

FINANCIAL UTILITY AND STRUCTURAL LIMITATIONS OF DEBT-EQUITY CONVERSIONS

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1. Introduction

The Third World debt crisis now in its seventh year, continues to loom large: less developed countries owe nearly \$1 trillion to the governments and banks of the developed world. To date, the parties involved have been unable to agree on a broad solution to the debt crisis. Debtor nations and their creditors have, instead, turned to narrower, alternative approaches (Exhibit 1). The harsh reality is that debtor nations do not have, nor are they likely to have for a long time, enough dollars to make interest payments on their foreign debt. (Paying back principal will remain a fiction). Consequently, unconventional avenues are being explored for debt repayment.

The most publicized scheme for alleviating debt, and one of the most creative, is the debt-equity conversion (DEC). This article defines debt-equity conversions and their functions, traces their development; provides operational and case illustrations; briefly presents the U.S. Government role surrounding these transactions; and summarizes the benefits and limitations of the DEC.

2. Definition and Function

The DEC is a scheme in which a firm purchases a foreign country's outstanding dollar bank debt on the secondary market and receives local currency to be used as an equity investment. Enacted to assist developing countries reduce their dollar debt burdens, these programs have emerged as a viable investment vehicle for MNCs interested in expanding or acquiring new operations in such countries as Brazil, Mexico (temporarily suspended), Chile, Argentina, Venezuela and the Philippines.

While the details of the programs vary from country to country, a DEC transaction generally involves four actors — a commercial bank, the central bank (CB) of the debtor country, an MNC, and its subsidiary domiciled in the debtor country — and can be explained in three steps:

(i) A commercial bank, serving as an agent for an MNC, purchases a \$1 million debt obligation of the CB at a discount. Assume that the MNC pays 70% of face value, or \$700K, on the secondary market.

(ii) On the MNC's behalf, the bank swaps the \$1 million debt with the CB for a local currency (LC) entitlement equal to a certain percentage of the debt's face value, say 80%. At a hypothetical free-market or official exchange rate of 10LCs: \$1, the local cur-

rency entitlement would be 8 million LCs.

(iii) The 8 million are then transferred to the MNC's local subsidiary in exchange for equity in the subsidiary. The use of the 8 million by the subsidiary is subject to government restrictions and must be reinvested locally in a project approved by the government.

The DEC furnishes advantages to all parties. First, the commercial bank is paid back \$700K of the debt — most likely a lot more than it can reasonably expect to recover from the debtor nation. The bank also gets the debt off its books. Second, the CB retires dollar debt with local currency while, at the same time, servicing new foreign investment in the country. Third, the MNC receives LC 8 million for a cost equivalent to only LC 7 million¹.

The symbiotic relationship among the four major participants in a DEC is illustrated in Exhibit 2. The lending bank assesses the possibility of unloading part of its problem loan portfolio, evaluating the loan, country-risk factors, bargaining power with other debtors and DEC market discounts. The bank establishes a suitable negotiation discount range; when the discounted loan is matched by an offer from a corporate investor, the loan is sold.

Redemption of the debt in local currency is made once the debtor nation defines and implements policies systems, and procedures for the DEC. The debtor country usually prescribes the sector in which a DEC is permitted; soft currency sources; administrative mechanisms for screening and approving the DEC; redemption rates; and limits on remittance of profits as well as the repatriation of capital².

Participants in a DEC are linked through a broker who, via competitive bidding, assists in furnishing both financial and market information. In addition to individual brokers (entrepreneurs who possess both financial expertise and debtor country political connections), brokerage services are provided by established financial brokers and investment bankers. Active players include: FNC brokerage (Citibank), Guilder (Dutch NMB Bank), Multiplic (Lloyds), Merrill Lynch, Shearson Lehman Hutton, and Morgan Grenfell³.

Another, more vivid, illustration of a DEC may be found in Exhibit 3. Manufacturers Hanover Trust Company, with an estimated Brazilian debt of \$2 billion, has invested \$100 million worth of Brazilian cruzados into Companhia Suzano de Papel e Celulose, a Sao Paulo-based forest products manufacturer. The bank now has a 10% stake in the

1. "Debt-Equity Swaps: How US MNCs Can Keep the Transaction Tax Free", *Business International*, March 28, 1988.

2. Joseph Ganitsky and Gerardo Lema, "Foreign Investment through Debt-Equity Swaps", *Sloan Management Review*, Winter 1988, pp. 21-29.

3. "Debt-Swap Momentum Keeps Investment Alive in Brazil," *Business Latin America*, August 8, 1988.

Brazilian firm. Manufacturers Hanover obtained the cruzados by selling \$115 million in risky sovereign loans to Brazil's central bank⁴.

The form of the DEC may vary; however, the basic purpose and function are largely the same across all transactions.

3. The Development of the DEC

The emergence of the present debt/equity swaps market dates back to the onset of the debt crisis in the summer of 1982⁵. However, a number of isolated instances of such swaps had been recorded even earlier; for example, in Brazil from as early as 1965, certain non-residents had been allowed to convert external debt into equity investments at face value and at the official exchange rate. The latest example predating the debt crisis was that of Turkey, where in 1980 the authorities enacted legislation dealing with the settlement of some \$1.4 billion of foreign arrears claims. This legislation provided that creditors could be paid either in foreign exchange over ten years or in local currency on demand. It was specified that the local currency could be used for a wide variety of purposes, including the purchase of equity. Soon after the enactment of this legislation a certain amount of trading in Turkish debt began, with debt paper being sold at a discount from its face value⁶.

The first debt-equity swaps to take place after the emergence of the debt crisis were in Brazil in 1983. As part of a major rescheduling package agreed that year, private sector borrowers were required to deposit with the Central Bank of Brazil the cruzeiro equivalent of their foreign currency borrowings when those borrowings became due for repayment. Some creditors decided to relend this money in Brazil and some decided to use it for the purchase of equity. Several creditors, however, decided to sell their loans, and thus the right to use the corresponding cruzeiro deposits, to a multinational corporation or similar institution that was planning to invest in Brazil. In this manner the first of the post-debt crisis debt-equity swaps was introduced.

On November 17, 1987, the Central Bank of Brazil issued Resolution 1,416 establish-

4. "Deals That are Making a Dent in Third World Debt", *Business Week*, October 3, 1988.

5. This section cites extensively from Michael Blackwell and Simon Nocera, *Debt/Equity Swaps*, IMF Working Paper WP/88/15, February 12, 1988.

6. UNCTAD, *The Role of Foreign Direct Investment in Development Finance: Current Issues*, TD/B/6.3/196, December 14, 1984, p. 13.

ing a framework for debt-equity conversions. As set forth in the new regulations, the proceeds of the debt conversions must be invested in new projects or the expansion of existing projects. Public sector company debt can only be converted into equity in public sector enterprises. As for other sectors of the economy, restrictions are in force in selected areas such as communications, information, data processing, utilities, financial services, transportation, and agricultural property. Investments are transferable only after 12 years from capitalization. Additionally, proceeds accumulated prior to this time may not be used to acquire foreign investments unless the proceeds of the acquisition are reinvested in Brazil. Capital repatriation by a foreign investor is subject to a deposit in the Central Bank of 50% of the amount to be repatriated. One of the most restricted regulations of the new regimen disallows debt-equity conversion which directly or indirectly transfers control of the target company from Brazilian to foreign hands⁷.

Toward the end of 1984, Argentina became the next country to engage in debt-equity swaps. The Argentine scheme was also related to a rescheduling package but took a different form. The Argentine authorities issued promissory notes (BONODS) for debt covered by the package and then permitted the conversion of these notes to equity on a case-by-case basis. This particular debt-equity swap arrangement was discontinued before the end of 1985 after about \$500 million worth of debt had been converted. The reason for terminating the scheme reflected a concern that the investment associated with debt-equity swaps would substitute for inflows which would have taken place in any event. There was also apparently some concern that such swaps would lead to increased credit expansion. In June 1987, the Argentine authorities introduced a new scheme that allowed debt-equity swaps as long as the face value of the swapped debt was matched by the investment of an identical amount of "new" money.

Other key features of the Argentine DEC regimen pertain to "eligible investments" and decapitalization. The former requires that investment proceeds be used to purchase new equipment, create a new industrial plant, or increase physical capacity; additionally, eligible investments can include those aimed at increasing efficiency, productivity, or the supply of services — especially those with positive balance of payments impacts. Decapitalization restrictions prohibit the transfer of investments for the first 36 months from the time of conversion; the repatriation of capital may only be made after 10 years.

7. Walter Douglas Stuber and Eric Street, "Brazil's Debt-Equity Swap Programme", *International Financial Law Review*, February 1988, pp. 33-35; Francisco Pinheiro Guimaraes, "Capitalisation Programmes: A Survey — Brazil", *International Financial Law Review*, January 1988, pp. 40-41.

In the case of the former, conversion of the proceeds into a foreign currency, after the 3-year period, requires deposit in a public sector bank until the 10-year period elapses⁸.

Undoubtedly, the shining light in DEC's has been Chile. In May 1985, Chile introduced a more comprehensive scheme than those then operated by Brazil and Argentina. Under this scheme, debt-equity conversions could be made according to the provisions of Chapters 18 or 19 of the *Compendium of Rules On International Exchange* issued by the Chilean Central Bank. Under the provisions of Chapter 18, the Central Bank holds a monthly auction at which local banks bid for the right to engage in transactions to convert a specific limited amount of foreign debt into domestic currency. The banks act as agents by assisting the holders of the foreign debt to convert it, with the consent of the local debtor, into cash or a peso-denominated asset which can be resold. These provisions were the first to permit a country's own residents to exchange foreign debt obligations purchased at a discount for domestic currency or instruments denominated in domestic currency. The proceeds of the conversion may be used to repay debts to local financial institutions, acquire assets of those institutions, or be held as an investment. Under certain conditions, the proceeds may be used to acquire equity in local firms without going through the auction process. It seems that several Chilean interests have used the provisions of Chapter 18 to repatriate capital sent out of the country as part of the capital flight of earlier years.

The Chilean scheme is still operating and by the end of August 1987 some \$2.1 billion worth of debt had been converted through these and related mechanisms. In September 1987, Chile's Central Bank announced an extension of the country's debt for equity scheme to allow the formation of foreign investment societies, whose funds — obtained through the purchase of discounted debt — could be invested in a range of Chilean shares and financial instruments⁹.

In 1986, three other countries introduced arrangements for making debt-equity swaps. The first, and probably the most significant, of these schemes came into effect in Mexico in May. Under the Mexican arrangement, the Bank of Mexico was empowered to

8. Rafael La Porta Drago, "Capitalisation Programmes: A Survey — Argentina", *International Financial Law Review*, January 1988, pp. 41-42; "Financing, Investing, Taxes and Banking Trends", *Business International Money Report*, June 6, 1988.

9. Imogen Mark, "Debt Business Boom in Latin America", *Euromoney*, September 1987, pp. 81, 85; "Focus on Finance", *Business Latin America*, July 20, 1987, "Debt-for-Equity Deals Play Integral Role in the Economy", *Chile Economic Report*, July 1988, pp. 3-6.

redeem foreign currency public sector debt at a discount related to the perceived utility to the economy of the proposed investment of the proceeds of the swap: the Bank of Mexico could purchase Mexican debt paper at face value when the domestic currency was to be used to acquire state-owned firms; at 95 percent of face value when it was to be used for investments that would create new employment and introduce new technology in a firm that exports 80 percent or more of its production; and at other fractions of the face value down to 75 percent. By mid March 1987 there were \$2 billion worth of applications outstanding while the authorities' stated policy was to limit the amount of swaps to \$100 million a month. However, Mexico closed its DEC "window" in 1988 for political reasons: concern about being overrun by foreign capital (control) and more inflation¹⁰.

In the Philippines, the authorities introduced in August 1986 a program for debt-equity swaps which was intended to provide incentives for investment in designated priority sectors, to reverse capital flight, and to reduce the burden of external debt.

In determining whether to approve proposals, the objective of the authorities was to ensure that the swap would increase the availability of foreign resources to the economy, rather than merely providing a means for converting at a more beneficial rate those funds already intended for investment in the Philippines.

In April 1987, the Venezuelan authorities issued a number of rules covering the conversion of public external debt into foreign direct investment. Essentially, conversion can be authorized if the proceeds are invested in import-substituting or export industries or in industries in one of 11 designated priority sectors. The proceeds can also be used to invest in enterprises in danger of being closed down. The rules limit profit remittances to a maximum of 10 percent of the converted debt during the first three years and to 20 percent plus LIBOR thereafter. No capital repatriation from converted equity is allowed during the first five years; afterwards, repatriation can be made in eight equal yearly installments.

A number of other nations are also introducing or considering debt-equity swap schemes. These countries include Colombia, Costa Rica, the Dominican Republic, Jamaica, Morocco, Nigeria, Peru, and Uruguay.

10. "Deals that are Making Dent in the Third World", *Business Week*, October 3, 1988.

4. U.S. Government Role

The U.S. government's concern over the debt problem of less developed countries is two-fold. First, there is concern about the strain which the debt burden places on newly emerging democratic governments and others who have traditionally been friendly to the U.S. Second, there is particular concern about the impact of LDC debt on the entire international financial system¹¹.

The cornerstone of the Administration's policy regarding Third World debt is the Program for Sustained Growth, articulated in 1985 by former Treasury Secretary James Baker. Commonly known as the "Baker Plan", it recognizes that the only viable (and sustainable) means by which borrowers can work their way out of their problems is by reestablishing growth in their economies, via sound economic policies including balanced government budgets and a dominant role for market forces and private enterprise. Options such as compulsory cancellation or forgiveness of debt is deemed unacceptable, since it would discourage further bank lending and indicate to borrowers that there was no penalty for continued unsound and ineffective economic policies¹².

Within this context, U.S. government policymakers regard debt-equity conversions as a preferable route to "debt relief" for the debtor nations, especially if combined with measures to encourage new equity investment (local and foreign) and the repatriation of flight capital. Such swaps are deemed supportive of efforts to open up the investment environment, thereby improving the prospects for growth¹³.

During the last two years, the Federal Reserve Board has liberalized Regulation K governing foreign investments of U.S. banking organizations. The regulations permit investments abroad by banks via debt-equity swaps in private sector non-financial companies in heavily indebted developing countries.

Banks, through a DEC, may own up to 100 percent of non-financial companies that are acquired from the government of a heavily indebted developing country. The amendment of February 24, 1988 provides bank holding companies with broad flexibility to make investments in up to 40 percent of the shares of any private sector company in

11. John C. Whitehead, Deputy Secretary of State, address before the Council on Foreign Relations, New York City, October 21, 1987.

12. *Ibid.*

13. David C. Mulford, Assistant Secretary of the Treasury for International Affairs, address delivered at the Euromoney Debt/Equity Swaps Conference, New York City, March 11-13, 1987.

a heavily indebted LDC. The amendment also substantially lengthens the permissible holding period for investments made through a DEC. Another liberalizing measure is the ruling by the Office of the Comptroller of the Currency (OCC-No-Objection letter No. 87-10, November 27, 1987) which permits a national bank to swap troubled foreign debt of one or more countries (countries A and B) for debt of another country (country C), and then to convert such debt into an equity investment in a private company in country C¹⁴.

5. Operation and Cases

Operationally, the DEC can be advantageous to a firm's competitive situation in the host country. To begin with, there is the obvious benefit of securing local currency at an exchange rate more favorable than the official one. Additionally, the firm may be able to penetrate previously protected markets; remit profit more easily, due to relaxed regulations; and, in general, enjoy more harmonious relations with the host government¹⁵. Unquestionably, an enormous financial advantage to the firm which uses the DEC is that their lower costs produce shorter payback periods and higher rates of return.

Multinational companies that have employed the DEC mechanism successfully are prone to be repeat users within the same country or in other nations. Whirlpool entered the Brazilian debt-equity market twice within six months in 1988, and other companies such as Westinghouse, Ford, Chrysler, Intel, Dow Corning, Alcoa, Heinz and Lone Star Industries have been active participants¹⁶.

The range of uses of the DEC is wide. Chrysler has used part of the pesos secured in swaps to pay down debt owed by its Mexican subsidiary. Nissan paid \$40 million for \$60 million in Mexican government debt and invested the proceeds in its Mexican subsidiary. Eastman Kodak and Unisys have used swaps to expand their Chilean operations. And in the biggest deal in Brazil, Chase Manhattan Bank converted \$20 million of its own debt and plowed the cruzados into Autolatina, a joint venture between the Brazilian operations of Ford Motor Co. and Volkswagen¹⁷.

14. For a thorough and scholarly treatment of debt-equity conversions and the total options for U.S. banking organizations in utilizing DEC mechanisms see Saturnino E. Lucio, II, "Debt-Equity Swaps and U.S. Banks," unpublished manuscript, Hornsby and Whisenand, Attorneys-at-Law, Miami, Florida.

15. Ganitsky and Lema, p. 21.

16. S.L. Mintz, "Dancing the Debt Swap Tango", *Corporate Finance*, September 1988, pp. 50-55.

17. *Fortune*, August 3, 1987, p. 92; *Business Week*, October 3, 1988; Jaclyn Fierman, "Faust Bucks in Latin Loan Swaps", *Fortune*, August 3, 1987, pp. 91-95; *Business Week*, October 3, 1988.

Few countries have been as aggressive (and more successful) as Chile in DEC promotion and execution. In one of the largest swaps on record, Carter Holt Harvey, a New Zealand forest products company, bought almost half of Copec, the largest private company in Chile and the owner of Celulosa Arauco y Constitución, the country's leading pulp manufacturer. Carter Holt paid for its stake with \$161 million of Chilean loans that it bought in the secondary market for \$114 million. Subsequently, Fletcher Challenge, another New Zealand company, negotiated a swap for 79,000 acres of Chilean trees¹⁸.

In July 1988, the Central Bank of Chile approved the biggest investment ever to be carried out through a Chapter 19 operation. The \$277 million initiative was undertaken by the Royal/Shell group of the Netherlands, Scott Paper Company (U.S.) and Citicorp (U.S.).

The deal included the purchase of a partially built wood-pulp plant from Papeles Sudamérica; the purchase of 94% of outstanding shares of Forestal Colcura S.A.; and development of a eucalyptus afforestation program through a new company, Forestal y Agrícola Monte Aguila Ltda.

The lump-sum investment will be channeled through a newly established firm, Forestal e Industrial Santa Fé S.A. The Royal/Shell group will invest \$162 million under the provisions of Chapter 19 of the Central Bank's Compendium of Foreign Exchange Rules and will own 60% of Forestal e Industrial Santa Fe S.A. Scott Paper Company and Citicorp will add the remaining \$115 million through the same Chapter 19 operation and each will own 20% of Santa Fé.

The investment will be completed with fresh capital which will bring the overall amount of the project to \$420 million. This investment is quite significant considering that forestry sector Chapter 19 operations total \$200 million since mid-1985¹⁹.

Brazil is also making progress in debt conversions. In March 1988, the Central Bank of Brazil introduced a "Dutch auction" system for converting \$150 million of debt per month²⁰. (Over \$750 million has been retired so far; "informals" — bypassing the Central Bank in favor of a Brazilian financier — have converted \$2 billion to \$3 billion

18. Fierman, p. 93.

19. *Chile Economic Report*, August 1988.

20. Mintz, pp. 52-53. Each Dutch auction begins with the Brazilian Central Bank's offer to swap one dollar in cruzados for one dollar in face value of debt, or zero discount. When the amount of foreign loans offered exceeds the amount that the country wants to buy, the Central Bank increases the discount one-half percentage point at a time until bids are in line with the limit. The smaller the discount, the better for the bidder.

of debt). Half of the debt converted through the Central Bank is earmarked for the more industrially developed areas of Brazil; the other half must be invested in the dry, poverty-stricken region of Northeast Brazil²¹.

Fletcher Challenge Ltd. recently used conversions to invest \$80 million in Papel de Imprensa S.A., a Brazilian paper company. Reynolds Metals Co. of the U.S. and five or six banks plan to build a \$55 million aluminum-can factory in a project financed largely through conversions.

Smaller countries are also keen on getting into the debt-equity game. Honduras has formalized a DEC program which has led to a number of successful swaps. For example, the New York - based American Pacific Mining Company used the proceeds of a DEC to secure working capital in a deal that included the acquisition of the Rosario Company, a subsidiary of the U.S.-based AMAX Corporation²². In Jamaica, Trelawny Vegetables, a subsidiary of Western Agri-Management International, was the first firm to use that nation's DEC program with a \$600,000 swap to expand an existing facility. Hanes Printables, a subsidiary of Sara Lee Corporation invested \$3 million — half financed via a DEC — in a T-shirt sewing plant²³.

6. Advantages and Limitations

As more and more governments entertain debt conversion programs and banks and investors give serious consideration to the DEC as a viable tool for commercial transactions, the pros and cons of swaps must be carefully weighted.

In general, proponents assert that the DEC provides debtor nations with much-needed foreign investment and reduces, albeit slightly, a country's debt burden without damaging the remaining creditworthiness of the nation²⁴. The DEC also contributes to efforts to privatize the economies of Third World countries. Critics argue that swaps simply offer investors bargain basement prices on investments they would have made anyway, and that this comes at the debtor nation's expense. Additionally, the local curren-

21. "Brazil Plunges into Debt-Equity Swaps", *Wall Street Journal*, September 9, 1988.

22. *Business Latin America*, July 11, 1988.

23. *Business Latin America*, March 14, 1988.

24. Samantha Sparks, "The Debt-Equity Swap", *Multinational Monitor*, April 1987, pp. 26-27.

cy printed by the central banks to buy the swapped debt adds to inflationary pressures²⁵.

Clearly, there are advantages and limitations in the structure of debt-equity conversions for all of the principal parties concerned²⁶. For debtor nations, the critical benefits of a DEC are reduction in principal and interest payments on hard currency - denominated debt; the attraction of foreign direct investment; and capital flight repatriation (Chile is the prime example). Additional benefits to the nation are a better balance of payments position, a smaller portion of export earnings directed to service debt, and the leverage to focus new investments in selected sectors, regions within the country, and export-oriented industries. (Brazil is a case in point.)

Disadvantages for debtor countries include inflationary pressures (due to increased capital inflows), loss of control of state-owned enterprises, conveyance to the international business community of an international rating which may be negative (heavily discounted, as in the cases of Peru and Zaire), and pressure to access the DEC window from firms already operating in the host country.

Banks and financial institutions derive a number of benefits from DEC's, such as an alteration in the make-up of the loan portfolio, an increase in the bank's short-term liquidity, and the opportunity to retarget lending towards more promising prospects. Banks furthermore decrease their vulnerability to default and currency risks and additional "emergency" (bailout) lending. These gains do not come without a heavy price, however. DEC's can produce large cash losses as the loans are discounted, dividend payments and investment activity decrease as reserves are mandatorily raised, and the entire loan portfolio of the bank may well be downgraded by the rating services (Moody's, Standard & Poor's).

As for investors, the DEC unquestionably offers an innovative and lower cost source of investment financing. It can put slow-moving or planned projects on a faster track, and expedite the implementation a firm's market entry, including access to commercial activities, resources, and sectors normally restricted to foreign investors. On the

25. Andrew Marton, "The Debate Over Debt-for-Equity Swaps", *Institutional Investor*, February 1987, pp. 177-178, 180.

26. For a detailed presentation of the legal, economic, and financial constraints of debt-equity conversions see Lee C. Buchheit, "Converting Sovereign Debt into Equity Investments", *International Financial Law Review*, September 1986, pp. 10-14. Ganitsky and Lema, *op. cit.* provide a schemata for grouping long - and short-term benefits as well as the costs to participate in swaps.

down side, there is increased exposure to political and economic risks and the likelihood that the firm's operational policies and administrative activities will have to be modified to accommodate a joint venture partner, if such is needed (or mandated by the host country government).

7. Prospects for DEC's

Debt-equity conversions and similar market-oriented approaches clearly have the potential to alleviate some of the severity of the debt problems gripping less developed countries²⁷.

The Baker Plan, calling for additional multilateral and commercial bank lending in exchange for market-oriented economic reforms by borrowers, and the Bradley Plan, prescribing a debt-forgiveness approach, have received wide attention. Recently, a provocative proposal has been put forth by James Robinson III, Chairman and CEO of American Express Corporation. He calls for the creation of a new organization — the Institute of International Debt and Development — which would purchase a large portion of existing debt based on the current market worth of each country's borrowings. In return, nations would receive long-term bonds to help revitalize their economies²⁸.

Still another debt conversion scheme is the mutual venture capital fund. Accordingly, banks sell their unwanted debt to the fund and receive in return equity in the fund equal to a small premium over the market price for the debt. The fund then utilizes the debt to invest in debtor nations via DEC's. Shearson Lehman Hutton in a joint venture with the International Finance Corporation, a World Bank affiliate, has set up a mutual fund/debt conversion program for the Philippines²⁹.

Two particularly creative approaches to debt conversion are debt-for-nature swaps and debt-for-education swaps. The former entails a bank selling or donating a heavily discounted portion of the debt to a conservation group that negotiates settlement terms with the debtor government³⁰. Bolivia, Ecuador and Costa Rica have already done DEC's with groups such as Conservation International, The Environmental Defense Fund,

27. Ali M. Parhizgari, "Debt Swaps: Innovative Proposals", *Economic Impact*, Vol. 2, 1988, pp. 42-46.

28. Larry Birger, "Presidential Candidates Should Be Stressing Latin Debt Problems", *Miami Herald*, October 24, 1988, p. 3.

29. Martin French, "Swapping Debt — Just Hot Air?", *Euromoney*, May 1987, pp. 115-122.

30. Barbara J. Bramble, "Swapping Debt for Nature?", *Hemisphere*, Vol. 1, No. 1, Fall 1988, pp. 6-7.

the Native Conservancy, and the World Wildlife Relief Fund³¹. The latter proposal, debt-for-education swaps, has not yet been implemented; however, it basically comprises the conversion of Third World debt held by U.S. banks to finance on-the-scene study by U.S. students and executives of the languages, cultures, and business practices of less developed debtor nations³².

Whichever debt conversion scheme is pursued, economic research indicates that for debtor nations swaps will only reduce foreign debts to a certain extent. Moreover, to maximize the positive effects of a DEC program, the restructuring of monetary policies and monitoring their effects are essential³³. As for the banking community, empirical evidence suggests that a commitment to debt equity conversion depends more on the political climate in the country concerned than on economic and financial factors³⁴.

For companies that have already determined to make an investment funded from abroad, the DEC is a "no-lose" situation; for the firm that invests because of a DEC, it will probably be in trouble even with a 25 percent return³⁵.

One can expect to see an increase in DEC's and their usage for the immediate future — and not only by U.S. banks and corporations. Japanese firms are accelerating their purchase of U.S. dollar — denominated debt to swap for local currency needed for investment projects; moreover, the Japanese Government is actively encouraging these activities, as evidenced by the ruling several months ago which exempts swaps from corporate taxation³⁶. Japanese firms operating in the Philippines, Mexico, and Chile should benefit significantly from this liberalization measure. For U.S. banks, the recent breakthrough in negotiating a financial package for Brazil points the way to a new philosophy and framework for restructuring and debt reducing efforts (e.g., the DEC)³⁷. The package combines substantial new money with significant debt reduction, thereby demonstrating that the two concepts are not mutually exclusive.

31. Roque Sevilla, "Conserving Nature, Reducing Debt", *Hemisphere*, Vol. 1, No. 1, Fall 1988, pp. 7-8.

32. Michael R. Czinkota and Martin J. Kohn, *Improving U.S. Competitiveness: Swapping Debt for Education*, A Report to the Secretary of Commerce, U.S. Department of Commerce, International Trade Administration, August 1988.

33. Wolfgang Spieles, "Debt-Equity Swaps and the Heavily Indebted Countries", *Intereconomics*, May-June 1987, pp. 120-123.

34. Blackwell and Nocera, p. 8.

35. Mintz, p. 54.

36. Bruce Roscoe, "New Profit From Old Losses", *Far Eastern Economic Review*, January 29, 1987, pp. 42-43; *Business International*, June 20, 1988.

37. William R. Rhodes, "An Insider's Reflection of the Brazilian Debt Package", *Wall Street Journal*, October 14, 1988, p. A 15. Banks began signing the Brazilian package on September 22, 1988. The package includes \$5.2 billion in new money to support the government's economic program to mid-1989. It also has the most comprehensive and innovative menu of options negotiated to date. One option is exit bonds. They can be converted from foreign-currency debt into local-currency obligations in the form of Brazilian treasury notes and also can be traded or converted into equity. Banks that do not convert will receive a fixed interest rate of 6% over 25 years, with 10 years' grace on principal.

EXHIBIT 1
SCHEMES FOR MANAGING INTERNATIONAL DEBT

Plan	Who's Doing it	How it works	Result
Debt-for-equity swaps	Mexico Chile Brazil Argentina Venezuela Ecuador Philippines	Banks sell loans to a third party, typically a multinational corporation, at a discount. The corporation exchanges the loans at the country's central bank for local currency, which it then invests in local industry.	Debt is extinguished, new investment may come into the country.
Debt-for-commodity swaps	Peru	First Interstate Bank's trading company subsidiary proposes to export Peruvian asparagus, shrimp and textiles and to keep part of the proceeds as debt payment.	Country's export industries are stimulated. Hard currency is preserved.
Factoring company	Japan	Banks sell Latin loans at a discount to a newly formed factoring company that restructures and collects debt.	Although banks book losses equal to the discount, they get tax deductions otherwise unavailable. Loans are removed from banks' balance sheets, freeing management time.
Exit bonds	Argentina	Banks agree to accept low-interest Government bonds in lieu of a portion of their existing bank debt.	Because interest on bonds is low, new money needs are cut so smaller banks can opt not to participate in the package.
Philippines Investment notes (P.I.N.s)	Philippines	P.I.N.s are local-currency obligations of the Filipino central bank that banks may accept in lieu of part of their interest. They may hold them to maturity, trade them at a profit or sell them to countries wishing to use them in debt/equity swaps. P.I.N.s will be structured to be attractive to banks.	Hard currency is saved. Investment rises through debt/equity swaps.
Retiming	Chile	Banks agree to accept interest once yearly instead of semiannual.	Country's foreign exchange needs are more easily managed.
Early-bird special	Argentina	Banks agreeing early to new loans get extra interest.	New loan packages are completed more quickly.

Source Multinational Strategies, Inc.

EXHIBIT 2
PRINCIPAL ACTORS AND THEIR ROLES IN DEBT-EQUITY CONVERSIONS

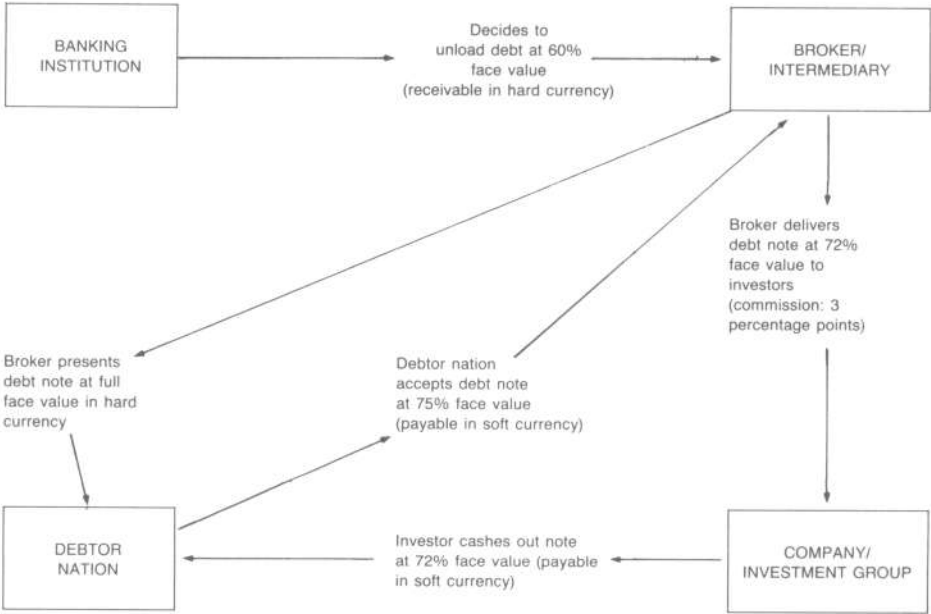
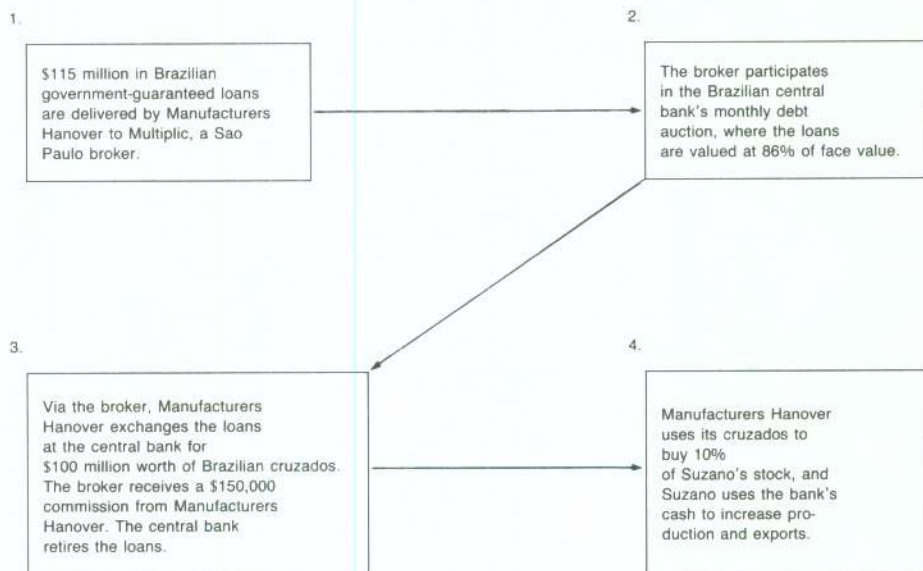


EXHIBIT 3
HOW A DEBT-EQUITY CONVERSION WORKS

Manufacturers Hanover Trust holds some \$2 billion. The bank decides to swap some of the debt for shares in Companhia Suzano de Papel e Celulose, a pulp and paper company:



Abstract

The continuing Third World debt crisis defies a comprehensive solution. As debtor nations and their creditors turn to narrower, alternative approaches, the conversion of debt to equity has emerged as a viable mechanism. This article examines the origin, function, benefits and limitations of these transactions, as well as the prospects for their growth and utility.

LES OUTILS FINANCIERS ET LES LIMITATIONS STRUCTURALES DE LA CONVERSION DE LA DETTE EN CAPITAL

RESUME

Crise devenue permanente, la dette du Tiers Monde continue de défier toute tentative de solution. Alors que créateurs et débiteurs travaillent en étroite collaboration à la recherche d'alternatives, convertir dette en capital (debt-equity swap), apparaît actuellement, comme étant le mécanisme le plus adéquate.

Cet article examine les origines, fonctions, bénéfices et limites de ces opérations, ainsi que la perspective de leur développement, alors que les besoins et l'utilisation de ces outils financiers s'accroissent.

