A Comparative Analysis of Debt Equity Swap Programs in Five Major Debtor Countries

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A Comparative Analysis Of Debt Equity Swap Programs In Five Major Debtor Countries

By DEREK ASIEDU-AKROFI


I. INTRODUCTION

Since the onset of the Least Developed Countries (LDC) debt crisis, developing countries have adopted various measures to meet their external debt servicing obligations. These measures include declarations of moratoria, debt exchange through collateralization, debt buy backs and debt-for-equity swaps. Of these, debt-for-equity swaps have become the most popular scheme for reducing debt servicing problems and attracting new investments. Several countries have either implemented formal programs or are in the process of doing so. Accordingly, the programs are the subject of extensive analysis and discussions.

A typical debt-for-equity conversion involves a purchase of interna-

1. Moratoria are the suspensions of debt servicing payments. Debt buy backs involve a repurchase by a country of its external debts at a discount. Chile and Bolivia are examples of countries which have used this debt reduction scheme. See, e.g., Truell, Chile Buy-Back of Foreign Debt at Discount Set, Wall St. J., Sept. 22, 1988, at 4, col. 1. Debt exchange or collateralization of debt involves the issue of new debt instruments in exchange for old debt. These exchanges usually involve the issue of zero coupon bonds as collateral for the new debt instruments. Mexico is one of the first countries to use this financing scheme. See Debevoise & Misback, The Mexican Exchange Offer, REV. OF FIN. SERVICES REG., 66 (Apr. 1988).

tional bank debt by a nonbank resident or nonresident investor. The purchase may be made on the secondary market or directly from the selling bank. The purchased debt is then converted into local currency. The proceeds from the conversion may be used to acquire approved equity investments or to extinguish local currency debts.

Rules of the debtor country govern the redemption of external debt claims. These rules may be the foreign investment laws, exchange control laws or special regulations promulgated to govern such transactions.

This Article examines the modalities for converting foreign debt into equity in Chile, Brazil, Argentina, Mexico, and the Philippines. It uses the common features of the various debt conversion programs to analyze their impact on the debt reduction efforts of these debtor countries and their economies at large.

II. SECONDARY MARKET TRADING OF LDC DEBT

Since 1982, a secondary market for trading developing country debt has emerged. The debts are sold at discounts ranging from twenty to ninety percent, depending on the extent of the country’s indebtedness. The debts of the fifteen most heavily indebted countries are sold at steep discounts in the secondary market.3

Trading in the secondary market has been slow due to a myriad of factors, including the increase in the loan loss provisions,4 and uncertainty regarding the impact that such transactions could have on the participating bank’s valuation of the remaining debts. The number and total value of the transactions are directly related to the economic developments in the debtor countries, their debt management policies (e.g. whether to impose a moratorium on debt servicing) and how these impact upon the creditor banks’ expectations, portfolio management strategies, and the attitude of bank regulators towards the balance sheet treatment of their outstanding claims. The uncertainty inherent in these factors has made the larger banks reluctant to engage in active trading in the market. The smaller European banks and the United States regional banks, however, have taken a keen interest in trading in the market and

3. See Watson, Mathieson, Kincaid, Folkerts-Landau, Regling, & Atkinson, International Capital Markets: Developments and Prospects, IMF World Economic and Financial Surveys 58 (Jan. 1988) [hereinafter International Capital Markets]. In late September 1987, the discount rate of the 15 countries averaged about 55 percent. The 15 heavily indebted countries are Argentina, Brazil, Columbia, Ecuador, Morocco, Peru, Uruguay, Yugoslavia, Bolivia, Chile, Cote d’Ivoire, Mexico, Nigeria, the Philippines, and Venezuela. Id. at 65.

4. Loan loss provisions refer to the practice of banks setting aside a certain portion of their earnings as reserves against their bad LDC debts. Id. at 63-64.
Debt Equity Swap Programs

have attempted to reduce their debt exposure by selling their debts. The total volume of trading has been estimated at between thirteen and eighteen billion dollars, a small amount when compared with the approximately 300 billion dollars of debt restructured since 1982.5

Trading activities in the secondary market for LDC debts have acquired a new impetus since Citicorp’s announcement on May 19, 1987, that it is increasing its loan loss reserves (approximating LDC debts) to about three billion dollars. This move has prompted similar action by the other money center banks and regional banks engaged in sovereign lending. These loss loans provisions against LDC debt increased the debt instruments available for conversion. Consequently, the prices of LDC debts on the secondary market declined. The increased provisions also meant an increase in the banks’ primary capital and a decrease in the size of their debt portfolios.

The secondary market’s operation has been enhanced by the active participation of several banks and investment firms which have developed expertise in handling transactions involving loan claims. So far, two variations of debt conversion have dominated the market. The first is a debt for debt swap among the commercial banks. This enables creditor banks to concentrate their holdings in one country or diversify their debt portfolios. The second type of transaction involves an outright sale of the debts for currency, which finances equity investments in the debtor country.

Other variations of debt conversion include debt for nature swaps, debt for bonds or securitization, and debt for export swaps. All of these have been used to a lesser degree.6

Smaller banks and regional banks no longer interested in lending to debtor countries welcome the growth of the secondary market for LDC

5. Id. at 58-59.

6. Debt for Nature Swaps involve the conversion of debts to local currency, the proceeds of which are used in the preservation and conservation of the environment. Countries which have implemented debt for nature swaps include Bolivia and Ecuador. See Evans, supra note 2, at 112. On the other hand, securitization involves the substitution of tradeable financial instruments for the debt of a country. Such financial instruments may be bonds. One example of a country which has securitized its debts is Nigeria. See WORLD BANK, ANNUAL REPORT, INTERNATIONAL BUSINESS CORPORATION DEBT EQUITY-SWAPS: HOW TO TAP AN EMERGING MARKET, 18 (1987) [hereinafter WORLD BANK]. Debt for Export Swaps involve creditor banks exporting domestic products of a debtor country to offset part of their outstanding claims against the country. Peru is an example of a country which has implemented such a program. Brazil is contemplating the implementation of a similar program involving nontraditional exports. See Brazil Debt Package to Offer Exit Bonds, J. of Com., June 24, 1988, at 7a, col. 3-4.
debt. This market offers them a way out of the restructuring bind\footnote{The restructuring bind refers to the frequent cycles of debt restructuring involving debtor countries and their creditors.} into which they have been cast.

\section*{A. Mechanics of Debt Equity Swaps}

A debt equity swap is a scheme through which the debt of a country is exchanged for local currency equity in a local company. The conversion of debt to equity is not a new development. In fact it was used prior to the 1982 debt crisis. In 1965, Brazil permitted some nonresidents to convert loans owed to them into equity investments at face value and at the official exchange rates.\footnote{Blackwell & Nocera, supra note 2, at 226.} Also, in 1980, Turkey enacted legislation to govern debt equity transaction. The Turkish scheme was aimed at settling some 1.4 billion dollars worth of foreign debt claims in arrears. Under the Turkish arrangement, creditors had the option of being paid in foreign exchange over a period of ten years or in local currency payable on demand. Payments in local currency could be used for a variety of transactions including the purchase of equity interests in government parastals or private companies.

Generally, debt equity conversions follow a basic pattern: a bank to which debt is owed sells the debt at a discount to the debtor country or to a private investor. After purchasing the debt paper, the investor presents it to the central bank of the debtor country, which then converts all or part of the loan paper at the prevailing exchange rate into the domestic currency at near face value. The investor uses the converted funds to acquire an equity interest in a government or privately owned corporation. The redemption of loan claims for local currency is subject to a number of conditions. The most common condition requires that the redeemer use the converted funds to finance approved investments. The redemption of the loan claim at a discount enables the investor to obtain local currency at a lower foreign exchange outlay than otherwise possible.

Debt equity swaps are commonly classified into three types. The first involves the exchange of government or public sector debt for equity in a private sector project, the second involves trading a private company's debt for an equity interest in that entity, and the third involves the trading of government or public sector debts for equity investments pursuant to a privatization of public sector industries.

In order to implement a debt equity conversion program, it is neces-
Debt for the debtor country to obtain waivers of the sharing,\(^9\) prepayment, and *pari passu* clauses\(^10\) in the agreements governing the debts to be converted. This is important because payment prior to the stipulated original maturity date can trigger mandatory prepayment clauses, obliging a borrower to prepay *all* creditors pro rata if he prepays any creditor. Failure to seek the requisite waivers may also trigger the *pari passu* and sharing clauses in other loan agreements. Furthermore, debt to equity conversion schemes may result in preferential treatment of participating creditors. This may be through a steady stream of payments of principal and interest or dividends on their investments albeit in local currency. In the absence of the requisite waivers, nonparticipating creditors may invoke the sharing provisions, which would compel the participating creditors to share such payments pro rata with the nonparticipating banks. To avoid this, the creditors participating in “new money” and debt restructuring arrangements require the imposition of certain restrictions on repatriation of profits by the borrowing country.

### III. SURVEY OF COUNTRY PROGRAMS

#### A. Chile

Prior to the implementation of a formal debt conversion program in Chile, there had been a limited form of debt conversion\(^11\). The Chilean program was first instituted in May 1985. Its primary objectives are to reduce Chilean external debt and take advantage of the discounts offered on the depreciated loans.\(^12\) Under the program, debt equity conversions are negotiated on a case by case basis with investors.

The two principal provisions governing debt equity swaps in Chile are Chapters XVIII and XIX of the Compendium of Foreign Exchange Regulations of the *Banco Central de Chile* (Central Bank). Chapter XVIII permits both natural and juristic persons, be they residents of Chile or not, to acquire Chilean foreign debt instruments, which have an

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9. Sharing clauses or provisions are common clauses found in syndicated loan agreements which provide for pro rata sharing of payments received above the agreed payments by all the syndicate banks. *See* White, *Sharing Clauses in International Loan Agreements*, in *Prospects for International Lending and Reschedulings* §§ 23.01-23.07 (J. Norton ed. 1988).

10. *Pari Passu* clauses are clauses which ensure that all creditors receive equal treatment from the debtor. This is a common feature in syndicated loan agreements. *See* P. Gabriel, *Legal Aspects of Syndicated Loans* 62-64 (1986).

11. This refers to the few cases of debt conversion which had taken place since 1977. Blackwell & Nocera, *supra* note 2, at 227.

extended or original maturity of more than 365 days, from a Chilean debtor (directly or through an agent). The debt eligible for conversion under Chapter XVIII includes both private and public sector debt (i.e., Central Bank debt, State Bank (Banco del Estado) and private bank debts and public and private company debts). However, conversions under Chapter XIX include only Chilean external debts acquired by foreign investors.

1. Chapter XVIII Investments

Chapter XVIII governs investments by Chilean nationals. Its provisions were the first to permit Chilean nationals to buy the country’s external debts at a discount and exchange them for local currency or debt instruments denominated in local currency. Under Chapter XVIII, a buyer, acting through a financial intermediary, seeks Chilean debt for sale at a discount and negotiates an agreement to purchase the debt instrument. The foreign debt instrument is redenominated at face value into pesos at the official exchange rate. On the authority of the buyer, the Chilean debtor collects the redenominated face value amount in cash or exchanges it for a new debt instrument payable in pesos on terms mutually agreeable to the parties. The Chilean debtor must submit a sealed bid to the Central Bank stating the total face value of the debt that the buyer is willing to pay for the debt, in addition to a commission payable to the Central Bank for the conversion of debt into local currency. Also, there is a twenty percent value added tax on the commission.

The Central Bank sets preallocated ceilings for all debt conversions, usually approximately forty to sixty million dollars per month, taking into consideration market conditions and demand. These factors influence the number of bids which are eventually selected for the fortnightly auctions. If the bid is deemed acceptable, the Central Bank notifies the seller (the Chilean debtor) and debits the account of the Chilean Bank chosen to handle the transaction. The buyer, acting through its agent, buys the foreign denominated debt obligation from the foreign creditor with a one percent commission for the agent. The foreign denominated debt instrument is then submitted to the Chilean Bank for conversion into pesos at the official exchange rate and redeemed at a value equal to the original value of the debt. This is done in accordance with the prior sale agreement between the seller (the Chilean debtor) and the buyer.

13. See id. at 25. At the inception of the debt conversion program in June 1985, a monthly ceiling of about 30 million dollars was established and the participation of local banks was limited to 5 percent of their capital and reserves. This ceiling was later changed in July 1986 to about 60 million dollars and later reduced to 10 to 20 million dollars. Id.
The Chilean Bank issues the buyer a new debt instrument and the original debt is cancelled.\textsuperscript{14}

2. Chapter XIX Investments

Conversions under Chapter XIX involve the acquisition by foreign investors of Chilean external debts. Once the external debt is acquired the investor then submits an application to the Central Bank for the conversion of the foreign-denominated debt instruments into pesos. The application should state the nature of the investment to be funded by the converted debt. Typically, the investment must not be of a speculative nature. When Central Bank debt, new money or restructured debt is involved, the Central Bank will issue the investor dollar-denominated debt instruments which are payable in pesos. These can be converted into inflation indexed \textit{Unidades de Fomento} (UFS)\textsuperscript{15} within eighteen months. Alternatively, the investor may convert the UFS, when it is ready to make its investments, by selling them on the secondary market. When the debt involved is not Central Bank debt, then the obligor must sanction the redenomination of the debt into pesos and the prepayment of the debt.

Repayment may be made by either promissory notes or cash (pesos). The method of payment and the discount obtained on the sale are usually negotiated between the debtor and the note holder. This is one feature which distinguishes the Chilean program from the Mexican program. While the former exchanges debt at a negotiated discount, the latter does so at a fixed discount. The only exception to the use of a negotiated discount under the Chilean program is when the Central Bank is the obligor. In that case, the debt is redeemed at one hundred percent of its value in local currency.

3. Restrictions

Despite the liberal rules governing debt conversion in Chile, there are a few restrictions. These relate to the divestment, remittance of profits and dividends, and repatriation of capital. Dividends accruing from debt conversion may not be repatriated for four years. Similarly, capital

\textsuperscript{14} Proceeds accruing from debt conversion may be used in repaying debts owed to domestic financial institution or held as investment. It is also possible to acquire equity in local firms without going through another process. The regulations under Chapter XVIII permit the repatriation of capital lost through capital flight of previous years. Chapter XVIII does not provide any list of projects in which converted funds may be invested.

\textsuperscript{15} Inflation indexed UFS are local financial instruments taking into consideration the inflation index.
repatriation is not allowed within the first ten years. An investor may divest and invest in another venture with the permission of the Central Bank, but the capital cannot be repatriated until the expiration of the ten year period. This "lock in" provision is aimed at ensuring that foreign exchange remittances are made on the same terms as the restructured debt. Any local currency obtained through debt conversions may only be used for approved investments.

In September 1987 the Chilean debt conversion scheme was expanded to allow the formation of foreign investment societies. These societies are funded through the purchase of discounted debt and investments in Chilean shares and financial instruments. The societies are expected to hold sixty percent of their portfolios in shares of publicly quoted companies and the rest in local bonds. One significant restriction on the investment societies is that they are not permitted to hold majority shares in any company.

4. Decree Law No. 600 Investments

This is the principal foreign investment law in Chile. Investments under Decree Law No. 600 anticipate the infusion of new foreign exchange investments or physical assets. Section 2(e) of the decree authorizes debt conversion. This conversion can only be carried out if the investor specifically requests it. In such a case the investor and the Secretariat for the Foreign Investment Committee negotiate the terms which amend the original investment agreement. The amendment must include an extension of the three year limit on remittance of profits and repatriation of capital (as contemplated under the original Decree Law No. 600), and investment for four and ten years, respectively, as required of Chapter XIX investments. The different treatment of investments under Decree Law No. 600 and Chapter XIX is based on the fact that investments under Decree Law No. 600 are more beneficial because they involve new foreign exchange. Investments under Decree Law No. 600 are governed by agreements between the State and the investor, while investments under Chapter XIX are governed by a Resolution of the Executive Committee of the Central Bank. These differences affect the degree of protection enjoyed by each investment. According to Francisco García, investments under Decree Law No. 600 "are considered more traditional and [therefore] rank higher in the view of the OPIC [Oversees Private

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17. García, Foreign Debt Conversion In Chile, in GUIDE TO DEBT EQUITY SWAPS, supra note 2, at 29.
Investment Corporation], the EDC [Export Development Corporation], and the ECGD [Export Credit and Guarantee Department].”

Decree Law No. 600 also gives the investor the option of choosing between two regimes of tax rates namely, rates generally applicable to Chilean nationals or a fixed tax of 49.5 percent for ten years. Investments under Chapter XIX, however, are all taxed according to the rates generally applicable to Chilean nationals. When the investment under Decree Law No. 600 exceeds fifty million dollars, the fixed tax rate is guaranteed for twenty years instead of ten years and the proceeds from the investment are placed in a special escrow account overseas. This safeguards the investors from shortage of foreign exchange when remittances have to be made.

It is important to note that Decree Law No. 600 offers better protection against exchange risks because it allows investors to use the Central Bank’s currency swaps. Foreign bank investors are allowed to freely engage in foreign exchange transactions.

5. Results

Between June 1985 and May 1987, Chile’s external debt was reduced by about 1,888 million dollars. Of this amount, 155 million dollars represents debt capitalization under Section 2(e) of Decree Law No. 600; 714.1 million dollars represents Chapter XVIII (and Appendix 4) investments; 483.6 million dollars represents Chapter XIX investments; 68.3 million dollars accounted for portfolio swaps and 467.4 million dollars represents changes in debtors and repayments by debtors. By the end of May 1987, Chile’s external indebtedness was reduced from 19,342 million dollars to 19,126 million dollars. This represents a significant decrease in Chile’s total external indebtedness. It has been estimated that the debt conversion program saved Chile some 132 million dollars in interest payments up to May 1987. This represents approximately seven percent of both the medium and long term annual interest payments. Also, it is estimated that in 1986 about 385 million dollars in Chilean capital invested abroad was repatriated through Chapter XVIII investments.

18. Id.
19. See id. at 30.
20. Id.
21. Id.
B. Brazil

Brazil was the first country to institute a debt equity swap program after the onset of the 1982 debt crisis. The program began as part of a rescheduling package in 1983 as an attempt to reduce Brazil's external debt and to attract foreign investment. Under this scheme, private sector borrowers were required to deposit the cruzado equivalent of their foreign currency debts with the Central Bank as the loans became due. Some creditors reloaned those funds in Brazil, or bought equity interests in local companies, while others sold their loans, and the right to use the local currency deposit, to multinational corporations or institutions interested in investing in Brazil.

The Central Bank imposed restrictions on the repatriation of capital and dividends. Repatriation of capital was not allowed before the scheduled date of repayment of the loan. Remittance of profits from the investment was not allowed to exceed the interest payments on the original loan. In 1984, the Brazilian authorities limited authorizations for debt equity swaps to the original creditors due to the government's concern that the program's restrictions would hamper direct investment.

Between 1983 and mid-1987, about two billion dollars of Brazil's external debt was converted into equity. In February 1988, the original debt equity swap program was suspended and a new program was instituted. Its object was to increase the volume of transactions. In the first quarter of its operations, Brazil's external debt was reduced by over 500 million dollars.

The principal regulation establishing the debt equity swap program in Brazil is Central Bank Resolution 1416, issued on November 17, 1987. Under the new debt conversion program, all of Brazil's external debt which is subject to restructuring is eligible for conversion. The eligible debt includes medium and long term credits (registered with the Central Bank) arising from loans and financing which are foreign currency deposits with matured interests and principal, and other foreign currency deposits held at the Central Bank. The ineligible debt includes interest on foreign currency deposits as of February 20, 1987, as required by Res-

24. Brazil has since changed its currency twice, first to cruzado and more recently to new cruzado.
25. Id.
26. Id.
solution 1263 which suspended the remittance of interest on external loans.

1. Eligible Investors

The program recognizes two classes of investors: original creditors and assignees. Original creditors who are party to any restructuring agreements are required to obtain amendments to any existing restructuring agreements to modify the prepayment and sharing clauses and to provide for the securitization of Brazil's external debt. Assignee investors must ensure that the assignor creditor has obtained the necessary modifications. Once the necessary modifications are obtained, Brazil issues bonds on the international financial market. The conversion is subject to the following conditions: (1) with respect to Central Bank debt, the creditor is expected to purchase Brazilian bonds; (2) where the eligible debt is owed by debtors other than the Bank, the creditor parties to the restructuring agreements assume the responsibility of obtaining the necessary modifications to the agreement; and (3) when assignees hold any eligible debt, the original creditors assume the commitment to obtain the necessary modifications to the agreement.

2. Restrictions

The Central Bank is vested with authority to limit the amount of debt converted by any creditor. The exercise of this power is influenced by the value of the bonds subscribed to by the creditors. There are also restrictions on the transferability of investments. The permissible period for the transfer of investments is twelve years starting from the date of the investment. Remittance of profits and dividends accruing from the investment is not allowed within the first four years of the investment. Additionally, investments in certain sectors of the economy are restricted. They include public utilities, communications, mining, banking and finance, informatics, transportation, and agriculture. Conversion is not allowed when it would result in direct or indirect foreign control of a Brazilian company. Similarly, if the conversion involves a repayment from public funds, or if the investors or any entities controlled by them have, in the thirty-six months prior to the application for conversion, remitted capital or capital gains, conversion may be denied. However,

29. Stuber & Street, supra note 27, at 34.
30. Id. at 33.
if the remitted capital or capital gains is returned to Brazil for reinvestment, the conversion will most likely be allowed.

The proceeds of any debt conversion may not be used by the investor or any entities controlled by it to acquire any foreign investment. However, they may be used to fund new projects, expand existing ones, or be invested in Foreign Capital Conversion Funds which are governed by different rules. The proceeds of the conversion may also be used to extinguish any outstanding medium or long term credits registered with the Central Bank or loans covered by MF Advice No. 309 of August 29, 1983 and its successors. The later includes loans granted by the Central Bank to public sector entities with the approval of the Finance Ministry to repay loans or financing guaranteed by Brazil.

3. Procedure

The conversion of debt to equity is done through an auction. The Central Bank has established two ceilings for the bidding. One permits fifty percent of the aggregate amount earmarked for the bids to be allocated to specific projects in particular developments areas, i.e., projects under the control of the Development Authority for the Amazon (SUDAM) and the Development Authority for the Northeast (SUDENE), in Espirito Santo and in the Jequitinhonha valley. The other is for investments not located in special development zones.

4. Eligible Debt

Both public and private sector debts registered with the Central Bank are eligible for conversion, but they also require government approval. Public sector debts are comprised of the debts of public corporations or entities registered in their name at the Central Bank. These entities include the States, the Union, the Federal District, the territories, agencies and instrumentalities, mixed-economy companies and foundations, and any loans contracted under Resolution 63 of August 21, 1967. Resolution 63 permits Brazilian banks to borrow from foreign
financial institutions and also relend the proceeds to the final borrowers — public corporations.

Private sector debts are debts of private sector companies and, like public sector debts, these debts must also be registered with the Central Bank. Private sector debts can be converted into equity investments in other private sector companies or public sector companies. This is also true of deposits made at the Central Bank and governed by Circular 230 of August 29, 1974, and Resolution 432, June 23, 1977. These conversions are also subject to ceilings set by the Bank.

5. Foreign Capital Conversion Funds

Proceeds accruing from the conversion of funds owed by or deposited with the Bank may be used to purchase securities on the domestic capital market or via Foreign Capital Conversion Funds. In Brazil, “securities are considered as shares, founders’ shares and debentures, and their respective coupons, certificates of deposit of securities and any other securities created or issued by Brazilian corporations at the discretion of the CMN.”

Foreign capital investment funds are one of the investment opportunities open on the Brazilian domestic capital market. The principal regulations governing Foreign Capital Conversion Funds are the provisions of Attachment 11 to Resolution 1289, March 20, 1987. Attachment 11 contains the operative rules for the incorporation, operation, and management of Foreign Capital Investment Funds. Prior authorization of the Securities Commission (CVM) is required for the formation of a Foreign Capital Conversion Fund. Such funds are not allowed to have more than five percent of the voting capital, or twenty percent of the total capital, of any particular company in its portfolio. Foreign Capital Conversion Funds are not granted any favorable treatment. Any income distributed to the foreign quota holders is taxed.

Compared to Chile, the Brazilian debt conversion program has many restrictions. It is yet to be seen whether this will influence the inflow of foreign investment.

C. Argentina

Argentina’s debt equity swap program was first announced in June 1986 and was instituted pursuant to Ministry of Economy (ME) Resolution 520 on June 24, 1987, and Central Bank Circular A 1035, dated

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37. Id.
38. Id.
June 1, 1987.\(^{39}\) The program was modified in October 1987.\(^{40}\) The modification adopted a more pragmatic approach towards issues such as matching funds. Under the old program, a foreign investor had to invest a dollar for every dollar of debt converted. Under the amended program the matching funds requirement is relaxed, to approximately thirty percent of the investment. Additionally, the matching funds are not required to be in foreign exchange. The original Argentine program was considerably more restrictive than either the Chilean or the Brazilian program. This was due to three main factors: (1) fear of the program's effect on monetary and fiscal policies; (2) political opposition arising from nationalist groups who argued that the program was a ruse designed to exchange non-performing debts for viable Argentine assets; and (3) concern about the possible increase in Argentina's domestic debts. Because of these factors, "the agreed programme . . . [was] almost entirely based on the . . . government's proposal, [and was] designed to meet these misgivings."\(^{41}\)

1. Eligible Debts

Under Circular A 1035, all private and public sector debts are eligible for conversion except short term trade credits, alternative participation instruments (API's), and debts owed to official agencies or guaranteed or insured by official Argentine agencies. Some types of debts require the fulfillment of certain conditions before they can be converted.\(^{42}\) For example, promissory notes issued or held in connection with guaranteed private sector debts must have the guarantees cancelled before they can be eligible for conversion under the program. Similarly, private sector debts carrying foreign exchange coverage must also have the coverage cancelled before being converted. Private sector borrowers seeking to convert their debts must obtain the consent of all their creditors and the Central Bank, to avoid possible breaches of any of the terms of the loan agreements.\(^{43}\)

The conversion of public debts covers the following: (1) nominative bonds in dollars; (2) obligations of the national government in dollars; (3)

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39. For details of the Argentine Program, see Joint Communique No. 7691 of the Ministry of Economics. See also Report 1104, supra note 2, at 182-91; Cárdenas, supra note 2, at 32-34; World Bank, supra note 6, at 95-105.
41. Report 1104, supra note 2, at 182.
42. Id. at 183-84.
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interim obligations of the national government in dollars; (4) external bonds of the Argentine Republic; (5) other foreign loans granted to the national government; (6) credit and deposit facilities for current deposits at the Central Bank; (7) Central Bank obligations in dollars and interim obligations in dollars; (8) medium term loans granted to the Central Bank; (9) other foreign debts of the Central Bank; (10) guaranteed public sector refinanciation contracts; and (11) other foreign obligations of the public sector, excluding short term commercial obligations and credits which have been granted or guaranteed by foreign official offices.\textsuperscript{44} Circular A 1109 allows creditors of such securities to present them to the Central Bank and request the Bank, at the order of an investor, to invest converted funds in an approved project which has been favored in the bidding system.\textsuperscript{45} The proceeds of the conversion may be used in financing up to about seventy percent of the total cost of an approved project. This percentage excludes the costs of imported equipment. The remaining thirty percent may be financed in foreign exchange, australs\textsuperscript{46} or by third parties.

2. Eligible Investments

Eligible investments are governed by Article 4 of Resolution (ME) 922. They include: (1) purchasing new equipment; (2) building new industrial plants or expanding existing industries with a view to increasing their current productive capacity; and (3) any other investments which increase productivity, efficiency, the supply of goods and services, and contribute to improving the country's balance of payments. Eligibility is determined by the Under Secretariat for Economic Policy (UEP) within forty-five days of receiving all the necessary information relating to the project. The list of eligible investments is fairly general, the purpose of which is to attract investments which will contribute to increased production and supply of goods for export.

Like the Chilean program, the Argentine program is accessible to local and foreign investors alike. Both investors are subject to the same regulations but foreigners must also comply with regulations laid down in Foreign Investment Law 21,382, as amended by Law 22,208.\textsuperscript{47}

Despite the general nature of the description of eligible investments

\textsuperscript{44} BCRA, supra note 40.
\textsuperscript{46} Australs is the currency of Argentina.
\textsuperscript{47} It permits a wide variety of foreign investment including capitalization of eligible foreign debts. See Cárdenas, supra note 2, at 32.
under the program, some projects are specifically excluded. These in-
clude: (1) the acquisition of real estate; (2) quotas, shares, and other
corporate participations; and (3) the acquisition of movable assets such
as those previously installed in other industrial plants. Also, projects
generally requiring government incentives such as tax and other benefits
are excluded from the program, except for the importation of capital
goods under Decree 515/87. In that case the company must provide
matching funds on a one to one basis. Also the goods must be financed
for a term of six years with a four year grace period.

3. Conversion Process

When a project is approved as an eligible investment by the UEP,
the investor must participate in a monthly or bimonthly bidding organ-
ized by the Central Bank to award the debt conversion funds. Annual
quotas and monthly or bi-monthly debt limits are determined by the
UEP in conjunction with the Central Bank. The Central Bank reserves
the right to increase the limits when necessary to cover approved
projects.

The process of debt conversion begins with an investor presenting a
proposal to the UEP in the Ministry of Economy for approval. This is
followed by a conversion request made by an investor or a bank interme-
diary acting on behalf of an investor to the Central Bank. The conver-
sion request should be accompanied by documentation showing the
availability of matching funds, at least up to the amount of debt to be
converted, a description of the matching funds, a conversion guarantee (a
guarantee that the eligible debt and the matching funds will be provided),
and an unconditional written acceptance of the regulations governing the
debt equity swap program in writing.

The required matching funds must comprise fresh funds provided
by the investor. Those funds are funds not obtained under the swap pro-
gram. They include, inter alia, long term private loans with a minimum
term of six years and a grace period of four years, foreign exchange
denominated bonds (Bonex bonds) used by companies to remit their
funds overseas, funds obtained from multilateral agencies such as the In-
ternational Finance Corporation and the Inter-American Investment
Corporation, and up to fifty percent of other funds obtained outside the
country and used in financing imports into Argentina.

The conversion guarantee amounts to one percent of the debt to be

48. Res. ME 922 art. 2.
49. R. Werrett, supra note 12, at 66.
converted. The conversion guarantee may be made either by a deposit in a bank authorized to deal in foreign exchange or by a bank guarantee. In the case of the former, the funds are held as a reserve requirement at a nonregulated interest rate.

All conversion requests are subject to a public bidding held every two months, during which all projects are considered on a case by case basis. Every bid is assigned a certain number of points. The points are based on the type of debt converted and the proportion of matching funds provided. In the event that the bids exceed the bimonthly quota, priority may be given to bids involving greater percentage of matching funds.

Within four days of bidding, investors are notified of conditional acceptances or rejection of their proposals. In the following fifteen days, the investors are required to file the securities to be converted with the Central Bank. It analyzes them and within six days of its analysis gives the investor notice of a definite award.

Three days after the definite award is made, the BCRA converts the securities, less the commissions and discount received. The resulting amount is then deposited in a local bank in the name of the investor. The investor has the option of receiving interest on the deposit according to a financial index established by the Central Bank, at the prevailing market rate or at the Libor rate. When the conversion request is rejected, the “conversion guarantee” funds are returned to the investor with interest at a nonregulated rate or at a rate indexed to the official exchange rate. These deposits may be assigned to a firm in which the investment is to be made.

The local currency is disbursed according to a schedule presented as part of the project proposal approved by the Ministry of Economy. The bank intermediary informs the Central Bank that the funds have been used for the project as indicated in the schedule.

4. Restrictions

Like the other programs, the Argentine program also has some restrictions. For example, the capital investment participations accruing from the conversion of public external debt securities may not be sold or assigned to other investors within the first three years of their conversion.
Also, the capital may not be repatriated during the first ten years of the investment and profits may not be remitted within the first four years of the investment. But if the investor assigns participation after the first three years and before the expiration of the ten years repatriation restriction, the investor is entitled to purchase foreign currency provided that the investor establishes a fixed term foreign currency deposit with an official bank. The deposit covers the remaining period of the repatriation restriction.

To facilitate effective record keeping, the UEP has established a Registry of Investments under the Conversion of Public External Debt Programme (Codex registry). This registry is independent of the Registry of Foreign Investments. It records all investments made by both local and foreign investors using funds from debt conversions. It also monitors all assignments or modifications in shareholders participations, and performs any other activities which the UEP considers necessary.

In conclusion, the Argentine program “is endowed with modest objectives that suggest its use will be limited. However, on the plus side, the investment criteria are broad and the program may be used by Argentine citizens who wish to convert their own debt instruments.”

D. Mexico

The Mexican debt conversion program was first authorized in April 1986. Although the primary object of the program was to “cancel public sector debts, reducing the government’s foreign debt servicing costs,” the Mexican government is promoting the mechanism primarily as an incentive to investors.

The conversion process begins when a prospective investor files an application to participate in the debt capitalization program, acting by himself or through a bank intermediary. The application is accompanied by a processing fee which is about 0.25 percent of the face value of the debt to be converted. The applications are submitted to the Public Credit Directorate of the Ministry of Finance, which reviews them and then forwards them to the National Foreign Investment Commission with a recommendation for approval. Although the Commission is not bound by the Ministry’s recommendations, it usually approves projects based on its recommendations. Upon approval, the Ministry of Finance issues an official letter of agreement stating the amount, the terms, the

53. R. Werrett, supra note 12, at 37.
54. Report 1104, supra note 2, at 102.
55. The fee used to be about 85,000 pesos.
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origin of the debt paper, and the discount at which it was exchanged. The investor purchases the debt from the bank creditor and the debtor is then discharged of his obligations to the creditor. The Ministry of Finance informs the bank creditor of the exchange and requests cancellation of principal and the termination of interest payments. To obtain the debt instruments for conversion, two formal agreements are necessary. The first is a stock purchase agreement, which is between the appropriate Mexican government agency, the debtor, and the Mexican company in which the investment is to be made. The second agreement is between the investor and the bank holding or selling the debt paper.

Following the approval of the project, the project is ready for the exchange of the foreign denominated debts into \textit{pesos}. The eligible debt for the transaction is obtained on the secondary market or from a bank. The conversion may also be arranged by a bank intermediary acting on behalf of an investor. Bank intermediaries charge fees which range between four percent of the exchanged debt to a flat fee of about twenty thousand dollars. The active bank intermediaries in Mexico include \textit{Banco de Comercio} (Bancomer) and \textit{Banco Nacional de Mexico} (Banamex). These banks act in conjunction with foreign financial services firms. The debt paper is converted at a rate equal to the average of the bid and offer rates issued by Mexican commercial banks in Mexico City at the beginning of the business day on which payment is to be made.

The proceeds of the conversion are kept in a controlled account held by the Ministry of Finance. Such funds earn interest at the rate of Current Mexican Treasury Certificates (Cetes). The Ministry of Finance disburses the funds in accordance with a schedule contained in the approved application. It pays the funds directly to the investors, creditors, suppliers, and other beneficiaries for any services provided. Creditors are expected to issue receipts covering any transactions between them and the investor. All such receipts and invoices are submitted to the Ministry for approval. The receipts must correspond to a budget line item in the approved conversion application.

1. Eligible Investments

Eligible investments under the program are prioritized by the gov-

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56. See Report 1104, supra note 2, at 103; R. WERRETT, supra note 12, at 46-47.

57. For example, Sherson Lehman Brothers works closely with Banamex, and Libra Bank also works closely with Bancomer. Other foreign banks which have been active in swap transactions in Mexico include Deutsche Bank, Chemical Bank, Citicorp, and Manufacturers Hanover.
High priority projects include privatization of state-owned companies. These are referred to as category O investments, and include, *inter alia*, export-oriented investments, investments in high technology and investments in manufacturing, with a higher percentage of domestic content. Investors in high priority projects are allowed to redeem the debt at full face value. On the other hand, debt conversion for low priority investments are allowed at seventy-five percent of their full value in *pesos*. It is important to note that the discounts are not on the original value of the dollar denominated debts as quoted on the secondary market. Instead they are on the full face value of the debt in *pesos*.

Most of the large swap transactions that have taken place have been category three transactions. These transactions permit the redemption of debt at an eight percent discount. This category is composed mainly of investments in high-technology, in the manufacturing sector, and industries relocating to designated development zones outside large Mexican cities. During the first phase of the program, the Mexican authorities approved 110 million dollars every month for swap transactions.

In 1987 a temporary ceiling of 1.5 billion dollars was set for debt conversion. In March of that year, the Mexican government suspended the program. The suspension was carried into effect before the signing of a new money agreement involving twelve billion dollars in new commitments. During the negotiation of the new money agreement, the Mexican government used the program as leverage to obtain cooperation from recalcitrant bank creditors. It threatened to exclude such banks from participating in the conversion process by declaring their debts ineligible for conversion and also by denying them any role as agents or intermediaries for potential investors. Fortunately, the threat was not carried out. Instead, the government used the program to increase equity capital in the private sector. So far, large multinational corporations such as Volkswagen, Chrysler, Nissan, and Ford, all private sector manufacturing industries, have used the program to expand their activities in Mexico. The largest conversion was made by Volkswagen, which exchanged 141 million dollars of Mexican government debt, valued at 85 million dollars on the secondary market, for 125 million dollars worth of *pesos*. The transaction was arranged by Deutsche Bank on December 5, 1986. Nissan exchanged sixty million dollars in Mexican government debt to expand its plant in Mexico.

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59. *Id.* at 104-05.
60. *Id.* at 105.
Debt swaps have also been used in moderate amounts to expand Mexico’s tourist industry. For example, Club Med is financing a new hotel in Huatulco through a swap transaction involving three million dollars. In another hotel venture, Somex, a Mexican state investment Bank, and Japan Airlines are financing a hotel (Hotel Nikko) through a joint venture.

Privatization of government industries has also been carried out using debt swaps. Komatsu, a Japanese tractor company, used a swap transaction to increase its shares in Dina-Komatsu, a joint venture with a Mexican State company. Heavily indebted Mexican private sector companies have also participated in the debt equity swap program. One of the largest participants is the Alfa Group, Mexico’s most profitable private sector company in 1978-81. An agreement in principle has already been reached between the Alfa Group and its foreign creditors. Under that agreement, 920 million dollars of the group’s debt will be traded for 25 million dollars in cash, 200 million dollars in Mexican government debts, and forty-five percent of the group’s equity shares. Plans are also under way to exchange the foreign debts of other private sector companies for equity shares in several other companies.

To facilitate the repayment of private sector debts, the government of Mexico has established a trust fund called ficorca, which guarantees repayment to foreign creditors. Under this scheme, the indebted companies liquidate their debts in pesos at a preferential exchange rate. The foreign debts are then rescheduled over a term of twenty years, as in the case of public sector debts. The prepayment of the debts is facilitated by an agreement entered into between the private company and ficorca, pursuant to which the Finance Ministry acquires the company’s debts. After the transfer of the debts the company obtains permission to pay ficorca the equivalent of the debt in pesos.

2. Public Sector Debts

There are four classes of Mexican government debts: (1) direct loans obtained by the government of Mexico since 1982; (2) direct loans granted under the Restructuring Agreement; private sector debt guaranteed by the Government under the ficorca scheme, (such debts were made eligible for conversion under Mexico’s 1987 rescheduling Agreement, and are exchanged within one percent of the other Mexican

61. *Id.* at 106.

government debts); and (4) restructured debts of government parastatals, such as the State Electric and Power Company (Comision Federal, de Electricidad (CFE)), the State Food Procurement and Distribution and Retail Agency (Compania Nacional de Subsistencias Populares (Conasupo)) and Mexico City’s Municipal government (Departamento del Distrito Federal (DDF)).

3. Regulation

Until the Mexican debt equity swap program was suspended in 1987, it was regulated by Mexico’s Foreign Investment laws. 63 Under the March 20, 1987 rescheduling agreement, Clause 5.11 was amended to permit the participation of Mexican companies in the program. Mexican companies participating in the program must show that the funds used to purchase the debt papers are funds obtained from their overseas activities. As a result of this development, the Mexican authorities are revising the country's tax laws to accommodate profits accruing from debt equity swap transactions. The National Foreign Investment Commission is the body responsible for administering the foreign investment laws of Mexico. Its consent is not required in all cases relating to investment in Mexico, especially when the foreign investor holds less than fifty-one percent of the investment capital and does not control the company.

Foreign investment of up to one hundred percent is allowed in inbound companies under Resolution 2 of the Law of Foreign Investments. 64 However, when the acquisition of an existing Mexican company is concerned, the approval of the Commission is required, especially when the foreign investor contributes more than twenty-five percent of the capital or the investor intends to hold more than forty-nine percent of the company’s fixed assets. The Commission approves projects after consultations with the Ministries responsible for the sectors in which the investment is intended to be made.

Investment related activities which do not require the consent of the National Foreign Investment Commission include increasing a foreign partner's share in a company in which the partner already holds more than fifty percent of the shares and transferring assets or stocks among

63. These laws were a set of regulations issued by the Ministry of Finance including the terms of Clause 5.11 of the New Money Arrangements covering direct loans to Mexico, the Restructuring Agreements modified by the amendment date March 29, 1987 and the New Restructure Agreements of August 29, 1985 for the United Mexican States and Mexican Public Sectors Obligors. See Manual Operativo Para la Capitalization de Pasivos y Sustitucion de Dueda Publica por Inversion

64. Report 1104, supra note 2, at 109.
Debt Equity Swap Programs

foreign investors. Unlike general foreign investments, all debt equity swap transactions require the authorization of the National Foreign Investment Commission (NFIC) in addition to authorization from the Ministry of Finance and Public Credit. While the latter is concerned with the technicalities of the investment, the former is concerned with the actual investment. Furthermore, investments must meet the requirements of the Law of Transfer of Technology administered by the Mexican Ministry of Trade even though this is not expressly written into the regulations governing debt equity swaps.

4. Restricted Investments

Investments in the petroleum industry, public utilities, and transportation and communications industries are limited to government parastatals or public companies. Similarly, investments in radio and television, forestry, gas distribution and transportation (air/sea) are limited to Mexicans and Mexican companies. Foreign investors are expressly excluded from investing in these sectors. Investments by foreign investors in the extractive and processing industries are limited to forty-nine percent or thirty-four percent in special cases. Investments in secondary petrochemical products and automotive parts and components are limited to forty percent.

Outside the specified categories, foreign investors may hold up to a forty-nine percent interest in Mexican companies unless otherwise authorized by the NFIC. Such authorizations are granted on a case by case basis. Between April 1986 and March 1987, the NFIC approved transactions involving 1.513 billion dollars of Mexican government debts. By the end of 1986, forty-five approvals had been made. These involved about 631 million dollars of public debts.

The Mexican program has not come under serious attack from nationalistic Mexican Unions and politicians. This is largely because of "the widespread but erroneous perception of the programme as a mechanism designed primarily to reduce debt, rather than to stimulate investment . . . ." Despite the absence of a serious nationalistic attack on the

65. Id. at 110.
66. The few examples of 100% foreign owned companies in Mexico include IBM, Apple, and Hewlett Packard.
67. Eighty percent was used for the liquidation of local debts owed to Mexican banks and the remainder was used for approved productive investments.
68. Schubert, supra note 22, at 12.
69. Report 1104, supra note 2, at 104.
program, its potential inflationary side effects have been a source of concern. It has been suggested that for every 100 million dollars of debt swapped, inflation increases by about three to five percent.\textsuperscript{70}

Another issue which has aroused great concern is “round tripping.” Round tripping involves the repatriation of the peso proceeds of debt conversions out of the country. To avoid this, peso conversions are kept in pledged government securities and in controlled accounts. They are directly disbursed to the investors, their suppliers, contractors, creditors, and other beneficiaries upon approval of their invoices and receipts by the Ministry of Finance. Chile controls round tripping by limiting the amounts of debt available at the monthly auctions for capitalization by local investors. It also monitors the local foreign exchange market closely. Any offenders are prosecuted after the fact. Both Brazil and Argentina have at different times suspended provisions for local investor participation in the swap program due to currency speculation. The Mexican authorities have expressed an inclination to do the same should they encounter these problems. Such a step, however, could deny the local investors the benefits of the program. Also, it would make it impossible for the country to encourage the repatriation of private Mexican funds invested abroad.

Since Mexico suspended its debt equity scheme in October 1987, it has not been reinstated. By the end of that year, total debts converted amounted to approximately 1.1 billion dollars, about two percent of Mexico’s total medium-term bank debt. In suspending the scheme, the Mexican authorities expressed concern about its inflationary side effects and especially the increase in domestic cash flow. The government’s decision to suspend the program was also influenced by the increase in discounts on Mexican debt, which was believed to be more beneficial to foreign investors, and also by the impact of conversions on the allocation of new investments.

E. The Philippines

The Philippine program was proposed on July 24, 1986, pursuant to Executive Order 32. Implementation of the program was carried out under Central Bank Circular 1111, which was issued on August 4, 1986, and amended on October 20, 1987. The amended Circular 1111 states the objectives of the program as: (1) stimulation of long-term equity investments in the Philippines; (2) repatriation by Philippine nationals of their overseas capital holdings; (3) provision of investments incentives in

\textsuperscript{70} Id.
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particular sectors of the economy; and (4) reduction of the debt servicing burden on the country. One of the principal objectives of the amendment was to increase the amount of discount "captured" by the Philippine authorities. This was accomplished by introducing a schedule of fees and new money requirements. Also, the payment of conversion fees from the peso proceeds of conversions was prohibited. Consequently, if an investor is unable to obtain local currency to pay for the fees, he must bring in foreign exchange to do so. In addition to the above, the amendment to Circular 1111 included amounts under the 1985 New Money Agreement to the list of debts eligible for conversion. In February 1988, the Philippine authorities also introduced several policy changes in respect to the implementation of the debt equity swap program. These include limiting the amount of central bank debt paper converted under the program (to contain the inflationary impact of debt conversion), waiving fees for conversion involving private sector debts, and establishing guidelines for the evaluation of applications for debt conversion. The guidelines required, inter alia, eighty percent of the goods produced be for export, exemption of export products from foreign quotas, the contribution of the investment in the creation of employment, and the location of the investment in less industrialized areas.

1. Eligible Investments

There are two categories of eligible investments under the program: Schedule 2 and Schedule 3 investments. Schedule 2 investments are high priority investments and consist of activities such as banking, manufacturing of goods for export, provision of health care, the construction of health care facilities, the construction and maintenance of low and middle-income housing projects and educational facilities, the rendering of technical and professional services in exchange for foreign currency, and the acquisition and management of nonperforming assets disposed of by the Asset Privatization Trust and the Office of the President. Schedule 3 investments are lower priority projects and include technical and professional services which are paid for in local currency and the production of nonagricultural goods for domestic use.


72. The Asset Privatization Trust was established by Presidential Decree 50, which was signed on December 9, 1986. It was charged with the responsibility of disposing of nonperforming assets of questionable projects undertaken during the Marcos era. See Report 1104, supra note 2, at 130; Kwan, Converting Debt To Equity In Philippine Enterprises, E. ASIAN EXEC. REP., Mar. 15, 1988, at 21.
Schedule 2 investments are subject to less onerous restrictions and lower fees because of their priority status. This is illustrated by the fact that in practice, the commercial banks participating in the program think that

the Central Bank has taken a very restrictive approach to approvals, in most instances approving only Schedule 2 preferred investments, and even then only the ones that are directly on target. Central Bank figures show that as of May 12, 1987, only seven Schedule 3 or non-priority investments were approved, whereas some [fifty-three] preferred activities received authorisation.73

2. Procedure

To participate in the program, interested investors (of any nationality) must submit a triplicate application to the Central Bank's Office of Debt Restructuring (ODR). The main function of the ODR is to review the applications and forward them with its recommendations to the Monetary Board, which approves the applications. Even though the Monetary Board is not bound by the recommendations of the ODR, it usually follows them.74

Within forty-five days of filing an application, an investor may know the fate of the application. When an application is rejected, the investor may reapply at another time. If the transaction is approved, the investor has sixty days to close the transaction unless ODR grants a special extension. In the absence of such an extension, the approval automatically lapses.75 On the closing date of the transaction, the purchased debt paper is deemed to be redenominated into its peso equivalent at the Central Bank's buying rate and the obligor is required to pay the investor the peso equivalent.76

Some factors which may influence the approval or nonapproval of a particular investment include its contribution to the generation of foreign exchange for the country, its role in the creation of job opportunities, how it increases economic activity, and the amount of local materials used in the manufacturing process.77 These factors also determine the classification of the investment as either high or low priority.

74. Id. at 136-37.
76. Id. at ch. XI, § 23.
77. Report 1104, supra note 2, at 136.
3. Fees

The investor is required to pay an initial application fee of 10,000 pesos (about 500 dollars) and a closing fee based on the proceeds of the converted debts. The amount charged depends on how the investment is funded. For example, where the investment does not involve any new funds, the Central Bank's fee in the case of Schedule 2 investments is twenty percent of the peso proceeds, while a Schedule 3 investment attracts twenty-four percent of the proceeds of the converted debts. Schedule 2 investments involving new funds up to fifty percent of the project cost are exempt from any fees. On the other hand, Schedule 3 investments require up to sixty percent of new funds to be eligible for the fee exemption. Also, the use of qualified debts of Philippine private sector borrowers or obligors in financing investments attract no fees.

4. Eligible Debts

Debts eligible for redemption under the program are classified into categories A, B, C, and D. Category A includes all the principal maturities of foreign debts covered by a Restructuring Agreement. Category B consists of two classes of debt: (1) all principal maturities of external debts owed by Philippine public sector borrowers falling due on or after January 1, 1987 (other than debt covered by a Restructuring Agreement or New Money Agreement); and (2) all principal maturities owed by Philippine private sector borrowers, provided that the debt instruments permit prepayment or extinguishment of such debts through the delivery of an equivalent amount in pesos, or the appropriate creditors consent to such prepayment. Also included are, the maturities of any debts in category B which qualify for conversion, provided such debts are discharged in accordance with the terms of the restructuring agreement.

Category C debts are credits covered by a trade facility, including deposits maintained by the Central Bank. Under the policy changes introduced in February 1988, short-term trade facilities were excluded from the list of debts eligible for conversion. Category D is comprised of other debt obligations, the terms and conditions of which are approved by the Monetary Board.

5. Restrictions

An investment's classification determines its restrictions. Higher
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Schedule 2 investments are subject to fewer restrictions than Schedule 3 investments. Schedule 2 investments are only charged a five percent commission instead of ten percent. Investors making Schedule 2 investments cannot repatriate their capital within the first three years of the investment. But, after the fourth year, they are allowed to repatriate twenty percent of their capital. There are no restrictions on the repatriation of dividends accruing from such investments. On the other hand, investors in nonpriority Schedule 3 investments cannot repatriate their capital within the first five years of the investment. However, on the sixth year, they can repatriate twenty percent of their capital. Repatriation of dividends from Schedule 3 investments is not allowed within the first four years. Also, such dividends are not guaranteed. Local investors are not allowed to repatriate or remit their capital, profits or dividends overseas. An investor in any category may sell his interest in the transaction and transfer his stock to another person two years after the closing of the transaction.

In the event of liquidation or dissolution of the Philippine enterprise in which the investment was made, if the amount paid to the investor exceeds the amount allowed to be repatriated the investor has two options. The investor may reinvest the excess in an approved equity investment or in a nontransferable peso denominated Central Bank debt instrument until it can be reinvested in an approved equity investment. Where the original investment was a Schedule 2 investment, the investor is expected to place the excess in a Schedule 2 investment.

6. Philippine Investment Notes (PINs)

In July 1987, the Philippine government amended Circular 1111 to permit the use of Philippine Investment Notes (PINs) in the debt equity swap program. PINs are non-interest-bearing foreign currency denominated obligations of the Central Bank of the Philippines guaranteed by the Government. PINs have a normal maturity of six years from the date of issue. They are also easily transferable to financial or nonfinancial institutions. Also, they may be redeemed anytime before maturity for full value in Philippine pesos and the proceeds may be used in financing equity investments. PINs are not subject to any fees by the Central Bank. They are usually issued to correspond with interest payments due

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82. The guarantees used under the PINs program may take the form of unconditional obligations of the central bank to pay a certain amount of foreign exchange to the registered holder of the PIN upon maturity or a certification that the instrument is redeemable at any time before maturity for full value in pesos used for financing an equity investment.
under the Philippine Public Sector Restructuring Agreements and the 925 million dollar Credit Agreement of May 20, 1985. They are issued and sold through underwriting or placement arrangements with third parties. They may also be sold at discounts from their face value according to current market prices. The Central Bank records all PIN transactions.

Since the introduction of the PIN program, it has become mandatory for investors to use them (the PINs) to finance part of their investments in the Philippines. Schedules 2 and 3 require about twenty-five percent and fifty percent PIN financing respectively. As a result of the requirement that PINs be used, discounts on PINs are not as attractive as those available on secondary market credits. Unlike the conversion of eligible Central Bank debt for investments, no redemption fees are charged for PINs. PIN investments for 1988 are estimated at between 100 to 150 million dollars.

The PIN program possesses several advantages over an ordinary debt equity swap transaction. The program ensures the availability of fresh foreign exchange and carries a lesser risk of inflationary side effects. Secondly, it is less expensive for prospective investors because there are no redemption fees. It also obviates the necessity of seeking the consent of the relevant creditors and preparing different assignment agreements with the interested sellers. In short, it is less time consuming. Furthermore, it may be used to make up for any future shortages in Philippine government debt paper.

The redemption of the PINs . . . represent[s] immediate cash savings for the country of the amount of foreign exchange corresponding to a current interest payment on the external debts. [Furthermore,] [t]his type of debt service relief is much greater than that resulting from a conventional debt equity transaction involving an item of restructured debt. In the later case, since the principal amount of the credit subject to redemption has already been rescheduled over a long term, the borrower nation saves not only the amount of interest that would have accrued on the credit had it remained outstanding. The benefit of cancelling restructured indebtedness is, therefore, somewhat attenuated. 84

83. Report 1104, supra note 2, at 125.
84. Id. at 139.
IV. REGULATORY ASPECTS OF DEBT EQUITY SWAP TRANSACTIONS

A. United States

Prior to August 1987, the participation of United States banks in nonfinancial companies through debt conversions was limited to twenty percent of the company’s equity. Before the amendment of Regulation K, the participation of United States banks in nonfinancial activities caused considerable concern. The concern was based on: 1) the banks’ lack of expertise; and 2) a fear that the banks would help their nonfinancial affiliates by granting loans on nonmarket terms. By limiting the holding of shares to Bank Holding Companies, the commercial banks are insulated from the commercial activities of the companies in which they hold interests. Thus, any loans they grant to entities are treated as investments in the company. Accordingly, the appropriate approval procedures have to be followed with respect to such investments. In August 1987, the Federal Reserve Board (FRB) amended Regulation K which had limited the holding of any interests in nonfinancial companies overseas. Presently, United States banks can hold up to 100 percent equity interests in nonfinancial companies in LDC’s that have reduced their debts since 1980, as long as the investments are made in state-owned enterprises that are in the process of being privatized.

The amendments expanded section 211.5(b) of Regulation K to permit United States banks to hold up to 100 percent equity interests in foreign nonfinancial companies in the thirty-three heavily indebted countries. The shares obtained by the bank in the conversion must be shares of government agencies and instrumentalities. The new Regulation K does not permit conversion of debt for equity in foreign nonfinancial companies not owned by government. The FRB’s commentary clearly stipulates that the acquired shares must be government owned. Consequently, it will not suffice for the foreign government to acquire the shares only for the purpose of transferring them to the Bank Holding Company in a debt equity conversion. The FRB’s commentary states that “private investment in such companies that are currently state owned may provide some benefit to the countries by reducing economic inefficiencies and governmental subsidies.”

85. 12 C.F.R. § 211.5 (1988).
86. Id. § 211.5(f)(2)(ii).
87. Id. § 211.5(f)(1)(i).
The acquired interest in the company may be evidenced by shares or "other ownership interest." The acquisition of a foreign company's shares may be through conversion of eligible debt claims or through payment in local currency, with the proceeds being used to acquire the shares. A bank may also own interest in a company not issuing shares. The interests acquired in the foreign company must be held by the Bank Holding Company or its subsidiaries and not by a United States insured bank or its subsidiaries.

Asset transfers from banks to their Holding Companies and the conversion of assets from debt to equity could lead to recognition of losses for tax and reporting purposes. The same is true of portfolio valuations.

1. Subcategory Restrictions

Regulation K also imposes certain restrictions on the acquired company. First, the acquired corporation shall not have a name similar to that of the acquiring bank. According to the FRB's commentary,

[i]he restrictions on the sharing of a similar name by the US banking organization and its non-bank affiliate reduce[s] the likelihood that a bank [will] be identified with the nonbank company and thereby reduce[s] the pressure on a banking organisation to support the affiliate in case of losses.

Secondly, the Bank Holding Company and the affiliate are forbidden to provide the acquired foreign company with any confidential information regarding their customers or other affiliates engaged in a similar or related business. As a general rule, the acquired company cannot directly or indirectly engage in trade or business in the United States. The commentary on section 211.5(b), however, provides that there may be a few interlocking directors for administrative purposes when necessary.

The acquiring banks are expected to divest themselves of their interests in the affiliate corporation within five years. Extensions of up to five additional years may be granted by the FRB if good cause is shown.

89. 12 C.F.R. § 211.5(f)(2) (1988).
90. Id. § 211.5(f)(1)(ii).
91. Id. § 211.5(f)(1)(iii).
92. Id. § 211.5 (f)(3)(ii); Spencer, supra note 88, at 14.
93. 12 C.F.R. §§ 211.5(f)(1)(v), 211.5(b)(3)(f)(A) and (B) (1988).
94. Id. § 211.5(f)(1)(iv).
B. Japanese Regulations

Regulatory changes have also been made in Japan, especially in the tax treatment of debt equity swaps involving non-Japanese banks. The Japanese authorities have ruled that debt equity conversions made out in single and integrated transactions are exempt from capital gains taxes even if the debts are converted at or near face value. This is a good incentive to encourage the participation of Japanese banks in debt equity swaps.

C. Valuing Debt

The balance sheet treatment of debt equity conversions is of considerable importance to creditor banks engaging in such transactions.\(^9\) One of the major concerns of banks engaged in debt conversion is the valuation of the remainder of their debts. In May 1985 the American Institute of Certified Accountants (AICPA) stated, “in an exchange involving loans to debtors in such financially troubled countries, the estimated current face value of the consideration given and received will be less than the respective face of the loans and other considerations.” Assuming that, this generally results in a loss. Many banks fear that conversion may contaminate the remainder of the unconverted debts in their portfolio. In this respect, the AICPA notice stated, that “in the course of preparing financial statements, a bank must review the loan portfolio in order to assess the adequacy of the allowance for loan losses.” This is because private sector nonguaranteed debt treats each of the obligor’s debts separately while private and public sector debt guaranteed by governments are treated together. Thus, the risk of contamination is considered to be greater for (public sector and private debt) guaranteed debt.

V. THE IMPACT OF DEBT EQUITY CONVERSIONS

The impact of the debt equity conversions differs from country to country and scheme to scheme.\(^{96}\) Benefits of debt equity schemes may be obtained through the imposition of conversion fees, sale or auctioning of conversion rights or the establishment of different exchange rates for the conversions. Most of the countries engaged in debt equity conversions have established formal procedures by which they benefit from discounts in the secondary market.

Debt equity swap schemes promote increased domestic investments

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95. See generally Schwarz, supra note 2, at 87-97.
96. For a discussion of the economic impact of debt equity swaps, see International Capital Markets, supra note 3, at 59.
and enhance foreign exchange savings. When there is no significant increase in foreign savings, that could result in a crowding out of investments to make funds available for early repayment. Because of this, some countries require the provision of matching funds.\textsuperscript{97}

Debt equity conversions help to reduce debtor countries' external debts because they eliminate the payment of interest and restructuring fees. These are however, replaced by remittance and repatriation of profits. Since these are subject to considerable restrictions, it is arguable that they do not have as severe an impact on the economies of these countries as debt servicing does. Also, because converted debts are usually excluded from the calculation of bank base exposure, it may be more beneficial for banks to engage in debt equity conversions than frequent rescheduling of debt, which requires the provision of new money to debtor countries.

Issuance of domestic currency to pay for debt conversion might also have an adverse impact on the monetary and fiscal policies pursued by the countries. The impact may be felt in inflation, exchange rates and the level of debtor countries international reserves. For example, debt conversions involving bonds could cause a rise in interest rates as well as make it difficult for debtor countries to meet the International Monetary Fund's inflation targets.

Issuance of company stock and long term debt instruments is a useful means of controlling the consequences of increased domestic currency flow. Another effective way of control is the institution of volume restrictions on exchanges.

Debt equity swap programs encourage the repatriation of private capital of nationals which has been invested abroad and also promote investment of foreign capital. For example, it is estimated that between 1985 and 1987 about 385 million dollars of private Chilean capital abroad was repatriated to Chile through debt equity conversions involving Chilean nationals.\textsuperscript{98}

Although United States financial institutions were initially reluctant to participate in debt equity swaps, many have now changed their minds and have begun to participate actively as brokers of debt paper and also by converting some of their own debts into investments. Manufacturers Hanover, Bankers Trust, Security Pacific, American Express, and Citicorp have all made substantial debt equity swaps. Manufacturers Hanover recently exchanged about 70 million dollars of its Brazilian debts for

\textsuperscript{97} Argentina is one such country.

\textsuperscript{98} Schubert, \textit{supra} note 22, at 14.
60.4 million dollars of cruzados for investment in a pulp and paper company in Brazil. It is also negotiating another investment of about 30 million dollars in another paper and pulp factory.99 In all, Manufacturers Hanover expects to convert at least 150 million dollars of its loans into direct investments in Brazil.100 Recently, Bankers Trust bought the controlling interest in Provida, Chile's largest pension fund manager and Consanco, Chile's biggest life insurance company. It has also purchased a gold mine in Chile.101 As of January 1987, Bankers Trust's debt equity swap transactions were valued at about 100 million dollars.102 Citicorp is exploring the prospects of purchasing fishing fleets and a port in Chile.103 American Express declared its intention to buy seventeen percent of a Brazilian textile company in addition to swapping debts in exchange for investments in seven Mexican hotels.104 Security Pacific bought a Chilean electrical company through a debt equity swap transaction. The above examples represent new investments which perhaps would not have been made in the absence of debt conversion programs.105

Several commentators and bankers have expressed positive comments about debt equity swap programs and their great potential. For example, Mr. Newman of Sherson Lehman Hutton said, "[o]ver the next five to ten years, debt-for-equity conversions will probably become the single largest use of sovereign debt."106 Richard Marin, head of Bankers Trust's asset enhancement operation in New York stated "[d]ebt/equity swapping is the hottest game in town."107

Through debt equity swap programs, debtor countries are able to capture discounts on debts sold on the secondary market and convert such debts into investments. These programs encourage debtor countries to re-evaluate their economic policies, (i.e., the extent of government involvement in economic activities) and foster the expansion of the private sectors of their economies through privatization of government owned

100. Id.
102. Evans, supra note 2, at 100.
103. Id. at 100-01.
104. Id. at 100.
105. Cf. Schubert, supra note 22, at 19; Donald Lessard argues that "when a major multinational invests in a... country via a debt/equity swap, it probably has a pretty good investment opportunity which it might undertake anyway. The percentage discount on the cost of the investment may be important, but I doubt if it is a convincing factor." Id.
106. Id. at 85.
107. See Evans, supra note 101, at 6.
enterprises. For the bank creditors, debt equity swaps offer the opportunity to get rid of problem loans, to increase liquidity, and to rationalize their portfolios.

VI. COMPARISON

Under most of the debt equity programs discussed above, the eligible investors include banks, multinational corporations, and domestic and foreign debt holders. One notable exception is the Brazilian program, which limits eligible investors to the original creditors. Prior to June 1984, any nonresident could participate in the Brazilian program. It is now open to domestic investors as well. In Chile, Argentina, Mexico, and the Philippines, any resident or nonresident creditor may participate in the program. Eligible debts in the countries include both private and public sector debts.

Restrictions on capital repatriation and profit remittances exist in all the five countries. However, since March 1987, regulations in Brazil require that any investment made via debt conversion must remain in the country for at least twelve years before becoming eligible for repatriation. In Chile, Argentina, the Phillipines, and Mexico, debt conversion restrictions relating to the remittance of profits are more restrictive than the restrictions for other forms of foreign investment.

Debts for conversion are valued at either face value or below face value. The countries which permit the redemption of debts at face value are Brazil and the Phillipines. In the latter, conversion fees are charged for such debts. On the other hand, in Chile, Argentina, and Mexico, the debts are converted at a value below face value.

The exchange rate for debt conversion is either at the official exchange rate or at parallel exchange rates. Of the five program examined, Argentina and Mexico use a parallel exchange rate (the free market exchange rate), while Brazil, Chile, and the Phillipines convert debts at the official exchange rate.

Argentina, Chile, and Mexico have debt conversion programs which require additional funds. In Mexico, this requirement only relates to investments in nonpriority sectors. In Chile, the requirement is not always enforced and when it is, it is usually only a small percentage of the investment.

In the countries studied in this Article either the Central Bank or the Ministry of Finance administer the program. For example, in Argen-

109. Report 1104, supra note 2, at 100.
tina and Mexico, the Ministry of Finance plays a crucial role in the administration of the program. In Argentina, the Central Bank works in conjunction with the Ministry of Finance, whereas in Mexico, the Ministry of Finance is assisted by the Foreign Investment Commission. The other three countries’ programs are basically administered by their Central Banks.

Debt conversion programs can facilitate government efforts at privatization. Chile, for example, has used the program to undertake an extensive privatization program. The Philippines, too, has used its program to sell the nonperforming assets of government owned businesses. Mexico and Brazil have also achieved modest success in using their debt conversion program to advance privatization. Compared to the Chilean program, however, the Mexican and Brazilian privatization programs may at best be described as incipient. Even though Argentina has a privatization program it has not extensively used debt equity swaps to further its program.  

VII. CONCLUSION

The above programs display a variety of options. Some are very strict, others are fairly liberal. The differences exhibited in the various programs reflect different attitudes towards foreign investment. For example, some of the programs require matching funds to offset the impact of early retirement of debts, while others do not. The programs are tailored to meet the economic needs of the various countries. Notwithstanding the existence of slight variations, all the programs allow the conversion of both private and public sector debts and also impose restrictions on the remittance of profits, dividends, and the repatriation of capital. These restrictions are tighter than those on other types of foreign investments. Furthermore, debts are usually retired at face value even though they are purchased at generous discounts.

While debt equity swaps offer debtor countries a good opportunity to retire their debts, they also raise serious problems, such as the fear of domination of the economy by foreign investors, inflation, and increased domestic debts. The reactions of debtor countries to these issues are usually reflected in the structure and restrictions of their debt equity swap programs. Although these concerns warrant attention, they do not require massive regulation. Such a step could scare prospective investors away to countries with more liberal programs. Debt equity swap programs must be seen as attempts by both debtor countries and creditor

110. Id. at 101.
banks to make the best of a bad situation. Debtor countries should carefully consider the types of incentives they offer to investors, the nature of the restrictions they impose, and their approval procedures. They should strive to avoid over regulation and endeavor to simplify the administrative procedures. Of all the programs examined, the Chilean program is the most liberal, and does not entail as complicated and confusing an approval process as the others.