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# Guide to Debt Equity Swaps (Rubin ed.)

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**Abstract**

The Guide to Debt Equity Swaps (the "Guide"), provides an excellent introduction to anyone seeking to understand why swap programs have proliferated throughout the developing countries, the variety of forms they have taken, and what they portend for the future. The Guide is divided into two segments. The first segment consists of a series of articles authored by a panel of experts in a variety of disciplines, while the second segment furnishes an in-depth analysis of the most significant debt-equity conversion programs.

# BOOK REVIEW

GUIDE TO DEBT EQUITY SWAPS. Edited by Steven M. Rubin. London: The Economist Publications Limited, 1987. x + 213 pp. US$295.00

*Reviewed by Daniel Schloendorn**

The impetus behind the growing use of debt-equity swaps is pinpointed in the opening paragraph of one of the essays included in this impressive work:

> The world is over-leveraged. The developing nations are especially so, particularly those of Latin America. . . . Equity financing must be substituted for some of the excessive debt currently carried by these countries. Debt equity conversions provide one of the quickest non-confrontational ways of reducing such excess leverage. (p. 85).

While no one disputes that debt-equity swaps, standing alone, never can be expected to solve the developing-countries debt crisis, they do hold out the prospect of making a significant contribution to this endeavor.[1] The *Guide to Debt Equity Swaps* (the "*Guide*"), provides an excellent introduction to anyone seeking to understand why swap programs have proliferated throughout the developing countries, the variety of forms they have taken, and what they portend for the future.

The *Guide* is divided into two segments. The first segment consists of a series of articles authored by a panel of experts in a variety of disciplines, while the second segment furnishes an in-depth analysis of the most significant debt-equity conversion programs. An introduction by Steven M. Rubin provides a brief summary of the area to be covered by each contributing author, with a useful suggestion that those unfamiliar with the subject review one of the country studies before reading some of the more specialized essay topics.

The first group of essays, captioned "Debt Swaps Present

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1. One recent study, for example, has projected that Brazil could reduce its US$66 billion long-term foreign bank debt by US$19 billion by the end of 1994 through debt-equity swaps. Truell, *Brazil Could Cut Foreign Bank Debt By $19 Billion By 1994, Study Says*, Wall St. J., Aug. 23, 1988, at 6, col. 1.

and Future," examines debt conversions from an economic point of view. Martin Feldstein, former chairman of President Reagan's Council of Economic Advisers and currently professor of Economics at Harvard University, leads off with an article that first appeared in *The Economist* in June 1987, "New Directions in Latin American Debt." Mr. Feldstein argues that because it is unrealistic to expect developing countries to finance the capital investment and imports of equipment and materials needed for industrial development by reducing their levels of private and public consumption, for some time satisfactory growth will be dependent upon the continued infusion of new capital from abroad. In his view, such infusion requires that (1) developing-country international debts must be rolled over as they mature or be swapped for equity, (2) the interest rates banks charge on new loans must be close to their cost of funds (so as not to deplete precious foreign exchange or require yet even more new credits from the banks), and (3) additional credit or an equivalent amount of equity finance must be extended to the debtor countries to pay some of the interest as it accrues. If this prescription is followed, Mr. Feldstein envisions that with only modest economic growth, debt will decline as a percentage of the debtors' GNP and exports. Hence, the relative burden of servicing the debt will gradually become lighter. This, in turn, his argument goes, would make a country's loans a better credit risk and improve the financial soundness of banks. As a case in point, the author projects that if the net debt service of Brazil were limited to 2.5% of GNP until 1997, Brazil could begin repaying its external debt.

Even if Mr. Feldstein's suggestions were scrupulously followed, the number of variables in the equation are such that his optimistic projections might never be achieved. For example, if LIBOR, the rate to which many developing-country loans are currently tied, was to continue to increase as it has recently, the developing-country debt-servicing requirements could increase dramatically. Furthermore, while the use of debt-equity conversions to reduce currently-maturing debt may in the long run prove beneficial, other considerations may come into play that derail these efforts. Mexico, for example, in 1986 announced that it was suspending its debt-equity conversion program, reportedly out of a concern regarding its inflationary effects.

Jay H. Newman, a senior vice-president of Shearson Lehman Brothers (now Shearson Lehman Hutton), next contributes an essay on "Trends in the Market for Developing Country Debt and Debt Equity Conversions." Mr. Newman traces the development of a secondary market in developing-country loans first to the loan swaps that dominated trading from 1982 to 1987. In a loan swap, banks would trade among themselves the debt of a country for the debt of another country, thereby rebalancing their risk exposure without recognizing any loss for bank purposes (except in the United States). He notes, however, that the most significant cash buyers of late have been those viewing the developing-country debt as a proxy under either debt-equity conversion or debt-capitalization programs. After briefly describing the programs in effect in various countries and listing in summary fashion the most frequently mentioned pros and cons of debt-capitalization transactions, Mr. Newman observes that the most significant aspect of these transactions may be that the value of debt as an instrument of local investment will ultimately determine the price of the debt, rather than the level at which banks are willing to exchange it among themselves. This may lead developing countries to compete with each other by offering better terms on debt-capitalization transactions, including the terms on which dividends and capital can be remitted. Looking ahead, he speculates that the massive loan-loss reserves established by U.S. banks presage much more active trading of the developing country debt, with banks reducing or eliminating their exposure through cash sales or becoming equity investors for their own accounts pursuant to debt-conversion programs. Mr. Newman conjectures that of the US$500 billion in developing-country bank debt outstanding, as much as thirty percent will be converted into equity, assuming developing countries continue to embrace foreign investment.

The optimism expressed by Messrs. Feldstein and Newman is tempered somewhat by the third essay, "The Effect of Debt Equity Conversion on the Economic Restructuring Process," prepared by Susan Segal, director of Manufacturers Hanover Sovereign Risk Group, New York. While noting the many benefits of debt-conversion programs to the debtor governments—reduction in foreign currency obligations, recapitalizing a liquidity-impaired domestic economy, providing financing for the expansion of the private sector economy, and providing a source of financing for government operating budgets through the fees imposed on local currency conversions—the essay properly points out that foreign investment laws, coupled with the additional restrictions on permissible investments found in the conversion programs themselves and the lengthy approval process, substantially diminish the attraction of these programs.

Ms. Segal also reviews the ways in which debt-equity conversion programs assist necessary economic reforms. First, since export-producing industries often receive preferred status under the programs, the programs have assisted in the reviving of the export sector. Second, the programs have provided a new source of financing to the private sector or been instrumental in government privatization programs, and thus have helped reduce the government's role in the economy. Finally, in those programs that permit nationals to participate, a repatriation of flight capital can occur. As to the future of debt-equity conversions, Ms. Segal believes that as the economies of the debtor countries improve, the debt-equity market should eventually die a natural death when the discounts in the debt narrow and the subsidy element of the conversions disappears. She emphasizes, however, that debt-equity programs can serve only as a catalyst of, and not as a substitute for, the economic reforms needed to accomplish a successful economic restructuring.

The next group of essays, under the heading "Debt Swaps and Debtor Countries," looks at debt-equity programs largely from the perspective of the debtor country. Leading off this section is an an essay prepared by Francisco Garcés, director of international affairs, Central Bank of Chile, discussing foreign debt conversion in Chile. In just a few pages, Mr. Garcés provides an excellent summary of the origins of Chile's conversion program, the justification for the program, and the various mechanisms for effecting a conversion. In the closing portion of the essay, when speculating on the outlook for debt conversions, he takes a none too subtle swipe at U.S. banking regulators for failing to take steps to facilitate debt-equity conversions. As discussed later in this review, this criticism, while perhaps justified when made, has been blunted by actions subsequently taken by the Federal Reserve Board to facilitate U.S. banks' participation in swap transactions.

Lee C. Buchheit, a partner in Cleary, Gottlieb, Steen & Hamilton, elaborates upon the perceived benefits and drawbacks of swap programs, which were alluded to in the earlier chapters, in his essay, "Debt Equity Conversion Programmes from the Debtor Country's Perspective," and goes on to describe the experimental approaches taken by Argentina and the Philippines to address some of the drawbacks. In the latter case, for example, the Central Bank of the Philippines proposed to issue Philippine Investment Notes ("PINS"), dollar-denominated certificates of indebtedness, as part of its bank debt restructuring for the purpose of satisfying current interest payments on external debt. The PINS were also intended as an alternative supply of debt instruments under the Philippines debt-equity conversion program. Events transpiring after the publication of the *Guide* indicate that this particular experiment may have been a false start. Following the resignation of Jaime Ongpin, the principal advocate of PINS, as Philippine minister of finance and after encountering resistance to the proposal from its creditor banks, the Philippines appears to have abandoned the PINS program.

Following Mr. Buchheit's essay is a paper originally prepared for a Group of Thirty study group by David L. Roberts and Eli M. Remolona, both of the Federal Reserve Bank of New York, entitled "Debt Swaps: A Technique in Developing Country Finance." It is at this point of the *Guide* that the problems inherent in addressing any topic through a collection of essays prepared by a disparate group of authors become apparent. While the paper itself is an admirable exposition of the various types of swaps, and unquestionably the most detailed and analytical discussion of the benefits and detriments associated with swap transactions, in several instances it retreads ground already covered to some extent in the earlier essays. That being said, the essay nevertheless offers several valuable insights, particularly the emphasis on "additionality" (i.e., the ability of swaps to attract foreign equity investment that would not otherwise materialize) in judging the utility of swaps (pp. 47-48).

Michael C. Hollihan, a consultant to the Central Bank of Ecuador until June 1987, contributes a short article discussing

"Economic Policy and Debt Equity Conversion in Ecuador." One of the unique features of the Ecuadorian program requires the company receiving the investment to cancel by the same amount any domestic credit owed to the Central Bank. While the article points out that this avoids any inflationary pressures (because no money is printed by the Central Bank in the process of converting debt to equity), the review of Ecuador's program in the second segment of the *Guide* observes that the program appears to be of most interest to companies or banks already in the country searching for a cheap way to cancel government debts.

The third group of essays focuses on the end product of conversion programs, the equity investments. Dennis P. Lockhart, head of the debt-equity conversion program of Citibank's Caribbean/Central and South American Banking Group, presents, in essentially checklist fashion, the factors one should consider in targeting and originating investments and analyzing the opportunities presented by potential investments as well as alternative deal structures. As checklists go, the article hits most of the relevant considerations, but the essay would have made more interesting reading had the author fleshed out the topic with some real-world case studies. This shortcoming is addressed to some extent by the immediately following chapter, an interview with Keith Nienhaus, the manager of international projects for Chrysler Corporation's corporate finance department, discussing Chrysler's US$100 million debt-equity conversion to finance new product programs in Mexico. However, a few similar case studies relating to other countries would have been a welcome addition to the *Guide*.

Debt-equity conversion funds, defined to include mutual funds, venture capital funds, and syndications, are explored in an essay contributed by Richard A. Marin, managing director of the Latin American Department of Bankers Trust Company in New York. While the author forcefully argues that the full potential of debt-equity swaps can be realized only through these collective vehicles, to date the marketplace's receptivity to this type of structure has been rather lukewarm. One can only hope that this attitude will change over time as the funds that have been established demonstrate an ability to successfully manage both the conversion process itself and the resulting equity investments.

Michael K. Phair, with the Capital Markets Division of International Finance Corporation ("IFC"), World Bank, in "Debt for Equity: A Portfolio Investment Approach" argues that in light of the fact that the returns in several emerging markets have surpassed both the Standard & Poor's 500 and a diversified international portfolio, commercial bankers can take advantage of these equity opportunites through country-specific conversion funds. The concept promoted by IFC envisions that funds with long-term capital appreciation as their investment objective will utilize debt-conversion programs, with the resulting proceeds invested by an independent professional investment manager in a diversified portfolio of equity securities. (One such fund contemplated at the time the article was prepared, the First Philippine Capital Fund, was subsequently successfully launched with the contribution by participating banks of Philippine sovereign debt and a cash infusion from IFC, with the Fund managed by an affiliate of Shearson Lehman Hutton Inc.) Mr. Phair correctly observes that the major constraint in establishing conversion funds is not the availability of debt for conversion but rather the shortage of satisfactory investment opportunities in the developing countries.

Following up on this last point, the *Guide* offers up in its next essay, "Debt Equity Swaps and Privatisation," by Dimitri Plionis, a partner in Arthur Young & Co.'s international management consulting group, a discussion of privatization as one of the more likely sources of attractive equity investments. When one considers the magnitude of the assets involved (the Philippines, for example, has assets considered for privatization with a book value exceeding US$15 billion), the conclusion seems inescapable that debt-equity conversions and privatization efforts can, and should, complement one another. Unfortunately, significant obstacles remain. In the Philippines, for example, there appears to be a growing reluctance to turn over to the private sector the more attractive assets now controlled by the government.

The final two essays in the first segment of the *Guide* consider the legal and accounting rules governing swap transactions. The first of these, "U.S. Banking Law and Other Considerations Relating to Debt Equity Conversions," by Andrew C. Quale, Jr., a partner at Sidley & Austin, reviews in detail the provisions of Regulation K of the Federal Reserve Board as well as other legal bases for a banking orgainzaton to own equity investment in a foreign country. By way of an editor's note at the end of the article, reference is made to amendments in August 1987 to Regulation K permitting banks in swap transactions to acquire up to one hundred percent of any enterprise in a heavily indebted developing country being transferred from public to private ownership, with a time limit of five years (up to ten with the Board's permission). Of greater significance is the further liberalization of Regulation K in February 1988, permitting bank holding companies to invest in up to forty percent of the shares of any private sector company through a debt-equity swap in a heavily-indebted developing country. These investments may now be held for two years beyond the end of the period during which full repatriation of the investment is restricted by the debtor country, up to a maximum of fifteen years.

The accounting treatment for swaps, including the issues presented by both individual swap transactions and the contribution of debt to a pooled fund to effect coversions, is addressed with admirable clarity by John W. Creamer, a partner in Arthur Young & Co., in "Accounting for Debt Equity Conversions." In order to avoid the spectre of an immediate write-down to market value of debt contributed to a conversion fund, Mr. Creamer suggests that each investment be subject to the approval of the bank participants. Because the banks would thus retain dispositive control over the contributed debt, he concludes that no write-down would be required until a decision was made by a bank to participate in a particular swap.

In the second segment of the *Guide*, the most significant conversion programs are analyzed on a country-by-country basis, preceded by a handy grid chart comparing the essential features of each program, including the price range within which redemptions are effected, the eligible investors, and restrictions on profits and capital remittance. While the country studies are thorough and informative, one must recognize that in this rapidly evolving area the descriptions can quickly become outdated (witness the virtual abandonment of the PINS program in the Philippines).

In conclusion, the *Guide to Debt Equity Swaps* has much to recommend it: an impressive array of contributors, a comprehensive treatment of the subject, and a detailed analysis of practically all of the conversion programs adopted to date. For the growing cast of players seeking to come to grips with these programs—whether it be a commercial banker studying the feasibility of swaps, an investment banker acting as an intermediary, or a lawyer or accountant rendering advice as to the proper structuring of a transaction—the *Guide* should prove to be an invaluable resource.