assess the degree of diversification and risk involved in bank investment portfolios.[76] The Act, therefore, requires banks to disclose their loans more frequently. Legislators believed that banks would lend more responsibly if investors subjected the banks to additional scrutiny.[77]

Initially, the regulatory agencies added very little to the language of

69. *See* Ellis, *supra* note 59, at 9, col. 1 (commenting that banks are making substantial profits by levying higher interest rates and charging high fees for the rescheduling of existing debts that developing countries cannot repay).

70. *Review of ILSA*, *supra* note 2, at 18 (statement of Robert R. Bench, Deputy Comptroller of the Currency). *But see id.* at 38 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (stating that few sovereign loan negotiations between 1985 and 1986 had "front-end" fees, not because the regulations prohibit them, but because the negotiations tended not to require them).

71. *See id.* at 38 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (criticizing the accounting fee regulations because even very small loan fees require amortization, creating expensive accounting costs for banks).

72. ILSA, *supra* note 1, § 3906(a).

73. *Id.*

74. *Id.*

75. *Id.* § 3906(b).

76. *Hearing on Proposed Solutions to International Debt Problems*, *supra* note 48, at 28.

77. *Id.*; *see also Review of ILSA*, *supra* note 2, at 18 (reviewing the provisions of ILSA, including the disclosure provisions). One bank official recently praised the new disclosure requirements: "As a result of ILSA, more frequent, accurate, and useful information about U.S. banks' international activities is now available to bank management, bank supervisors, the markets, and the general public." *Id.* at 18 (statement of Robert R. Bench, Deputy Comptroller of the Currency); *see also id.* at 43 (statement of Karen Lissakers, Adjunct Professor of International Affairs, Columbia University) (noting that although increased disclosure inhibits the maneuverability of banks on the debt question, the provisions do allow investors to make more informed investment decisions).

the Act. The agencies simply determined that changes to existing reporting forms could satisfy the new quarterly reporting procedures.[78] In 1986, however, the regulators strengthened the reports, "requiring improved data on banks' international risk distribution, trade credits and off-balance sheet activities."[79]

D. CAPITAL ADEQUACY REQUIREMENTS

The Act authorized regulatory agencies to establish capital adequacy requirements to guard against the risk of a debtor nation's default.[80] In the past, the regulators subjected banks involved in international lending to less stringent capital adequacy requirements because the banks were able to diversify their portfolios.[81] The Act underemphasized this

---

78. 12 C.F.R. §§ 20.10(b), 211.44(b), 351.3(b) (1986) (adopted Feb. 13, 1984). Lawyers specializing in banking law report that currently, banks must file a new two-part summary, the Country Exposure Information Report (CEIR). Mitchell, *supra* note 1, at 2, col. 2 (noting that the CEIR is required as an attachment to the Country Exposure Report that banks must file quarterly).

The CEIR "requires disclosure of information on lending exposure in countries which have borrowed the equivalent of greater than one percent of a bank's total assets. For exposures ranging from 0.75 percent to one percent of a given institution's total assets less detailed information is required." *Id.* According to the bank regulators, "the reports include data on the banks' longest exposures" and are available for public viewing under certain circumstances. *Review of ILSA*, *supra* note 2, at 18 (statement of Robert Bench, Deputy Comptroller of the Currency). In 1984, 190 banks engaged in lending that would require them to file the CEIR under these recent regulations. FED. RES. WK., Jan. 9, 1984, at 5, *cited in* Mitchell, *supra* note 1, at 2, col. 2 n.22. In some cases, a number of banks voluntarily disclosed more information than is required. Witcher, *Big Bank's Latin Debt Figures Underscore Potential Danger From Huge Write-Offs*, Wall St. J., Mar. 14, 1984, at 33, col. 4. [hereinafter *Latin Debt Figures*] (reporting that the SEC required banks to disclose foreign loans in excess of one percent of their total assets and the amount of delinquent loans classified as nonaccruing in countries where loans exceed one percent).

79. *Review of ILSA*, *supra* note 2, at 18 (statement of Robert Bench, Deputy Comptroller of the Currency). The regulators also shortened the dissemination time for coordinating the disclosure statements and publishing aggregate country exposures. *Id.* at 38 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank). The aggregate country exposure publications are essential for banks to "keep track of what is going on in the market place." *Id.*

80. ILSA, *supra* note 1, § 3907; *see also* Minimum Capital Ratios, Issuance of Directives, 50 Fed. Reg. 10,207, 10,215 (1985) (codified at 12 C.F.R. § 3.6 (1986)) [hereinafter Minimum Capital Ratios] (recognizing that the benefits of increased capital levels outweigh the costs). Some of the predicted benefits of the capital adequacy requirements include the following: (1) an increased capacity to withstand losses associated with the risks of banking; (2) increased stability in the financial system; and (3) increased capacity to fund economic growth. *See id.* at 10,215 (disclosing the new capital adequacy requirements).

81. H.R. REP. No. 175, *supra* note 61, at 45, *reprinted in* 1983 U.S. CODE CONG. & ADMIN. NEWS 1898, 1928.

Prior to ILSA, banks needed to maintain a minimum capital-to-assets ratio of only five percent. Federal Reserve System, 49 Fed. Reg. 30,317, 30,318 (1984); Schierl, advantage because some legislators and regulators believed this diversification may have added to the problem.[82]

The regulatory agencies did not issue a final ruling with regard to capital adequacy requirements until 1985.[83] The new regulations require banks to maintain total capital equal to at least 6 percent of adjusted total assets and primary capital equal to at least 5.5 percent of adjusted total assets.[84] The regulatory agencies realized that the new requirements would not have a significant impact on a substantial number of banks because most banks had already established capital requirements exceeding the new levels.[85] Increased capital levels, how-

---

International Banking: Risk Reserves for International Loans, 26 HARV. INT'L L.J. 271, 272 n.10 (1985) (citing 12 U.S.C. § 3907 (1983)) (providing the guidelines applicable to domestic and multinational banks since 1983).

82. *See* H.R. REP. NO. 175, *supra* note 61, at 46, *reprinted in* 1983 U.S. CODE CONG. & ADMIN. NEWS 1898, 1929 (stating that diversification did not remove the number of troubled loans on accounts of banks); *see also Senate Hearings on International Debt*, *supra* note 5, at 147 (statement of Martin P. Mayer) (underscoring the value of diversification because separate borrowers within one country still depend on a single source of dollars to meet their obligations).

83. Capital Maintenance, 50 Fed. Reg. 11,218, 11,131 (1985) (codified at 12 C.F.R. § 325.6 (1986)) [hereinafter Capital Maintenance] (promulgating the FDIC capital adequacy requirements); Minimum Capital Ratios, *supra* note 80, at 10,209 (providing OCC capital adequacy requirements); Capital Maintenance, *supra*, at 16,058 (codified at 12 C.F.R. § 225 app. A (1986)) (setting forth the Federal Reserve Board's requirements); *see also* Holland, *Foreign Bank Capital and the United States Federal Reserve Board*, 20 INT'L LAW. 785, 809 (1986) (reporting that the FDIC and the OCC did not promulgate a final rule until March 11, 1985, and that the Federal Reserve Board approved its rules on April 24, 1985).

84. 12 C.F.R. § 3.6 (1986); *see also* Rosenstein, *FDIC Raises Capital Ratio Requirements*, Am. Banker, Feb. 12, 1985, at 1, col. 4 (interpreting the new capital ratio requirements); *FDIC and OCC Adopt New, Uniform Capital Requirements*, Wash. Fin. Rep. (BNA) No. 44, at 449 (Mar. 18, 1985) (interpreting the new rules).

The regulatory agencies deemed these regulations necessary because of the peculiar problems that several banks faced in making foreign loans. Am. Banker, Nov. 4, 1983, at 3, col. 3, *cited in* Mitchell, *supra* note 1, at 2 n.7. The regulations, however, are aimed at banks that may or may not have substantial international loans. *Review of ILSA*, *supra* note 2, at 23 (statement of Charles Collier, Assistant Director, Division of Bank Supervision, FDIC). Some of these peculiar problems include the following: (1) the absence of bankruptcy laws in many foreign nations; (2) the absence of public security markets; (3) the relative difficulty United States lenders have in effecting a change of management in a foreign business; (4) the potential for intra-bank conflict between the foreign office initiating a loan and the domestic bank office supervising the loan; and (5) the use of current value accounting and other unfamiliar methods not conforming to Generally Accepted Accounting Principles. *Id.*

ILSA also authorized the OCC to implement and enforce capital directives that require particular banks to increase their capitalization. ILSA, *supra* note 1, § 3907. With regard to this authorization, the OCC has noted that "it is a useful supervisory tool and has been used in cases where a bank's level of capital is an immediate and overriding concern." *Review of ILSA*, *supra* note 2, at 19 (statement of Robert R. Bench, Deputy Comptroller of the Currency).

85. Minimum Capital Ratios, *supra* note 80, at 10,215 (stating that nearly all small banks had already met the requirements).

ever, have allowed banks to cushion some of the shock associated with the Latin American debt crisis after 1982.[86] For the most part, banks have "increased their capital by half since 1982 while LDC lending has remained fairly constant."[87] These levels are higher than the minimum guidelines the regulators promulgated[88] and are higher than the levels foreign regulators require of their banks.[89]

E. Requirements for Approval of Specific Project Loans

The Act requires banks to prepare an economic feasibility evaluation and to receive approval from a senior official of the banking institution for any project loans exceeding $20 million.[90] Under ILSA, banks must prepare foreign loan valuations of large loans granted to "finance project loans for various types of mineral or metal operations, outside of the United States."[91] Representatives of the appropriate federal banking agencies review the evaluation when they perform examinations of the banks.[92] Legislators and regulators included these provisions because banks did not properly review the reasons for foreign loans or the viability of the projects they funded.[93]

The provisions of the Act concerning specific project loan approval require very little regulatory action. Congress arguably enacted the provisions as a protectionist measure for certain failing industries in the United States that compete with similar industries in the developing countries.[94] The requirements for specific project loans have had little

86. *See* Cline, *A Quick Fix that Would be Harmful*, N.Y. Times, Aug. 9, 1987, sec. 3, at 2, col. 3 (noting that the risk to the international banking system was lower in 1987 than in 1982 because of increased capital adequacy and loan loss reserves).

87. *See Review of ILSA*, *supra* note 2, at 1, 4 (Chart I) (recognizing ILSA as the reason for increased capital levels of banks).

88. *See id.* at 11-12 (statement of William Taylor, Director, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System) (stating that in 1986, capital, including amounts for loan loss reserves, increased 20% from levels existing on December 31, 1983); *see also id.* at 19 (statement of Robert R. Bench, Deputy Comptroller of the Currency) (providing figures for the increases in capital from 1982 to 1986).

89. *See id.* at 38-39 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (criticizing the current system because foreign banks can compete more easily when their regulators require lower capital adequacy levels).

90. ILSA, *supra* note 1, § 3908(a)(1).

91. *Review of ILSA*, *supra* note 2, at 39 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank).

92. ILSA, *supra* note 1, § 3908(b).

93. H.R. Rep. No. 175, *supra* note 61, at 44-45, *reprinted in* 1983 U.S. Code Cong. & Admin. News 1898, 1927-28.

94. *See Lending to Foreign Nations*, *supra* note 1, at 733-34 (suggesting that protectionism prevailed because Congress never articulated a motive for the provision and because strong labor unions represent the industries affected).

impact on the banks.[95] As one bank representative stated in 1986, "[g]iven the poor economic situation in most of the LDCs and low world commodity prices, the demand for new project loans has come to a standstill."[96]

III. HOW BANKS ARE COPING WITH THE CURRENT LATIN AMERICAN DEBT CRISIS AND AVOIDING THE REGULATIONS PROMULGATED AFTER ILSA

To deal with the new statute and regulations, banks developed activities and transactions that allow them to cope with the crisis and often avoid the new rules under ILSA. Some of these activities and transactions include: increasing loan loss reserves, rescheduling existing loan agreements, conducting bank loan syndications, swapping and selling loans, and conducting debt-equity swaps. All of these activities appear to eliminate problems associated with the Latin American debt crisis.

A. ATTEMPTS BY BANKS TO DEAL WITH NEW RULES REGARDING ALLOCATED TRANSFER RISK RESERVES (ATRRs)

The new rules regarding loan loss provisions do not harm bank earnings, but set far reaching precedent on how regulators will evaluate loans to major foreign debtors.[97] Establishing special reserves has the same effect on a bank's records as writing off a loan as uncollectible.[98]

95. *See Review of ILSA*, *supra* note 2, at 39 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (noting that few project loans are extended to debtor countries).

96. *Id.*

97. Wall St. J., Dec. 27, 1983, at 2, col. 2. The process that the regulators conduct when reviewing bank loans for possible ATRRs also imposes high costs on the banks involved. *See Review of ILSA*, *supra* note 2, at 37 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (noting that the regulatory process requiring banks to complete questionnaires and conduct meetings, cost Chemical Bank $368,000 between 1985 and 1986).

98. Wall St. J., Dec. 27, 1983, at 2, col. 2. When a debtor nation will not repay loan principal, a bank must write-off a loan. Write-offs do not have a direct effect on earnings, but they reduce the bank's loan loss reserves, which banks must maintain at adequate levels. Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D1, col. 2, D10, col. 1. The banks make quarterly provisions to the loan loss reserves. *Id.* Banks charge this amount against earnings, but eventually the banks must replenish the reserve because banks charge losses against it. *Id.* This replenishment decreases earnings of the bank for that quarter. *Id.* When a bank believes it will not receive more than half the value of a loan, it charges an appropriate amount against its loan loss reserves, thereby writing-off the loan in whole or in part. *Id.*

To avoid especially sharp declines in earnings, some banks sold undervalued bank assets or used other past gains to offset recent higher loan loss provisions. Hertzberg, *Major Banks Avoid Big Loan Write-Off but Sharply Boost Their Loss Reserves*, Wall St. J., Oct. 18, 1984, at 7, col. 2. For example, Security Pacific Corporation used a $76

Banks, however, criticize the special reserves. They claim that under the process the regulators use to determine the ATRRs, "the Bank is not informed ahead of time about the recommended level of the ATRR or proposed classification or the logic as to how these recommendations were reached."[99] Banks also claim that they are uncertain about which loans to particular countries will require the ATRRs in the future and therefore are reluctant to lend further amounts to heavily indebted countries.[100]

Peer pressure has compelled banks to increase general loan loss reserves.[101] Indeed, many major banks voluntarily increased their loan loss reserves above the required levels or established these reserves before the regulations were promulgated.[102] Banks would rather establish special reserves for problem loans than write them off, and banks use this tactic to protect earnings that would decrease if they wrote off the loans.[103]

In 1986, major banks reported increased net earnings and lower loan loss provisions because they previously established large reserves.[104] In 1987, however, major banks and regional banks, following the actions of Citicorp, substantially increased their loan loss reserves.[105] These

million gain from the sale of its headquarters building in Los Angeles, Chase Manhattan Corporation used $49 million of settlements from law suits in 1982, and Manufacturers Hanover Corporation sold securities carried on its books at low values to record high earnings in 1984. *Id.* Profitable lending activity, therefore, is not the only contributing factor to the success of a bank. *Id.*

99. *Review of ILSA*, *supra* note 2, at 37-38 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (arguing that the regulations should include the banks more directly in the ATRR decision-making process).

100. *Id.*

101. Hertzberg, *supra* note 98, at 7, col. 2.

102. *See id.* (finding that in 1984, Security Pacific Corporation increased its reserves by 42% to $155 million, Manufacturers Hanover Corporation increased its reserves $30 million, and Chase Manhattan Corporation increased its reserves $50 million). Banks voluntarily established special reserves in anticipation of the new ATRR regulations. Am. Banker, Dec. 19, 1983, at 2, col. 4; *see also* Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D10, col. 3 (stating that several banks created reserves when public confidence in their earnings reports declined).

103. Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D10, col. 1. *But see Review of ILSA*, *supra* note 2, at 74 (written response of William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System) (indicating that most banks accept a partial charge-off rather than establish a specific reserve).

104. Wash. Post, Oct. 16, 1986, at E10, col. 1 (reporting that the net earnings of Manufacturers Hanover Corporation rose five percent in the third quarter of 1986 because required loan loss provisions were lower than in past years).

105. *See Banking Gamble: Citicorp Sharply Lifts Loss Reserves, Putting Its Rivals on the Spot*, Wall St. J., May 20, 1987, at 1, col. 6 [hereinafter *Banking Gamble*] (reporting that Citicorp added $3 billion to its foreign and domestic loan loss reserves); *Continental Bank Adds to Reserves*, Wash. Post, June 23, 1987, at E8, col. 1;

bank actions received mixed comments concerning the effect the actions will have on the overall Latin American debt crisis. These increased reserves could resolve some of the problems associated with the crisis. First, the reserves are an indication that banks are finally recognizing, in a constructive manner, that their loans to heavily indebted nations are risky.[106] Second, the increased reserves allow banks to venture into innovative lending transactions such as debt-equity swaps without fear of incurring substantial losses.[107] Third, the reserves allow banks to lend more funds to countries that are performing on their financial obligations.[108] Fourth, the conduct "is a positive step toward restoring confidence in U.S. banks"[109] and shows a "sign of strength" in the United States banking industry.[110] Finally, establishing reserves can create "peer pressure" among other banks encouraging them to establish similar loan loss reserves, thereby improving the overall strength of the banking industry.[111]

The increased reserves, however, could create problems for debtor countries. First, after increasing reserves, banks are in a better condition to declare a country in default or write off a loan to a country and

---

BankAmerica Raising Reserve $1.1 Billion; Manufactures Hanover Mulls Similar Step, Wall St. J., June 9, 1987, at 3, col. 1; Truell & Guenther, *Chase Increases Loan Reserve by $1.6 Billion*, Wall St. J., May 28, 1987, at 2, col. 1; Weiner, *Continental and Bank of New York Post Losses*, Am. Banker, July 16, 1987, at 2, col. 2; *Security Pacific Posts $172 Million Loss*, Am. Banker, July 17, 1987, at 2, col. 2; Weinstein, *Bank of Boston Loses $83 Million with Loan-Loss Reserve Increase*, Am. Banker, July 17, 1987, at 2, col. 2; *3 Banks Add to Loss Reserves*, Wash. Post, June 30, 1987, at E3, col. 6; Sugawara, *Riggs Boosts Loan Reserves; Expects Loss*, Wash. Post, July 1, 1987, at G1, col. 3.

106. *Banking Gamble*, *supra* note 105, at 1, col. 6; Swardson, *Citicorp Will Lose $2.5 Billion*, Wash. Post, May 20, 1987, at A1, col. 1 [hereinafter *Citicorp Will Lose $2.5 Billion*]; *see also Citicorp's Bold Move*, *supra* note 21, at F1, col. 5 (recognizing that more is necessary to resolve the debt crisis than simply following the Baker Plan).

107. Swardson, *Citicorp Move Brings New Era*, Wash. Post, May 21, 1987, at F1, col. 3 [hereinafter *New Era*]; *see also* Berg, *U.S. Banks Swap Latin Debt*, N.Y. Times, Sept. 11, 1986, at D4, col. 1 (recognizing that banks can sell their loans at a loss or forgive principal after taking large loan losses); *cf. Banking Gamble*, *supra* note 105, at 22, col. 1 (quoting a top banking official as claiming increased reserves will allow Citicorp to participate in creative new investment mechanisms).

108. *Banking Gamble*, *supra* note 105, at 22, col. 1.

109. *Citicorp Will Lose $2.5 Billion*, *supra* note 106, at A1, col. 3 (quoting Senator Bill Bradley).

110. Rowe, *Bank's Decision Seen as Sign of Strength*, Wash. Post, May 21, 1987, at F1, col. 3 (noting that increased reserves will make Citicorp's earnings in the future far less vulnerable to debtor countries' economic and political setbacks); Rowen, *Fresh Ideas for Debt Crisis*, Wash. Post, June 7, 1987, at H1, col. 1 (noting that increasing reserves demonstrate that banks are in a much better financial position than they were in 1982).

111. *See supra* note 105 (indicating some of the banks that followed Citicorp's lead to increase loan loss reserves and take substantial losses to earnings in 1987).

thus place themselves in a more powerful negotiating position when they reschedule existing loans or establish terms for new loans.[112] Second, the new reserves can cause concern outside the banking industry, and lead investors to believe the banking industry is not "sound."[113] Third, increased reserves do not, by themselves, restore growth to Latin America.[114] Fourth, increased reserves can cause prices of debtor country loans on the secondary market to decrease, thereby decreasing the return a bank receives when it sells or swaps its loans.[115] Finally, the increased reserves might lead banks to decrease their lending to indebted countries because banks are better able to withstand the shocks associated with a country failing to service its debt after lending ceases.[116]

The actions of major banks to increase loan loss reserves appear to have more of a beneficial impact than the ATRRs. The regulators initially required banks to establish ATRRs for only two Latin American countries: Nicaragua and Bolivia.[117] The regulatory agencies chose those countries because they demonstrated a protracted inability to re-

112. *New Era*, *supra* note 107, at F1, col. 3; *Banking Gamble*, *supra* note 105, at 22, col. 1; *cf. infra* notes 138-40 and accompanying text (recognizing that banks enjoy a superior negotiating position over debtor countries attempting to negotiate favorable terms in a rescheduling agreement). *But see New Era*, *supra* note 107, at F4, col. 1 (noting that Brazilian officials and Citicorp officers claim the increased reserves will not change relations between, or the positions of, Brazil or Citicorp).

113. *Banking Gamble*, *supra* note 105, at 22, col. 1.

114. *See Citicorp Will Lose $2.5 Billion*, *supra* note 106, at A1, col. 3 (quoting Senator Bill Bradley); *see also* Weiner, *Swearingen Caps His Continental Career*, Am. Banker, Aug. 12, 1987, at 24, col. 1 (quoting John Swearingen as saying increasing reserves is not enough to resolve the problems banks experience with the international debt crisis); *Review of ILSA*, *supra* note 2, at 2 (statement of Senator Heinz) (noting that when banks establish reserves or write down loans, debtor countries do not benefit because such activity does not reduce their debt burden).

115. *See* Forde, *Regional Banks Move to Cut LDC Debt*, Am. Banker, Aug. 12, 1987, at 2, col. 1 (noting that prices of LDC debt on the secondary market decline as banks set aside funds in loan loss reserves). Indeed, debtor countries may wonder why they should service loans that the banks have already recorded as a loss and are selling for less than 100% on the secondary market. Samuelson, *Debt Strategy Adrift*, Wash. Post, June 3, 1987, at G1, col. 4 [hereinafter *Debt Strategy Adrift*].

116. Truell, *Reserve Moves Are Likely to Slow Efforts for New Argentine Loans, Bankers Say*, Wall St. J., May 29, 1987, at 2, col. 3 (noting that banks are reluctant to join in new loan packages to Argentina after witnessing Citicorp and Chase Manhattan Corporation establish huge reserves for similar types of loans); *Debt Strategy Adrift*, *supra* note 115, at G1, col. 4 (noting that the banks are disengaging and do not want to make new loans or provide leadership in the debt crisis).

117. Wall St. J., Dec. 27, 1983, at 2, col. 3; *Fed Seeks Write-Offs*, *supra* note 51, at D1, col. 5; *Fed Rule*, *supra* note 51, at D3, col. 1; Mitchell, *supra* note 1, at 2, col. 2. After this initial determination, the regulators added loans from two other countries to this list. *See supra* note 53 (comparing the number of countries whose loans required ATRRs in 1983, to the number in 1985). Peru was one of the countries added to the list in 1985. *Id.*

pay their debts, or they demonstrated that no definite prospects for an orderly restoration of their payments existed.[118] Even though the regulators will find it difficult not to apply the same provisions to countries in similar economic situations,[119] the special reserve requirement does not affect most Latin American nations that are working actively with the IMF.[120] The Federal Reserve Board has no foreign relations functions, but the Federal Reserve Board arguably enacted these provisions with some political motives.[121] None of the countries immediately affected had a close political relationship with the United States. Furthermore, these requirements had little effect on United States banks because banks issued only small loans to most of these countries and had already substantially written off the loans.[122] If the regulators had required banks to set aside substantial reserves for countries such as Mexico, Argentina, or Brazil, both United States banks and the world economy would have suffered drastically.[123] Thus, the regulatory agencies are reluctant to apply reserve rules to major borrowers because their application could harm major creditors.[124] Furthermore, these major foreign borrowers may experience economic improvements that

118. Wall St. J., Dec. 27, 1983, at 2, col. 3.

119. *Id.* (quoting Institute for International Economics analyst William R. Cline).

120. *Id.* Because Argentina worked closely with its lenders to reschedule its debt, regulators did not require banks with loans extended to Argentina to meet the ATRR requirements. Mitchell, *supra* note 1, at 2, col. 2. Indeed, if banks had not rescheduled loans to Argentina at the last moment, Manufacturers Hanover Trust, the largest lender to Argentina, would have lost earnings of $35 million to $80 million. Bennett, *The Intricacies of Bank Accounting*, *supra* note 15, at D10, col. 2.

In 1983, Mexican and Argentine borrowers made escrow payments in pesos to their central banks, which did not have dollars to make loan payments to the United States banks, and regulators allowed the banks to treat the payments not yet received as current income. Gall, *supra* note 7, at 186.

121. *See Fed Seeks Write-Offs*, *supra* note 51, at D1, col. 5 (noting that political motives were involved in restructuring the foreign debt of Argentina).

122. Wall St. J., Dec. 27, 1983, at 2, col. 3; *Fed Rule*, *supra* note 51, at D3, col. 1; *see also Review of ILSA*, *supra* note 2, at 2 (statement of Senator Heinz) (claiming that the countries requiring the ATRRs are "absolutely dead in the water"); *id.* at 43 (statement of Karen Lissakers, Adjunct Professor of International Affairs, Columbia University) (noting that the regulators applied ATRRs to only a few countries with very small amounts of loans). The required reserves accounted for less than six percent of the 1982 pre-tax portfolios of the major United States banks. Wall St. J., Dec. 27, 1983, at 2, col. 3 (quoting Institute for International Economics analyst William R. Cline); *see also Review of ILSA*, *supra* note 2, at 22-23 (statement of Charles Collier, Assistant Director, Division of Bank Supervision, FDIC) (reporting that the ATRRs ranged from 85% to 15% of the loans to different countries in 1986 and totaled only $4.1 billion in 1983).

123. *See* Wall St. J., Dec. 27, 1983, at 2, col. 3 (stating that similar requirements for loans to Brazil or Mexico would be extremely costly).

124. *See Review of ILSA*, *supra* note 2, at 103 (written response of Charles Collier, Assistant Director, Division of Bank Supervision, FDIC) (assuring Senator Heinz that a premature ATRR requirement would harm both the debtor and the creditors).

special reserve requirements might frustrate.[125] Applying reserve provisions more broadly would also limit further lending to the major debtor countries.[126] A decrease in lending to these countries would frustrate IMF programs and prevent major debtor countries from paying their debts.[127]

Banks remain reluctant to write-off their troubled foreign loans,[128] but are very willing to increase their general loan loss reserves.[129] The regulatory agencies, however, continue their reluctance to require special reserves for other troubled Latin American countries.[130] Indeed,

---

125. *Id.*

126. *Fed Rule, supra* note 51, at D3, col. 1; *Review of ILSA, supra* note 2, at 43 (statement of Karin Lissakers, Adjunct Professor of International Affairs, Columbia University) (noting that the regulators would rather allow banks to continue the flow of funds to enable troubled debtors to continue servicing their debts than impose ATRRs on loans to debtors).

127. *Fed Rule, supra* note 51, at D3, col. 1 (stating that placing Brazil and Mexico on the special reserve list would cause banks to cease lending to them); *see also Fed Seeks Write-Offs, supra* note 51, at D1, col. 5 (stating that placing Brazil and Argentina on the special reserve list would create political ramifications that the federal regulators prefer to avoid); *Review of ILSA, supra* note 2, at 43 (statement of Karen Lissaker, Adjunct Professor of International Affairs, Columbia University) (noting that ATRRs could frustrate the "solution" to the debt problem that banks, the IMF, and regulators have adopted).

128. *Latin Debt Figures, supra* note 78, at 33, col. 4 (showing that most United States banks remain reluctant to write-off their loans to Latin American countries); *cf.* Gall, *supra* note 7, at 184 (showing that West German and Japanese banks frequently write-off a majority of their unsound foreign loans).

129. *See supra* notes 105-11 and accompanying text (showing how banks voluntarily increased loan loss reserves in 1987).

130. *See* Witcher, *U.S. Bank Regulators Issue Directive Likely to Cut Profits*, Wall St. J., June 26, 1985, at 5, col. 1 [hereinafter *Regulators Issue Directive*] (stating that the regulatory agencies would not require banks to establish reserves on their loans to Peru); *Review of ILSA, supra* note 2, at 27 (reporting the Deputy Comptroller of the Currency's statement that banks must be protactively delinquent six months or more and not in compliance with IMF or bank advisory committee programs to require ATRRs); *see also supra* notes 51-53 and accompanying text (indicating that loans from only seven countries require the ATRRs). The OCC reports:

> only seven countries have fallen within that degree of severe delinquency and severe inability to restructure their debts. A number of other countries have been close to that, but then have made the decisions to negotiate successfully with bank advisory committees or agreeing with the IMF on standby programs, and have not gone across that threshold of 6 months or more delinquency and inability to deal with the Fund.

Review of ILSA, supra note 2, at 27. The regulators will require ATRRs in the future if the six month delinquency period limitation is not met and if the country fails to negotiate an IMF or bank advisory committee program. *Id.*; *see also id.* at 74-75 (written response of William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System) (noting that risks of some loans are insured better with general loan loss reserves and increased capital than specific ATRRs).

Rather than require ATRRs, the regulators place loans to many debtor Latin American countries in the category of Other Transfer Risk Problems (OTRP). *Id.* at 86-88 the regulators are encouraging banks to make additional loans to countries that already require ATRRs.[131] The regulators indicate that these additional loans do not require ATRRs[132] because the countries involved are pursuing constructive structural adjustment policies.[133] In summation, as bank regulators have noted, "it is unlikely that reserve requirements have had any significant effect on banks' decisions to lend to 'ATRR' designated countries."[134] Banks, however, appear reluctant to lend to countries that do not already require ATRRs because the regulators do not indicate which countries they will add to the list in the future.[135] The activities of banks in increasing loan loss reserves, rather than the ATRR provisions in ILSA, thus appear to have a beneficial impact on the Latin American debt crisis.

B. RESCHEDULING EXISTING LOAN AGREEMENTS

For banks to avoid the ATRRs or writing off their loans to Latin American countries and for Latin American countries to avoid defaulting on their loans, creditor banks and debtor nations often must reschedule, restructure, or refinance existing debts.[136] The reschedul-

---

(written response of Robert Bench, Deputy Comptroller of the Currency) (indicating that loans from debtors whose payments are interrupted but who take positive actions to restore debt service fall into the category of OTRP). The OTRP designation is not part of the ATRR requirement, but regulators use it when determining the required level of a particular bank's capital adequacy and loan loss reserves. *Id.* at 28 (statement of Charles Collier, Assistant Director, Division of Bank Supervision). This classification does not appear to negatively affect banks' decisions to lend to countries with loans in the OTRP category. *Id.* at 24.

131. *See Review of ILSA*, *supra* note 2, at 58-59 (written response from William Taylor, Director, Division of Bank Supervision and Regulation, Board of Governors of the Federal Reserve System) (noting that the additional loans the regulators encourage are trade credits that carry a classification below substandard).

132. *See id.* (noting that the regulators do not automatically require ATRRs for countries with previous loans requiring ATRRs).

133. *See id.* (noting that countries following the Baker Initiative often avoid additional ATRRs for new loans).

134. *Id.* at 24 (statement of Charles Collier, Assistant Director, Division of Bank Supervision, FDIC) (noting that the ATRRs have at least required banks to recognize losses that they might otherwise have deferred). *But see id.* at 38 (statement of Carleton R. Haswell, Senior Vice President, Chemical Bank) (claiming that banks are reluctant to lend even small amounts to countries because they fear the regulators will require additional reserves for the new loans).

135. *See id.* at 53 (noting that lenders are not lending to LDCs because the regulators might suddenly require special reserves or write-offs for the loans).

136. Biggs, *supra* note 22, at 176. Restructuring or rescheduling usually involves delaying or extending interest payments or reducing the amount of a specific obligation. *Id.* Refinancing, however, defines the new package as a separate transaction that replaces the original one and generally allows banks to charge a higher interest rate and loan fee. *Id.* Banks prefer refinancing for their more favorable terms, as impending default drastically reduces the debtor country's bargaining power. *Id.* Banks have suc-

ings allow banks to satisfy the requirements necessary to avoid ATRRs.[137] In the reschedulings, banks take advantage of the bargaining positions they maintain over debtor nations that are on the brink of default, use every bargaining tool at their disposal to extract large sums from the debtors, then cover unpaid amounts with new loans. Banks negotiate the new loans to avoid write downs on old loans that would decrease bank profits.[138] The superior bargaining position of banks allowed them to avoid linking the rescheduled loans of Mexico to the drop in the price of oil[139] and extract tremendous profits.[140] Rescheduling requires banks temporarily to forego principal payments, but banks offset this disadvantage when they raise interest rates in most of the refinancing agreements.[141] The banks also extract high fees for rescheduling, and ILSA's accounting rules on bank fees do not affect many rescheduling fees.[142]

Major debtor nations received better conditions in debt restructuring

---

cessfully imposed refinancing onto debtors to make loans profitable for the banks. *Id.*

Twenty-five countries with an aggregate debt of $250 billion rescheduled their financing terms in 1983. Poniachek, *U.S. International Lending and the Latin American Market*, BANKER'S MAG., Sept.-Oct. 1983, at 12, 14, *cited in* Comment, *International Loan Syndications: The Next Security*, 23 COLUM. J. TRANSNAT'L L. 155, 169-70 n.79 (1984) [hereinafter *International Loan Syndications*]. In late 1984, banks rescheduled $95 million of bank credits, representing more than one quarter of outstanding bank credits to LDCs. Sargen, *supra* note 7, at 539.

Most of the major debtor nations rescheduling loans with United States banks are in Latin America. Meissner, *supra* note 7, at 615; *see generally* Clark, *Sovereign Debt Restructuring Parity of Treatment Between Equivalent Creditors in Relation to Comparable Debts*, 20 INT'L LAW. 857, 859 (1986) (describing how banks and debtor nations negotiate the loan restructuring process).

137. *See Review of ILSA*, *supra* note 2, at 27 (noting Robert R. Bench, the Deputy Comptroller of the Currency, as saying that ATRRs are not necessary for banks that negotiate successfully with bank advisory committees or the IMF before a six month delinquency period expires).

138. *See Time for Banks to Write Down Loans*, *supra* note 10, part II, at 5, col. 1 (criticizing the conduct of major banks as damaging to both creditors and debtors); *International Loan Syndications*, *supra* note 136, at 170 (stating that the good bargaining position of banks allows them to receive tremendous profits); Biggs, *supra* note 22, at 175 (stating that banks use their resources to great advantage when renegotiating debt payments).

139. *$1 Trillion in Debts*, *supra* note 17, at A27, col. 1.

140. *See* Witcher, *Banks Criticized for Increasing Profits from Countries with Debt Difficulties*, Wall St. J., Dec. 5, 1983, at 32, col. 2 (noting that stiffer repayment terms on postponed debt provides tremendous profits to banks, but that rescheduling loans may also produce negative consequences for major lenders if debtors ultimately default).

141. Bleakley, *Waiting for the Big Banks to Revive*, N.Y. Times, Nov. 13, 1983, at F10, col. 4 (stating that rescheduling permits banks to do well even during the debt crisis).

142. *See supra* notes 59-71 and accompanying text (analyzing the new accounting rules for loans to debtor countries).

than minor ones.[143] Nicaragua, however, probably negotiated the best conditions for a developing country.[144] Recent reports indicate that commercial banks may move toward more constructive negotiating positions.[145]

Banks only recently demonstrated reluctance to issue new loans in restructuring agreements.[146] Contributing to the reluctance of banks are doubts over the prospects for repayment, the unwillingness of the World Bank to guarantee any loan packages, and increased demands of the debtor nations in the negotiation process.[147] Because large banks are reluctant to continue rescheduling these loans, they increasingly call on regional banks to contribute funds.[148]

A debtor country's failure to comply promptly with the terms of its rescheduling package undermines the confidence of the major banks and creates anxiety in the banking community. One only has to remember the shock that surrounded the temporary failure of negotiators to renegotiate a loan package for Argentina in 1984,[149] to appreciate the problems that could result if a debtor nation fails to negotiate a rescheduling agreement. Rescheduling is one of the few means of avoiding a country default; therefore, banks must overcome their reluc-

143. *See* Bogdanowicz-Bindert, *supra* note 9, at 529 (noting that the IMF limited assistance to smaller debtors that are obtaining outside financing).

144. *See* Biggs, *supra* note 22, at 178 (noting that Nicaragua received favorable interest rates upon restructuring its entire foreign debt).

145. *See* Watson, Keller, & Mathieson, *International Capital Markets: Developments and Prospects* 23 (Aug. 1984) (IMF Occasional Paper No. 31), *cited in* Sargen, *supra* note 7, at 539 (stating that commercial banks recently provided lower fees and longer repayment terms to LDCs than in the past).

146. *See supra* note 17 and accompanying text (reporting on the reluctance of banks to continue lending to Latin debtors).

147. *See $1 Trillion in Debts*, *supra* note 17, at A27, col. 1 (stating that Mexico is the only country likely to receive significant new commercial bank loans in 1986); Wash. Post, Oct. 5, 1986, at F7, col. 5 (showing that in its package in 1985 the World Bank gave a guarantee only to Chile).

148. *See* Gall, *supra* note 7, at 184 (noting that regional banks enter rescheduling agreements for political reasons). *But cf.* Rowe, *National Bank of Washington Joins in Mexico Rescue Loan*, Wash. Post, Nov. 4, 1986, at E1, col. 4 (stating that regional banks are also becoming weary of lending more to Latin American debtors). Regional banks reluctantly helped restructure loans with Brazil only for political reasons and warned the major banks they will not participate in other loan restructuring. *Id.* The National Bank of Washington helped restructure Mexico's debt only because it feared that Mexico would default without assistance, and because the IMF and the World Bank participated in the restructuring process. *Id.*

149. *See* Kraft, *It is Time for American Banks to Act*, L.A. Times, June 3, 1984, part IV, at 5, col. 3 (noting that several nations restricted loans with Argentina so Argentina could meet its deadlines for interest payments). As Argentina neared its deadline for interest payments, Mexican authorities worked quickly with Colombia, Venezuela, Brazil, the United States, and the banks to organize a loan. *Id.*

tance to reschedule.[150] Additionally, banks may have to make changes in the restructuring process before they can solve the debt crisis.[151]

C. Bank Loan Syndications

Bank loan syndications are another innovation banks use to avoid the problems associated with the Latin American debt crisis. Syndicated loans are single agreements between a debtor, a lead bank, and a borrower. In a syndicated loan, all lenders in the agreement are in privity with the debtor country, even though the terms of one syndication agreement limit the rights of each lender.[152]

Syndicated loans attract United States banks for several reasons. First, the lead bank can fulfill its clients' needs and earn a fee on the entire amount of the loan, without actually lending all of the money required. Second, participating banks can diversify their loans and avoid the regulations regarding ATRRs and disclosure that are established, in part, according to the amount a bank loaned to particular countries. Third, less sophisticated lenders in the syndicate, such as smaller regional banks, can indirectly use the analysis of the larger, more sophisticated banks in the syndicate. Fourth, several lenders and a borrower create a working relationship, thereby making future deals possible for the two parties. Finally, when a borrower has separate loans from many different banks, the debtor is less likely to default because it would harm several lenders rather than a few and undermine the debtor nation's prospects for future loans.[153]

---

150. *See* WORLD DEBT TABLES, *supra* note 10, at 465-71 (stating that rescheduling debt has a vital role in solving the crisis); Biggs, *supra* note 22, at 175 (stating that the only option is renegotiation because converting loans into tangible assets that banks could attach if a borrower defaults is not a legally feasible solution).

151. *See* Biggs, *supra* note 22, at 177 (stating that the loan returns to haunt both parties almost immediately because the time scale in renegotiations is too short). *But see* Ellis, *supra* note 59, at 9, col. 1 (stating that competition among banks and bank officers' fears that the debtors will default are the main reasons that reschedulings exclude longer repayment time periods).

152. *See In re* Yale Express Sys., 245 F. Supp. 790, 792 (S.D.N.Y. 1965), *cited in International Loan Syndications*, *supra* note 136, at nn.14-15 (describing a participation loan, in which only the original bank or lead bank, is in privity with the borrower and able to enforce the loan). In a participation loan, each purchasing lender buys a right to a specific percentage of the payments that the lead bank collects. *International Loan Syndications*, *supra* note 136, at 158-59; *see also* Goodman, *Syndicated Eurolending: Pricing and Practice*, 1 INT'L FIN. HANDBOOK § 3.4 (A. George & I. Giddy eds. 1983) (exploring the market for syndicated credits and analyzing rationales for its existence and rapid growth).

153. *Cf.* R. BEE, OFFSHORE LENDING BY U.S. COMMERCIAL BANKS 83-84, 177-78 (F. Mathias 2d ed. 1981) (describing the intricacies of syndications); T. DONALDSON, INTERNATIONAL LENDING BY COMMERCIAL BANKS 66-69 (1979) (providing information on European syndications), *cited in International Loan Syndications*, *supra* note

Syndicated loans also attract borrowers for several reasons. First, the borrower has to approach the banks and negotiate only once, avoiding the reputation of always needing loans. Second, the borrower can often raise a greater amount of money through a syndication. Third, Latin American debtor countries often suffer a financial position too weak to enjoy alternative sources of capital.[154]

One fault of the syndications is that regional banks typically have limited access to information about rescheduling the syndications in which they participate.[155] Regional banks are not usually included in the committee that negotiates the rescheduling.[156] Regional bank officers often hear about decisions affecting them from the media rather than having first-hand knowledge of these decisions.[157] Therefore, syndications do contain some disadvantages for regional banks.

Furthermore, the syndication market does not guarantee repayment,[158] and a serious possibility of default remains.[159] Indeed, it is likely that default is not a "probability" but an "inevitability."[160] A syndication will thus provide little security to United States banks if a country defaults.[161] One certainty is that syndications allow banks to avoid several provisions of ILSA because they reduce a bank's total loans to a particular country below the level where the ILSA requirements would apply.

D. INTERNATIONAL LOAN SWAPS AND LOAN SALES

Loan swapping is another tactic banks use to avoid regulations regarding loan loss reserves and make their disclosure statements appear

---

136, at 161 (describing some of the advantages of syndications).

154. T. DONALDSON, *supra* note 153, at 68, *cited in International Loan Syndications*, *supra* note 136, at 161.

155. *Id.* at 71-76, *cited in International Loan Syndications*, *supra* note 136, at 173-74; Tinnin, *The War Among Brazil's Bankers*, FORTUNE, July 11, 1983, at 55, *cited in International Loan Syndications*, *supra* note 136, at 173-74.

156. *International Loan Syndications*, *supra* note 136, at 173-74.

157. Tinnin, *supra* note 155, at 5 (recognizing the shortsightedness of banks for entering the transactions so hastily); *International Loan Syndications*, *supra* note 136, at 173-74 (stressing the dependence of regional banks on money center banks).

158. *International Loan Syndications*, *supra* note 136, at 169.

159. Gall, *supra* note 7, at 172. *See generally* Tinnin, *supra* note 155, at 50, 52 (discussing the Brazilian debt crisis); Quantius, *Problems with International Loan Syndications*, BANKERS MAG., Mar.-Apr. 1983, at 18 (noting the complications involved in loan syndications); Korth, *The Management of International Lending Risk by Regional Banks*, 64 J. COM. BANK LENDING, Oct. 1981, at 27 (discussing the effects of the likely default of Brazil).

160. Gall, *supra* note 7, at 184.

161. *Cf.* Korth, *supra* note 159, at 27 (discussing the effects of a likely default of Brazil).

more attractive. Loan swapping allows commercial banks to sell or trade their loans on secondary markets where price fluctuations enable banks to make substantial profits.[162] This activity is similar to the way investors deal in securities and is often connected with a syndication or rescheduling plan.[163]

The following example is the best description of how banks transact these swaps. Bankers Trust Company, the eighth largest bank in the United States, reduced its loans to Brazil by $100 million, ten percent of its total to Brazil, with swaps to Banco Real, a Brazilian bank.[164] In exchange for the Brazilian loans, Banco Real gave Bankers Trust loans from other Latin American countries totaling $190 million, and Bankers Trust paid Banco Real $90 million in cash, plus the $100 million of its Brazilian debt.[165] In the exchange, Bankers Trust received loans that it considered more valuable than those it was holding.[166] The Brazilian loans were worth only $75 million to Bankers Trust at the pre-

162. Rowen, *Swap Debts - or Write Them Down?*, Wash. Post, Oct. 16, 1986, at A21, col. 1 [hereinafter *Swap Debts - or Write Them Down?*]. Swaps are not overly important, but "they could be part of an overall economic reform so that dependence on external financing is lastly reduced." *Id.*; *see also* Gavin, *A GATT for International Banking?*, J. WORLD TRADE L. 121, 128 (1985) (stating that when access to credit is restricted, it is advantageous to have expertise in novel financing tools). Private United States banks claim their Latin American loans are worth 100 cents on the dollar, even though there is already a market where those loans are sold at discounts from 20% to 70% or more. *Swap Debts - or Write Them Down?*, *supra*, at A21, col. 1.

Swapping and selling such loans at drastic discounts indicates that banks are finally recognizing their loans to Latin America are worth considerably less than their listed face value. *See* Sachs, *It's the Right Time to Offer Real Relief*, N.Y. Times, Aug. 9, 1987, sec. 3, at 2, col. 3 (indicating that many loans are worth 40% less than their face value). In August 1987, international secondary markets sold a $100 claim on Brazilian debt for only $55. *Id.* Indeed, in August 1987, the secondary markets valued the external debt of Mexico at only 53 cents on the dollar, and listed Argentina at 47 cents on the dollar, Venezuela and Chile at 67 cents on the dollar, Peru at 11 cents on the dollar, and Bolivia at only 10 cents on the dollar. *Id.*

The declines in secondary market prices of loans to debtor countries are expected to continue due to the increases many banks are making for their loan loss reserves. *See* Forde, *supra* note 115, at 2, col. 1 (noting that after the loan loss allocations, balance sheets more accurately reflect the true value of loan portfolios). Investors in secondary markets may expect higher reserves to induce major banks to accept lower prices for loans of debtor countries. *Id.*; *see also* Berg, *Banks Study Strategies to Replenish Reserves*, N.Y. Times, Aug. 13, 1987, at D4, col. 1 (noting that because banks have already taken their losses, they can sell their loans at a loss in the secondary market).

163. *See Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (describing loan swaps); *A Hot New Market in Swapping High-Risk Debt*, BUS. WK., Dec. 5, 1983, at 144 [hereinafter *Swapping High-Risk Debt*] (promoting loan swaps).

164. *Swapping High-Risk Debt*, *supra* note 163, at 144; Hector, *The Banks' Latest Game: Loan Swapping*, FORTUNE, Dec. 12, 1983, at 111.

165. Hector, *supra* note 164, at 111.

166. *Cf. id.* at 111-12 (discussing loan swapping between Bankers Trust and Banco Real and the resulting benefits to Bankers Trust).

vailing discount rate.[167] At that time, Banco Real found it difficult to raise funds outside Brazil and immediately received $90 million from the swap, which it could use for foreign or domestic lending.[168] Bankers Trust concluded the transaction when its Brazilian loans nearly became "nonperforming assets" and thus avoided the ILSA regulations regarding loan loss reserves.[169] The assets acquired were also less likely to require any reserves in the future.[170] Most loan swaps that United States banks offer are only a small fraction of the swap offered in the Bankers Trust case.[171]

There are several reasons why banks engage in loan swapping. First, loan swapping allows participating banks to accept portions of the total package with each portion maturing at terms suitable to differing preferences of banks. Therefore, the desires of the debtor can weigh against the desires of the individual lenders.[172] Second, loan swapping allows the lender to decide if it wants to renew the loan.[173] Third, banks can reduce their loans to countries that appear unable to repay their loans and make their balance sheets appear more attractive without taking writedowns that Congress and some regulators demand.[174] Fourth, the price of a loan on the secondary market is a good indicator to another bank of the credit-worthiness of the country whose loan is being swapped or sold.[175] Finally, banks can completely remove their investments from some countries by swapping or selling their entire loan package if banks perceive the loans as too risky.[176]

---

167. *Id.*
168. *Id.*
169. *Id.*
170. *Id.*
171. *Id.*
172. Fox, *Country Lending, Grass-Roots Style*, INST'L INVESTOR, Oct. 1983, at 37.
173. *Id.*
174. *Swapping High-Risk Debt*, *supra* note 163, at 144. The federal regulators require banks that loaned one percent or more of their total assets to any one country to disclose the loans to their shareholders. *Id.* Several large New York banks swapped debt to reduce their exposure to any country below one percent, in an effort to completely avoid the disclosure requirement. *Id.*
175. *Cf. id.* (discussing how the emerging market sets actual values for sovereign-risk debt); *Review of ILSA*, *supra* note 2, at 89 (written response of Robert R. Bench, Deputy Comptroller of the Currency) (asserting that prices of loans on the secondary market are not a good indication of the ability of a country to pay its debt). Some argue the secondary market is "very imperfect." *Id.* The Deputy Comptroller, when referring to the secondary market in 1986 indicated:

> Volume is minimal; there is not breadth or depth to the market or a primary market maker. There is also no homogeneity to the instruments being traded. They vary by various characteristics. This demand and supply rests on various factors, only one of which is an assessment of creditworthiness.

Id.
176. *Swapping High-Risk Debt*, *supra* note 163, at 144. Some banks sell their

Regulators and bankers estimate that banks have swapped approximately $1 billion worth of loans and believe that the market is rapidly expanding.[177] An informal secondary market already exists in London where some loans sell at sixty cents on the dollar.[178] Many of the loan swaps originate with small financial institutions outside the United States that want to divest their Latin American loans.[179] Some banks have exchanged what they view as risky loans to Brazil, Peru, Argentina, and Mexico for safer loans to Spain, Portugal, and other more stable European countries.[180] Some banks in the Middle East and Europe have made their entire Latin American loan portfolios available for swaps.[181]

Some experts, however, argue that loan swapping is destructive because it allows banks to distort the purpose of the new rules on accounting and disclosure.[182] Swaps arguably do not eliminate the overall debt problem because they do not create interest and principal payments for nearly bankrupt countries.[183] The transactions, however, are helpful in reducing risks associated with the Latin American debt crisis because they allow banks to diversify their portfolios.

E. Debt-Equity Swaps

Another recent tactic United States banks use to manage the Latin American debt crisis and avoid the new rules on accounting special reserves for international assets is to exchange their loans (debt) for stock in state owned corporations and industries (equity) or sell loans to other lenders who then exchange the debt for equity. These transactions are simply an extension of the debt swap and debt sale techniques analyzed earlier. A growing number of United States banks, including Citibank, Bankers Trust, Morgan Guaranty Trust,[184] and several re-

---

Latin American loans at tremendous discounts to buyers who will trade those loans for other debt. *Id.*

177. *Id. But see* Hector, *supra* note 164, at 111 (stating that Citicorp, usually as innovative as most other major United States banks, was not swapping loans in 1983).

178. Gall, *supra* note 7, at 186.

179. Hector, *supra* note 164, at 111.

180. *Swapping High-Risk Debt*, *supra* note 163, at 144 (reporting that European banks trade Latin American loans for Eastern European and African loans at losses of 20 to 30 cents on the dollar).

181. Hector, *supra* note 164, at 112.

182. *Id.*

183. *See Swapping High-Risk Debt*, *supra* note 163, at 144 (comparing loan swaps to rearranging the deck chairs on the Titanic).

184. Rowe, *Chile Shrinks Loan Size with "Debt Swaps": Scheme Allows Nation to Convert Dollar-Based Loans into Peso Investments*, Wash. Post, Aug. 24, 1986, at H1, col. 2, H3, col. 4 [hereinafter *Chile Shrinks Loan Size*]; *see also* Truell & Yang,

gional banks[185] are gaining expertise in debt-equity swaps.

There are two ways to transact debt-equity swaps.[186] Most United States bank transactions involve a third party who views the debtor country as a less risky investment and purchases the foreign loan of this nation from the United States banks.[187] The purchaser exchanges the foreign loan of the debtor nations either for equity directly with the debtor country in a state owned company that is going through privatization or for domestic currency that the third party then uses to buy a stake in a company, state owned or privately owned, in the debtor nation.[188]

Fed Agrees to Let U.S. Banks Acquire Nonfinancial Firms in Debtor Nations, Wall St. J., Aug. 13, 1987, at 20, col. 2 (reporting that Citicorp and Bankers Trust conducted debt-equity swaps); Berg, *Banks Generally Praise Fed's Third World Shift*, N.Y. Times, Aug. 14, 1987, at D2, col. 5 (reporting that officers at First Chicago Corporation and Security Pacific Corporation praised regulations concerning debt-equity swaps and would continue to conduct swaps in Latin America); *Citicorp Firm Will Promote Debt Swaps in Venezuela*, Wall St. J., Sept. 3, 1987, at 16, col. 2 [hereinafter *Citicorp Firm Will Promote Debt Swaps*] (reporting that Citicorp's Venezuelan unit created a company that will promote debt-equity swaps in Venezuela). *But see* Schubert, *Trading Debt For Equity*, THE BANKER, Feb. 1987, at 18 [hereinafter *Trading Debt for Equity*] (claiming that many institutions are ill-equipped to manage the documentation, restructuring agreements, trade skills, and local contacts necessary to conduct debt-equity swaps).

185. *See* Forde, *supra* note 115, at 2, col. 1 (reporting that Mellon Bank swapped loans for equity in an agricultural and industrial holding company in Chile, and Signet Banking Corporation swapped loans for equity in various residual mortgage trusts and servicing arrangements in Chile and Mexico); *see also Trading Debt for Equity*, *supra* note 184, at 19 (noting that United States regional banks are ready sources for debt-equity swaps in the secondary market).

186. *See* Regulation K: International Banking Operations, 52 Fed. Reg. 30,912 (1987) (to be codified at 12 C.F.R. § 211.5) [hereinafter Regulation K] (describing the different forms of debt-equity swaps); *Trading Debt for Equity*, *supra* note 184, at 19-20 (describing how debt-equity swaps work, particularly in Chile and Mexico); Hannon & Gould, *Latin America Swaps Debt for Equity*, BUS. AM., (U.S. Dept. of Com., Int'l Trade Admin.) Jan. 19, 1987, at 3-6 (outlining how debt-equity swaps are conducted in Chile, Mexico, and Brazil); *Chile Shrinks Loan Size*, *supra* note 184, at H1, col. 4 (noting how debt-equity swaps are conducted, particularly with Chilean debt); Berg, *U.S. Banks Swap Latin Debt*, N.Y. Times, Sept. 11, 1986, at D1, col. 1 [hereinafter Berg, *Latin Debts*] (describing how debt-equity swaps work); Halliwell, *Could Debt-Equity Swaps Make Global Debt Manageable?*, 76 A.B.A. BANKING J. 78, 84 (1984) (describing how to conduct debt-equity swaps using an export trading company). The regulators recognized a third type of debt-equity swap. Regulation K, *supra*, at 30,912. The regulators indicate that when banks earn fees as brokers for other banks seeking equity investments in developing countries, a debt-equity swap takes place. *Id.* Banks would rather act as brokers for these transactions than sell their own loans because selling a loan at a discount requires a bank to report a loss on its earnings statement. Berg, *Latin Debts*, *supra*, at D5, col. 1. In addition, banks receive hefty fees for acting as brokers. *Id.*

187. *Cf. Chile Shrinks Loan Size*, *supra* note 184, at H1, col. 4 (noting the benefits to United States banks from loan swapping).

188. *See id.* (describing debt-equity transactions of United States banks).

Every party benefits from the swap. A bank or company that buys the debt should profit because it buys the debt at a sizable discount. This buyer considers the loans of the debtor country to be less risky than the seller does. Buyers often can use more effectively the domestic currency that they receive from the debtor country. A bank selling the loan receives dollars, allowing it to make other investments, spread its risk, and thus avoid the ATRR regulations if the loan sold is in arrears for a considerable length of time. The debtor country gains a new investor to help stimulate production and employment.[189] United States banks eager to decrease their exposure to debtor Latin American countries appreciate these transactions and sell their loans at substantial discounts.[190]

In another type of transaction, the lending bank itself accepts the equity in a privatized state owned company or the domestic currency of the debtor Latin American country, rather than selling the loan to a third party that accepts the equity investment or foreign currency. These transactions are common among banks located in other countries and may become common to United States banks in the future.[191] This form of debt-equity swap allows the United States banks to avoid the large writedown they experience when they sell their loans at a discount. Stock ownership in potentially successful Latin American industries is preferable to defaulted loans.[192] In addition, it is better to trade the loans for equity now rather than wait until the country defaults and repays none of the money owed United States banks.[193] The Federal Reserve Board in August 1986, released new regulations specifically declaring debt-equity swaps legal in most circumstances.[194] Further-

---

189. *See Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (describing the benefits for all parties of the swap); *Chile Shrinks Loan Size*, *supra* note 184, at H3, col. 1 (describing benefits to United States banks); Witcher, *Venezuela's Plan to Swap Debt for Bonds Worries its International Creditor Banks*, Wall St. J., July 16, 1986, at 26, col. 1 [hereinafter Witcher, *Venezuela's Plan*] (describing benefits to debt-burdened countries).

190. *See* Witcher, *Venezuela's Plan*, *supra* note 189, at 26, col. 1 (stating that banks are scrambling to perform debt-for-equity transactions as more debt-burdened countries buy back their foreign debt at a discount).

191. *See Review of ILSA*, *supra* note 2, at 35 (noting that non-United States banks are using the financing alternatives).

192. *See* Needham, *supra* note 18, at 31, col. 3.

193. *See Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (reasoning that it is better for the banks to suffer losses now on bad loans, in an organized way, than to wait for an avalanche of defaults later); Needham, *supra* note 18, at 31, col. 3 (showing the benefits of present debt-equity swaps over future defaults); Orme, *Favorable Debt Swaps Aid Mexico Investment*, Wash. Post, Dec. 21, 1986, at K6, col. 1 [hereinafter *Favorable Swaps Aid Mexico*] (outlining the benefits of Mexican debt conversion).

194. Regulation K, *supra* note 186, at 30,912. Under the new regulations, a United

more, the Treasury Department encourages the debt-equity transactions.[195]

Debt-equity swaps also benefit Latin American debtor countries. The transactions are easy to negotiate, with safeguards for sovereign control established at the initial stages and participation in international trade negotiated thereafter.[196] Debt-equity swaps return flight capital to capital account deficit countries,[197] stimulate "entrepreneurial dyna-

States bank may acquire 100% of the shares of a foreign financial company when (1) a government is in the process of transferring the nonfinancial company from public to private ownership (privatization); (2) the country where the nonfinancial company is located is a "heavily indebted developing country;" (3) the shares of the company are acquired through debt-equity swaps; (4) a bank holding company or its subsidiary holds the shares; and (5) the acquiring bank divests the ownership interest within five years from the date of acquisition, unless the Federal Reserve Board extends the period another five years for good cause. *Id.* If debtor countries require the bank to invest new money in the country in addition to the proceeds of the swaps, the regulators will address such investments on a case-by-case basis. *Id.*

Countries that qualify include developing countries that have rescheduled their external sovereign debt since 1980. *Id.* Under the new regulations, a bank holding company may invest in a foreign company using existing debt through loans or equity under existing procedures outlined in Regulation K. *See id.* (noting that under Regulation K, banks may invest the lesser of $15 million or five percent of the capital of a bank without prior regulatory consent).

The Federal Reserve Board requested and received the accounting standards applicable to debt-equity swaps. Staff Memorandum concerning the Amendment to Regulation K to permit certain investments through debt-for-equity swaps by U.S. banking organizations to the Board of Governors (Appendix E, Accounting for Debt Equity Swaps) (Aug. 7, 1987) (available at the Federal Reserve Board Freedom of Information Office). These accounting issues were addressed recently in a draft practice bulletin of the American Institute of Certified Public Accountants (AICPA). *See id.* (summarizing the new AICPA accounting standards for debt-equity swap transactions issued on June 12, 1987).

195. *See* Statement Before IMF, *supra* note 15, at 8 (advocating that the swaps be conducted more frequently to provide debtor countries with needed foreign investment); *Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (quoting J.D. Whitehead, Deputy Assistant Secretary of State, as saying that debtor countries are already beset by much larger debt than their economies can support, and that one answer to the debt crisis is finding ways of reducing that debt, and permitting debtors to pay it off); Rowen, *Baker Rejects Quick Fix on World Debts*, Wash. Post, Dec. 5, 1986, at G5, col. 1 [hereinafter *Baker Rejects Quick Fix*] (quoting Treasury Secretary Baker as saying debt-equity swaps provide opportunities for innovation); Statement by the Honorable David C. Mulford, Assistant Secretary for International Affairs, U.S. Treasury Department, Before the Bankers' Association for Foreign Trade Annual Meeting, Phoenix, Arizona, *printed in* TREASURY NEWS, May 16, 1986, at 6 [hereinafter Mulford Statement, May 16, 1986] (available from the United States Treasury Department) (indicating that debt-equity swaps reduce outstanding debt obligations and return flight capital to indebted countries); *see also* Needham, *supra* note 18, at 31, col. 3 (stating that swaps have the blessing of the United States Treasury Department and State Department).

196. *See* Needham, *supra* note 18, at 31, col. 3 (discussing methods of making foreign banks' partial ownership of foreign corporations more palatable to Latin American debtor nations).

197. Mulford Statement, May 16, 1986, *supra* note 195, at 6 (noting that debt-

mism,"[198] increase efficiency,[199] and transfer technology and managerial skills, each of which facilitates structural economic change and growth.[200] Foreign investment is a major component to solving the Latin American debt crisis, and debt-equity swaps create foreign investment that can help solve the debt crisis.[201] Debt-equity swaps improve the efficiency and resource mobilization capability of Latin American domestic markets because they take advantage of the investor's foreign technology and entrepreneurial skills.[202] Debt-equity swaps also reduce the number of banks holding a particular country's debt to those that desire a lasting relationship with that country, enabling Latin American countries to establish financial ties with banks that are most interested in their development.[203]

Because these policies are essential to growth in the debtor countries, Latin American countries should support debt-equity swaps.[204] Foreign and domestic investment has decreased in most developing countries in recent years.[205] This reduction is one reason why the foreign external debt has not subsided. Debt-equity swaps, however, can reverse this

---

equity swaps can provide the capital countries require to service their debts); *see also Trading Debt for Equity*, *supra* note 184, at 19-20 (stating that swaps can provide a significant economic boost to debtor countries).

198. Statement Before IMF, *supra* note 15, at 8.

199. *Id.*

200. *Id.*

201. *Id.*

202. *Id.* (calling for a "hospitable climate" for domestic and foreign banking institutions to improve the opportunities for the swaps).

203. *See Chile Shrinks Loan Size*, *supra* note 184, at H3, col. 4 (discussing the benefits of Chilean debt swapping).

204. *See* Statement Before IMF, *supra* note 15, at 8 (noting the advantages of Latin American debt swapping). Debtor nations need liquidity and financing if they are to implement structural changes and increase investments in quick-yielding projects. Bogdanowicz-Bindert, *supra* note 9, at 531. Latin American countries will not benefit from increased debt, and they will acquire more debt, unless they participate in these types of refinancing transactions. *Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1. Any plan that merely involves more borrowing and interest payments is not a total plan for success. *Id.* The Baker initiative stresses equity investment as an important factor fostering growth in Latin American economies. *Id.*

205. *See* WORLD DEBT TABLES, *supra* note 10, at 182-83 (presenting figures and graphs showing decreasing foreign direct investment); Statement Before IMF, *supra* note 15, at 8 (stating that foreign direct investment in developing countries decreased from 20% of total flows in 1975 to only 11% in 1984). *See generally* B. BALASSA, *supra* note 9, at 111-16 (discussing the problems in Latin America associated with capital flight and decreased foreign investment).

Some of the reasons for decreases in foreign direct investment are (1) the availability of private commercial bank financing; (2) domestic retrenchment and capital flight; (3) new restrictions and performance conditions of foreign investment; and (4) perceptions of increased political risk and poor growth prospects as a whole. Statement Before IMF, *supra* note 15, at 8.

trend and promote development in Latin America.[206]

A few Latin American countries have already started promoting debt-equity swaps.[207] Chile has extensive knowledge and experience in debt-equity swap transactions.[208] When Chile swaps commercial bank debt for peso investment in its country, it reduces its interest payments to United States banks and can apply the money to domestic investment and imports.[209] Most banks with Chilean holdings are so anxious to swap their holdings in that country that they will sell them for less than face value to receive cash immediately.[210] Other investors who view the situation in Chile as less precarious will buy these loans in dollars at the discounted price and exchange them at the Chilean central bank for their face value in pesos.[211] An investor who buys the loan can then obtain Chilean securities with these pesos.[212] Chile expects to

206. *See* Needham, *supra* note 18, at 31, col. 3 (defining capital formation that produces goods and services for international commerce as the real solution to the Latin American debt crisis).

207. Witcher, *Venezuela's Plan, supra* note 189, at 26, col. 1 (discussing a new Venezuelan law authorizing the government to issue dollar denominated bonds for $7 billion that private Venezuelan businesses owe abroad); *Citicorp Firm Will Promote Debt Swaps, supra* note 184, at 16, col. 2 (reporting that Venezuela began programs for debt-equity swaps and debt capitalization); Needham, *supra* note 18, at 31, col. 3 (observing that Brazil has nearly 500 state owned enterprises that allow it to benefit from debt-equity swaps); *Chile Shrinks Loan Size, supra* note 184, at H1, col. 3 (reporting that Chile encourages domestic and foreign investors to participate in debt swaps); Bridges, *Ecuador Will Seek Debt Refinancing*, Wash. Post, Dec. 17, 1986, at C4, col. 1 (noting that Ecuador intends to convert $100 million in dept-equity swaps in 1987); *Favorable Swaps Aid Mexico, supra* note 193, at K6, col. 1 (indicating that although investment rules in Mexico are more strict than in Chile or Brazil, the Mexican government still intends to retire $3 to $4 billion in foreign debt using the swaps); *Trading Debt for Equity, supra* note 184, at 18 (noting that Argentina and the Philippines established debt-equity programs, and Colombia, Uruguay, Venezuela, Peru, and the Dominican Republic are studying such programs).

Libra Bank, Ltd., a London based consortium bank, which Latin Americans acting as middlemen partially own, offers Mexican investors options to buy Mexican government loans at a fixed price during a specific period. *Venezuela's Plan, supra* note 189, at 26, col. 1.

208. *See Chile Shrinks Loan Size, supra* note 184, at H1, col. 2 (reviewing the ample experiences of Chile with debt swapping in 1985 and 1986); *Trading Debt for Equity, supra* note 184, at 18-19 (indicating that the largest volume of swaps has occurred in Chile, partially because its programs do not restrict opportunities for local investors); Mulford Statement, May 16, 1986, *supra* note 195, at 6-7 (complementing Chile for its movement toward promoting new transactions).

209. *See Chile Shrinks Loan Size, supra* note 184, at H1, col. 4 (describing the benefits of the Chilean debt swapping program).

210. *See id.* (explaining the success of the Chilean Program).

211. *See id.* at H3, col. 6 (describing the types of lenders willing to participate in Chilean debt swapping programs). Through June 30, 1986, Chile removed $450 million from its outstanding debt of $19.5 billion. *Id.* at H1, col. 3.

212. *See generally id.* (discussing the ability of Chile to reduce interest payments by converting dollar debt to peso investment).

use these swaps more often, once it becomes more familiar with the swaps and lenders become more familiar with Chilean programs.[213]

In 1986, debt-equity programs converted about $1 billion in bank loans to all debtor countries, and this trend should continue.[214] Although $1 billion is tiny compared to the total Third World debt of $900 billion to $1 trillion,[215] the small part of the loan it does eliminate also cancels the interest on the debt.[216] Because debt-equity swaps operate on a small scale, they will not solve the entire Latin American debt crisis. There simply are not enough investors to absorb all of the loans to Latin American nations.[217]

Debt-equity swaps will not develop if banks continue to persuade the World Bank and the IMF to "kick in" to pay off interest on old loans of Latin American debtor nations and allow banks to reschedule loans in more favorable terms.[218] In addition, some banks are not interested in looking at the long-term advantages these swaps provide because earnings initially suffer in the short-term.[219]

Debtor countries may also attempt to avoid such transactions. The swaps may imply "loss of control over national affairs,"[220] or lack of confidence in the debtor nation.[221] For the transactions to decrease the amount of debt exposure a country maintains, the debtor countries must also limit debt-equity swap use to foreign investors who can provide foreign currency from foreign sources.[222] Some local investors

---

213. *See generally id.* (describing the recent acceleration of Chilean debt swapping due to the increasing familiarity of Chile with the technique and investors' growing familiarity with the Chilean programs). Francisco Graces, International Director of the Chilean central bank, said Chile expects to convert an additional $550 million in foreign debt to domestic Chilean loans or investments by the end of 1986, which is more than the country had converted in the 15 previous months. *Id.* These programs should also work for Brazil because Brazil has nearly 500 state owned enterprises. Needham, *supra* note 18, at 31.

214. *See Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (discussing the increased use of debt swapping).

215. *Id.*

216. *See Chile Shrinks Loan Size*, *supra* note 184, at H1, col. 2 (associating reduced Chilean interest payments to foreign lenders with its ability to use export earnings for domestic investment).

217. *See id.* at H1, col. 2 (asserting that debt swapping alone cannot solve the debt crisis).

218. *See Swap Debts - or Write Them Down?*, *supra* note 162, at A21, col. 1 (discussing methods to prevent new lending that the Baker Plan recommends).

219. *See* Needham, *supra* note 18, at 31, col. 3 (outlining the adverse consequences of debt swaps).

220. *Id.*

221. *Chile Shrinks Loan Size*, *supra* note 184, at H3, col. 1 (explaining why some Chilean officials do not appreciate debt swapping).

222. *Trading Debt for Equity*, *supra* note 184, at 19. Mexican entrepreneurs with funds outside Mexico have established offshore companies to take advantage of the

could see this as unfair and protest debt-equity swap use.[223] If not controlled, these transactions can also cause inflation.[224] Individuals monitoring the banking industry also criticize the transactions because they do not attract new dollars to debtor countries.[225]

The major United States banks have developed numerous devices to manage the Latin American debt crisis. Banks must take advantage of all of the tactics available to them because legislative and regulatory attempts alone, like ILSA, will not solve the Latin American debt crisis.[226] Free enterprise and the free market activities associated with the crisis, such as rescheduling existing loans, syndicating existing loans, selling and swapping loans, and swapping debt for equity appear to be the best means to solve the Latin American debt crisis. Even if federal bank agencies established stricter regulations, United States banks would petition the regulators for exemptions if the regulations harm their earnings. Even without petitioning for exemptions, banks will find ways to avoid the regulations, just as they avoid several of the ILSA requirements using various accounting measures and investment transactions.

CONCLUSION

After analyzing the Latin American debt crisis, it appears the situation is not improving. Countries are able to make payments on their existing debts only if they take out new loans or reschedule or refinance existing loans. In an attempt to solve some of the problems associated with the international debt crisis, Congress passed the International Lending Supervision Act of 1983. The Act relied heavily upon federal regulatory agencies to fulfill its goals and objectives. The federal regulators, however, have been reluctant to promulgate stringent require-

---

swaps and avoid the limitations. *Id.* Mexico now conducts case-by-case investigations to permit local investors to take advantage of debt-equity swaps, similar to those allowed in Chile. *Id.*

223. *Id.*

224. *See Venezuela's Plan, supra* note 189, at 26, col. 1 (stating that Mexico limited its debt-equity swaps because the swaps create inflationary effects); *Favorable Swaps Aid Mexico, supra* note 193, at K6, col. 1 (stating that Mexican finance officials are concerned that a massive conversion of debt would increase the money supply and create hyperinflation); *Chile Shrinks Loan Size, supra* note 184, at H3, col. 4 (noting that Chile limited its swaps to $60 million per month because of inflationary fears).

225. *Chile Shrinks Loan Size, supra* note 184, at H1, col. 2 (referring to debt swapping as a double-edged sword that reduces a country's foreign debt, but fails to inject needed foreign capital into its economy).

226. *See Review of ILSA, supra* note 2, at 13, 18, 24 (reporting that neither the FRB, OCC, or FDIC recommend changes or amendments to ILSA or any congressional action in the international lending area).

ments. Even when the regulators have enacted rules, the rules have not applied because banks use many tactics designed to avoid them. These tactics allow banks to cope with the Latin American debt crisis and reduce the risk associated with it. Through this activity, banks are taking a more realistic view of the crisis. Some banks are realizing that some countries will never repay their loans. More enlightened banks are rescheduling, syndicating, selling, swapping, and liquidating their debts. In attempting to cope with the problem, banks make the best of a situation that has become uncontrollable.