NOTE

THE DEVELOPMENT OF A GLOBAL MARKET-BASED DEBT STRATEGY TO REGULATE PRIVATE LENDING TO DEVELOPING COUNTRIES

I. INTRODUCTION

As national economies become increasingly interconnected through the expansion of international trade and investment, international banking grows in size and importance. National boundaries have all but vanished for the large "money center" banks.[1] Banks lend to foreign governments and private individuals, finance international trade and investment, and make equity investments and place deposits in foreign banks. As international banking continues to develop, international bank regulation becomes increasingly important to the efficient operation of the global economy.[2]

National regulatory institutions provide an inadequate framework within which to regulate banks' international operations.[3] A recent assessment of national bank regulatory institutions concluded that while global coordination among these institutions has improved in recent years, new arrangements, expanded institutional authority, and perhaps new institutions are needed to cope with current global financial challenges.[4]

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[1] While U.S. banks such as Citibank, Chemical, and Chase Manhattan have traditionally dominated international banking, many Japanese and European banks joined the ranks of those money center banks in the 1980's. A substantial amount of the revenues of these banks comes from overseas transactions and investments. Glidden, *Capital-Based Limits on International Banking*, 11 N.C.J. INT'L L. & COM. REG., 465 n.1 (1986).

[2] Generally, bank regulation has two goals: to enable banks to withstand external disturbances such as credit, interest rate or other shocks, and to promote the efficiency and integrity of financial services. *See* R. DALE, THE REGULATION OF INTERNATIONAL BANKING 3 (1984); M. WATSON, P. KELLER & D. MATHIESON, INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS AND PROSPECTS 18 (1984) (Occasional Papers of the Int'l Monetary Fund No. 31).

[3] Hackney & Shafer, *The Regulation of International Banking*, 11 N.C.J. INT'L L. & COM. REG. 475 (1986). Connie M. Friesen, in an examination of current regulatory practices world-wide, notes "the *ad hoc* nature of current regulatory and supervisory procedures and the lack of full agreement on objectives among bank regulatory and supervisory agencies." Friesen, *The Regulation and Supervision of International Bank Lending: Part I*, 19 INT'L LAW. 1059, 1062 (1985).

[4] Hackney & Shafer, *supra* note 3, at 495.

The Cooke Committee, a committee of central bankers from the industrialized countries, is the only forum that attempts to globally coordinate bank regulation.[5] This extralegal body has been "severely limited" in its effectiveness since it must rely on the voluntary compliance of its members and their respective governments with informal and broadly drawn guidelines.[6]

An independent transnational institution designed to regulate international banking would be ideal;[7] however, its creation would require national regulatory institutions to cede a considerable amount of power for the greater global good. Due to these institutions' resistance to relinquishing their power, legally controlling agreements regulating transnational banking operations are "the exception rather than the rule."[8] Thus, creating a transnational institution appears politically unfeasible.

Nevertheless, the debt crisis in the developing countries has highlighted the need for an effective global framework for regulating international banking. While the debt crisis was precipitated by ad-

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[5] In 1974, the Bank for International Settlements created the Committee on Bank Regulations and Supervisory Practices, a standing committee of bank supervisors from the Group of Ten countries plus Luxembourg and Switzerland. The committee is commonly called the Cooke Committee, after the name of its chairman, Peter Cooke of the Bank of England. The purpose of the Committee is to provide a regular forum for closer international cooperation on banking supervisory matters and to work towards improving the cohesion of arrangements for supervising the activities of banks operating in international markets. *See* G.G. JOHNSON & R.K. ABRAMS, ASPECTS OF THE INTERNATIONAL BANKING SAFETY NET 25-26 (1983) (Occasional Papers of the Int'l Monetary Fund No. 17).

[6] *International Bank Lending: Hearings Before The Subcomm. On Financial Institutions Supervision, Regulation and Insurance Of The House Comm. On Banking, Finance and Urban Affairs*, 98th Cong., 1st. Sess., 17 (1983) [hereinafter *Hearings*] (Statement by Richard S. Dale).

[7] In a paper prepared for the Federal Reserve Bank of New York Conference on Less Developed Country (LDC) Finance, *LDC Finance — The Role of Bank Supervisory Policies*, New York, May 6-9, 1984, at 1, Paul Cooke asked whether the current debt crisis "may not point increasingly toward a need for a single global regulatory framework within which the banks should conduct their international business." *Quoted in* Friesen, *supra* note 3, at 1062. Other commentators have noted that "because an interdependent multinational banking system with its mutual vulnerability is now a reality, . . . both banks and bank supervisors have a real incentive to develop uniform, or at least harmonized, rules of the game." Bench & Sable, *International Lending Supervision*, 11 N.C.J. INT'L & COM. REG. 427, 433 (1986).

[8] Bench & Sable, *supra* note 7, at 429. Others assert that with the exception of the EEC Contact Group, no single organization has sufficient authority to enforce compliance with mutually agreed upon principles. Hackney & Shafer, *supra* note 3, at 493.

verse economic conditions in the early 1980's,[9] it was fundamentally the result of inadequate bank regulation. Bank regulators in the industrial countries actually encouraged massive private lending to developing countries because the resulting increase in developing country spending stimulated the industrial economies.[10] When it became apparent that the developing countries would soon be unable to service their debt,[11] bank regulators were unable to prevent commercial banks from abruptly cutting off credit to developing countries, thus causing the very debt crisis the bankers had feared.[12]

Since private lending is necessary to revitalize economic development in developing countries,[13] a debt strategy must foster such lending to developing countries within reasonable, sustainable limits. To accomplish this objective, this Note proposes a market-based debt strategy that is comprehensive, globally uniform, and responsive to the changing conditions in debtor countries.[14]

The Background section explains the interrelationships between the four principal groups involved in the debt crisis: the major creditors (a few large commercial banks), the major debtors (a few advanced developing countries),[15] international financial organizations (the In-

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[9] *See infra* notes 57-74 and accompanying text for an explanation of these conditions.

[10] The lending stimulated demand for industrialized country exports which moderated the negative effects of the first oil shock on the industrialized economies. *See infra* notes 30-34 and accompanying text.

[11] The service of debt refers to the periodic payments that the debtor is contractually bound to pay the lender. During the first few years of a long-term debt this payment consists mostly of interest.

[12] *See infra* notes 62-69 and accompanying text.

[13] *See infra* notes 17-25 and accompanying text.

[14] The regulation of private lending to developing countries need not take the form of rules and guidelines administered by a coalition of central bankers like the Cooke Committee or an international organization like the World Bank or the International Monetary Fund (IMF). In fact, this approach has proven to be ineffective. *See infra* notes 75-78 and accompanying text. Government policies in the past have often encouraged misdirected lending patterns. Often, large capital-intensive industrial projects were promoted while agricultural development suffered. Friesen, *supra* note 3, at 1062.

[15] *See* WORLD BANK, WORLD DEVELOPMENT REPORT 1988, at 13, [hereinafter WORLD DEVELOPMENT REPORT]. The World Bank defines highly indebted countries as "countries [that] have encountered severe debt servicing difficulties." *Id.* at xi. Currently, seventeen countries fit this description: Argentina, Bolivia, Brazil, Chile, Colombia, Costa Rica, Côte d'Ivoire, Ecuador, Jamaica, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. In 1982, however, when the debt crisis surfaced, "just four advanced developing countries — Mexico, Brazil, Argentina and South Korea — [accounted] for more than half of the total outstanding

ternational Monetary Fund (IMF) and the World Bank), and the United States government.[16] The Background section is divided into five subsections which explain: (1) the need for foreign capital in developing countries and three alternative forms of capital transfer; (2) the economic, political, and social pressures of the mid-1970's that caused developing countries to rely almost exclusively on commercial bank loans for their capital requirements; (3) the economic and regulatory causes of the debt crisis; (4) the initial debt strategy orchestrated by the commercial banks using the muscle of the IMF; and (5) an innovative supplemental debt strategy that has recently been heavily promoted by the commercial banks — the debt-equity swap.

II. BACKGROUND

A. Alternative Forms of Capital Transfer

The greatest barrier to economic development in the developing countries is their lack of sufficient amounts of capital. The market-

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loans of private banks to non-OPEC developing countries, for some 85 percent of the net floating-interest debt and almost all of total net private bank 'exposure' (excluding guaranteed export credits) to non-OPEC developing countries." *How Serious is the Debt Problem of the Developing Countries?*, OECD OBSERVER, Jan. 1983, at 15 [hereinafter OECD OBSERVER]. These four advanced developing countries all have ample agricultural, mineral, and human resources, but only South Korea has been able to avoid significant problems in servicing its debt. Amuzegar, *Dealing With Debt*, FOREIGN POLICY, Fall 1987, at 152.

Poorer, commodity-dependent countries have incurred mainly official debt (official Development Assistance and officially extended guaranteed export credits) in minor amounts. OECD OBSERVER at 15. A default by one of these poorer developing countries would have a minor effect on the international banking system.

[16] While the U.S. government has always exerted a substantial influence in developing country debt negotiations (due to the fact that the largest holders of developing country debt are U.S. commercial banks), the U.S. government formerly protected its interests from behind the scenes through the World Bank and the IMF. Over the last three years, however, the U.S. government appears to have adopted a more public role in these debt negotiations. Treasury Secretary James Baker announced his "Program for Sustained Growth" at the annual World Bank-IMF meeting in the fall of 1985, *infra* note 95, added his "Menu of Options" in 1987, *infra* note 96, and lent his support to Brazil's debt proposal in the summer of 1987, *infra* note 138. Most significantly, at the end of December, 1987, the U.S. Treasury agreed to sell up to $10 million worth of 20-year, zero-coupon bonds to Mexico for $2 billion to secure a corresponding $10 billion Mexican bond issue used in debt-for-bonds swaps. *See infra* notes 149-50 and accompanying text.

Japan, which has recently emerged as the industrialized country with the largest capital reserves, has also taken a more active role as it becomes increasingly involved in lending to developing countries. For a discussion of Japan's new role in debt negotiations and as a source of capital for the developing countries, *see* Christ. Sci. Monitor, Feb. 26, 1988, at 12, col. 1; Wall St. J., Oct. 1, 1987, at 31, col. 2.

based industrialized economies have accumulated capital over a long period of time through private savings and investment. The non-market industrialized economies have accumulated capital quickly through government mandated savings and investment. In the developing countries, however, little savings and investment can occur since the basic needs of food, clothing, and shelter have not been met.[17]

With little capital accumulation possible, developing countries must obtain capital from the capital-rich industrialized countries in one of three ways: through foreign aid, direct foreign investment,[18] or public and private financing. The more advanced developing countries find foreign aid of limited use because their capital requirements are much greater than the amounts available.[19] Thus, most capital is obtained through direct foreign investment and public and private financing.

Despite many advantages direct foreign investment holds over financing for the purposes of economic development,[20] most developing

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[17] To compound the problem, when money does become available, "capital flight" frequently occurs, as earnings from domestic sales or exports are invested abroad, often in the industrialized countries. This occurs when the expected returns from holding money abroad are higher or safer than at home. *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 65-67.

[18] Direct foreign investment is investment by "non-residents in enterprises in which they or other non-residents exercise significant managerial control. . . ." WORLD DEVELOPMENT REPORT, *supra* note 15, at 296. Direct foreign investment in developing countries should be distinguished from indirect, or portfolio investment, which involves purchasing investments in foreign securities markets. Not even the more advanced developing countries attract much foreign investment in their local securities markets. For recent information on the level of foreign investment in developing countries, see Shihata, *Factors Influencing the Flow of Foreign Investment and the Relevance of a Multilateral Investment Guarantee Scheme*, 21 INT'L LAW. 671 (1987).

[19] Thus, foreign aid is generally reserved for the poorest countries and often has political strings attached. Grants-in-aid or below-market-rate loans are often provided to developing countries with the stipulation that the money be spent purchasing products and services from the donor country. *See* Fishlow, *Latin America's Debt*, COLUM. J. WORLD BUS., Spr. 1982, at 37.

[20] Ibrahim F. I. Shihata, Vice President and General Counsel for the World Bank and Secretary-General of the International Centre for Settlement of Investment Disputes, has concisely summarized the advantages of direct foreign investment:

> First, direct investment does not simply provide funds, but an integrated package of financial resources, managerial skills, technical knowledge, and marketing connections. Second, it is not a debt creating instrument. The investor bears the risks of project failure, while a lender has the right to be repaid regardless of how effectively the borrowed funds were used. Third, other indirect but important attributes of this form of capital relate to benefits that ensue from the introduction of efficient and internationally competitive enterprises into the local economy. In the long run, direct

countries in the 1960's and 1970's refused to embrace the former vehicle.[21] Latin American countries in particular regarded direct foreign investment as a type of commercial imperialism. The developing countries argued that the foreign investor's strong bargaining position[22] forced local governments to make too many concessions, thus enabling foreign investors to obtain an unfair advantage over national investors and hindering the countries' efforts to establish an independent industrial base.[23] To prevent foreign control over important sectors of their economies, developing countries adopted highly restrictive investment regulations[24] and nationalized many foreign-owned industries.[25]

> foreign investment can foster a general improvement in production by stimulating the adoption of improved techniques and management in other sectors of the economy, and among local entrepreneurs. Fourth, foreign investment often works as a catalyst for associated lending for specific projects, thus increasing the overall availability of external resources for productive purposes. Also, foreign investors often act as lobbyists in their home countries for the benefit of their projects in developing countries.

Shihata, *supra* note 18, at 675.

[21] However, the 1980's has witnessed a "fundamental change of attitude from the previous two decades. . . . As a result, a great number of developing countries are now competing to promote foreign investment. . . ." Shihata, *supra* note 18, at 676.

[22] Generally, foreign investors have great flexibility as to which country they will invest in. This gives them a strong bargaining position, as one country competes against another to attract the investors.

[23] This is the basis of the dependency theory, or *dependencia* as it is popularly called in Latin America. Developed by Raul Prebisch and Hans Singer and promoted by the United Nations Economic Commission for Latin America (ECLA) in the 1950's, the dependency theory challenged the neo-classical economic theory that international free trade benefited all participants. Prebisch and Singer saw the current trade structure as perpetuating underdevelopment. They argued that only the industrialized countries benefited from trade because the developing countries only produced and exported raw materials and were subject to deteriorating terms of trade *vis-a-vis* the industrialized countries. The dependency theorists argued that industrialization was necessary to equalize conditions. To speed up the process the ECLA advocated import substitution and protection of "infant industries" through tariffs. The first countries to follow ECLA strategy were Argentina, Brazil, Columbia, and Peru. R. PREBISCH, CHANGE AND DEVELOPMENT — LATIN AMERICA'S GREAT TASK (1971); *see generally* M. BLOMSTRAAM & B. HETTNE, DEVELOPMENT THEORY IN TRANSITION 38-44 (1984). For an analysis of the dependency theory see Jova, *Private Investment in Latin America: Renegotiating the Bargain*, 10 TEX. INT'L L. J. 455, 470-473 (1975). For a list of other relevant articles see Shihata, *supra* note 18, at 676.

[24] One example of restrictive investment regulations is the Andean Pact's old Foreign Investment Code — Decision 24. *See* Note, *The Andean Foreign Investment Code: An Overview*, 7 GA. J. INT'L & COMP. L. 656 (1977). Decision 24 has now

Despite developing countries' distrust of direct foreign investment, in the 1950's and mid-1960's the majority of capital transfer to developing countries occurred in this form. The commercial banks considered developing country loans too risky and instead took advantage of many good lending opportunities which existed within the industrialized countries themselves.[26]

B. Financing Economic Development

In a dramatic reversal foreign private lending surpassed direct foreign investment in the 1970's as the predominant form of capital transfer to developing countries. From 1976 to 1980, direct foreign investment amounted to only 20 percent of the total capital flowing into developing countries.[27] The greater amount of this capital inflow came as loans from private sources.[28] Starting in 1973, commercial banks assumed a progressively larger role in the lending.[29] A number of factors, both regulatory and economic, motivated the commercial banks to change their traditionally conservative lending policy with respect to the advanced developing countries.

It was the oil shock in 1973 that prompted commercial banks to make large loans to developing countries. The Organization of Pe-

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been replaced by Decision 220, which is more favorable to foreign investment. *See infra* note 112.

[25] Shihata, *supra* note 18, at 676. Many of these state-owned corporations are now being "privatized", i.e. the governments are selling the corporations back to private investors. Many of these transactions are being accomplished through debt-equity swaps. Wall St. J., Nov. 18, 1987, at 29, col. 1. *See infra* notes 94-107 and accompanying text.

[26] Although Latin American governments began applying for loans in the 1950's, few were granted during this earlier period. Fishlow, *supra* note 19, at 37. Commercial banks considered developing countries too great a risk compared to alternative borrowers within the industrialized countries. Instead, Latin America obtained most of its foreign capital in the early 1960's from the U.S. government in the form of loans and grants under the Alliance for Progress. *Id.*, at 36.

Mexico was the exception; because of its proximity to the United States, it was deemed creditworthy and received commercial loans earlier. Consequently, Mexico had its first debt crisis in 1975, much sooner than any other developing country, though the discovery of oil deposits in Mexico relieved much of its debt pressure at that time. *Id.*

[27] *Id.* Between 1974 and 1977, the external debt of developing countries is estimated to have doubled in real terms — from $113 to $231 billion. *See* Carvounis, *The LDC Debt Problem*, COLUM. J. OF WORLD BUS., Spr. 1982, at 16. At the same time, bank lending to the developing countries increased more rapidly than official aid, because commercial loans were cheap and relatively free of onerous restrictions. *See* WORLD DEVELOPMENT REPORT, at 27-29.

[28] *Id.*

[29] Fishlow, *supra* note 19, at 36. *See also* Amuzegar, *supra* note 15, at 141.

troleum Exporting Countries (OPEC) earned much of its revenue in U.S. dollars, which were deposited in large U.S. commercial banks, or deposited abroad as Eurodollars.[30] These large, dollar-denominated deposits called "petrodollars" created excess reserves in the commercial banks. Pressured by the need to find new borrowers for these excess reserves, the banks in 1973 relaxed their lending standards and extended more credit to developing countries.

The oil shock and the resulting surplus of petrodollars also greatly reduced money supplies in oil-importing industrialized countries. The reduced money supplies in turn threatened to increase the severity of the "stagflation"[31] plaguing these countries. The petrodollars needed to be "recycled" back into the world economy.[32] Since stagflation had eliminated most good investment opportunities in the Western economies, the developing countries were the natural alternative for investors.[33] The developing countries used the borrowed petrodollars to purchase Western goods and services needed for economic development, thus stimulating demand for Western exports and minimizing the impact of the first oil shock on the economies of the oil-importing industrialized countries.[34]

Despite its new authority over commercial banks under the Bank Holding Company Act,[35] the United States Federal Reserve did nothing to discourage the massive petrodollar loans U.S. banks were making to developing countries.[36] Additionally, central bankers agreed

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[30] Eurodollars are dollar denominated deposits at commercial banks outside the United States.

[31] Stagflation is a situation in which an economy is experiencing both substantial inflation and a slow growth in output. Under these conditions few good investment opportunities exist.

[32] "At the international level, there was no choice: the oil country surpluses had to be financed or global income would fall." Fishlow, *supra* note 19, at 36. *See also* Amuzegar, *supra* note 15, at 141.

[33] *See* Amuzegar, *supra* note 15, at 141.

[34] *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 14.

[35] The U.S. Bank Holding Company Act as amended in 1970, 12 U.S.C. §§ 1841-1850 (1982); 26 U.S.C. §§ 1101-1103 (1982), effectively placed all U.S. banks extensively engaged in international lending under the regulatory arm of the Federal Reserve. *See* Folkerts-Landau, *The Regulatory Origins of the International Debt Crisis*, THE BANKERS MAGAZINE, Sept.-Oct. 1984, at 49.

[36] One commentator blames the Federal Reserve for allowing the excessive lending:

> More importantly, the Federal Reserve did not *discourage* U.S. banks from assuming a loan exposure to non-OPEC developing countries that came to exceed $103 billion by the end of 1982. Given that it was the Federal Reserve that regulated the operations of bank holding companies, including all money center banks, those banks had good cause for complying with the Federal Reserve's wishes.

Folkerts-Landau, *supra* note 35, at 49.

in effect, through the international forum of the Cooke Committee, to cooperate in internationally-oriented lender of last resort operations, thus reducing the commercial banks' loan exposure risk.[37] The banks were given the impression that if the developing countries failed to service their debt to any great degree, the central banks of the industrialized countries would make up any deficiencies.[38]

In addition to pressuring banks and bank regulators to allow more developing country loans, the 1973 oil shock increased the developing countries' demand for dollars. When oil prices rose, the oil-importing developing countries experienced trade deficits, as the cost of their imports exceeded their export income. Concurrently, the oil shock caused a recession in the industrialized countries which indirectly increased developing country trade deficits by reducing demand for developing country exports.[39] The trade deficits soon translated into balance of payments (BOP) deficits, and the funds used to finance these payments deficits were diverted from capital formation, which in turn threatened to slow development.[40] The developing countries had to either restrict spending and thereby slow economic development, or find means to finance the BOP deficits.

Private foreign financing seemed the easiest short-term solution for the developing countries to correct their BOP deficits.[41] By financing

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[37] *See* Folkerts-Landau, *supra* note 35, at 45. Folkerts-Landau explains how "the historically low premiums on loans to developing countries in recent years have been a predictable and rational economic response by banks to the diminishing riskiness of foreign lending." The reduction in risk is in large part a result of financial backing by the central banks.

[38] This was one of many factors cited by Richard S. Dale that "blunted" market restraints on risk-taking for private lending institutions. *See SEC and Citicorp: Hearing Before the Subcomm. On Oversight and Investigations of the House Comm. On Energy and Commerce*, 97th Congress, 1st Sess., 199-208 (1982). Normally, if a bank has too great a loan exposure, the price of the bank's stock will decrease and act as a market restraint. Several instances where the Federal Deposit Insurance Corporation (FDIC) paid off 100 percent of failing bank's deposits also contributed to this false sense of security felt by U.S. banks. *See* Folkerts-Landau, *supra* note 35, at 49.

[39] *See* Carvounis, *supra* note 27, at 17.

[40] *Id.*

[41] The developing countries' alternatives to borrowing were not as attractive. For example, they could have used less oil by encouraging conservation, imported less of other products, or expanded exports — all of which would have improved their trade deficit. These measures were generally not adopted until after the debt crisis materialized. Fishlow, *supra* note 19, at 36. The easy credit terms available to the developing countries in the 1970's encouraged the debtors to overspend. Amuzegar, *supra* note 15, at 142.

the BOP deficits instead of reducing spending on imports, the developing countries could continue their development programs at a rapid pace.[42] The real interest rates on many of these foreign loans incurred to finance the BOP deficits were actually negative,[43] due partially to the competition between banks for the borrowers.[44]

Since private commercial banks were encouraged to lend, and the developing countries were eager to borrow, the banks extended substantial credit to the developing countries for the first time. The recycling of oil revenues in the form of loans to developing countries proceeded at a furious pace. The petrodollar loans were used to finance capital formation, oil imports, and new state enterprises. Large commercial banks in the United States were the principal lenders,[45] and the advanced developing countries received the majority of the loans.[46] Having more diversified economies that could more easily generate the foreign exchange necessary to service their debt, the advanced developing countries presented less risk. Additionally, these countries imported much more oil, and so required more loans.[47] Most loans were made to or guaranteed by the governments, the banks perceiving this as a means of underwriting the risk.[48]

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[42] Fishlow, *supra* note 19, at 36.

[43] An interest rate on a loan is negative when the inflation rate is greater than the interest rate charged on the loan:

> Given the double-digit inflation levels in almost every oil-consuming country at the time and the expectation that inflation would continue, [the 8.5 percent average nominal rate on loans between 1973 and 1979] . . . corresponded in fact to a negative real rate of minus one percent or less. In 1975, real rates fell as low as -4 percent, according to estimates by the World Bank. Borrowing therefore turned into a very attractive activity.

Folkerts-Landau, *supra* note 35, at 47. The commercial banks did, however, insist on floating interest rates. Thus, when market interest rates rose in the early 1980's, the negative interest rates disappeared.

[44] OECD OBSERVER, *supra* note 15, at 13.

[45] Highly competitive loan policies adopted by the largest commercial banks from 1976 to 1979, among them Citibank, Bank of America, and Chase Manhattan, concentrated the lending volume among a comparatively small group of banks. *See* Carvounis, *supra* note 27, at 16.

[46] The 1982 debt crisis, involved primarily a handful of developing countries because private banks had avoided lending to the poorest developing countries. *Id.*

[47] In 1973, low-income developing countries imported $6 million worth of oil, rising to $2.7 billion in 1979 and $3.3 billion in 1980. Concurrently, advanced developing countries imported $6.1 billion worth of oil in 1973, $40 billion in 1979, and $54.5 billion in 1980. *See* Carvounis, *supra* note 27, at 17.

[48] Not only was public guarantee an important attraction to banks, but "[it provided] unprecedented access to capital for the state sector . . . underwriting its expansion." Fishlow, *supra* note 19, at 37. The belief was that states don't go bankrupt. WORLD DEVELOPMENT REPORT, *supra* note 15, at 27-28.

The commercial banks imposed "hard terms" on the developing countries compared to the "soft terms" characteristic of official aid. For example, the private loans typically provided for floating interest rates[49] and shorter maturities.[50] The shorter maturities resulted in part from the commercial banks' inability to consistently predict the risk presented by the borrowing countries 8 or 10 years in the future.[51] Additionally, bank regulators actually encouraged the short-term lending since it allowed commercial banks to have a more flexible liquidity position.[52]

Throughout the 1970's, the developing countries serviced their debt without great difficulty. The value of the U.S. dollar had been declining,[53] commodity prices were rising,[54] and real interest rates were mostly negative.[55] Excessive government spending, financed from abroad, created artificially high growth rates in the developing countries. Public opinion in developing countries was therefore generally optimistic and growth-oriented.[56]

C. *The Economic and Regulatory Causes of the Debt Crisis*

The second oil shock precipitated the debt crisis. In 1979, to compensate for rising inflation rates, the industrialized countries adopted severe deflationary measures which resulted in world-wide recession and high unemployment and interest rates. As the recession deepened in the industrialized countries, their demand for imports fell and the developing countries' export volume declined correspond-

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[49] A floating interest rate is always linked to a variable base rate like the London Interbank Offered Rate (LIBOR) which is itself tied to other key rates such as the U.S. prime rate. The floating interest rate is equal to the variable base rate plus the "margin". It is recalculated at fixed intervals (usually every six months). *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 29 (Figure 1.9).

[50] *See* Carvounis, *supra* note 27, at 16.

[51] *See* Carvounis, *supra* note 27, at 17, and Fishlow, *supra* note 19, at 37.

[52] If the industrialized countries in the future required additional funds, the commercial banks could more easily respond provided that their money was not tied up in long-term loan commitments. *See* Freisen, *supra* note 3, at 1062.

[53] With the exchange rate for dollars being low, it cost less to pay off the dollar-denominated loans.

[54] One of the weaknesses of developing country economies is their dependence on the export of one or two commodities as the principal source of foreign exchange. With commodity prices rising, the borrowing countries had more foreign currency to make payments on the loans. However, in the early 1980's, commodity prices plummeted, severely limiting the developing countries' supplies of foreign exchange.

[55] *See* Amuzegar, *supra* note 15, at 142.

[56] As one commentator explained: "[C]apital inflows readily allowed poorer countries to maintain or raise their living standards." Amuzegar, *supra* note 15, at 142.

ingly. As a result of this decline in exports the developing countries lost much of the already scarce foreign exchange they needed to service their debt.

Not only did the demand in the industrialized countries for developing country products fall as a consequence of the recession, but the high unemployment rates in industrialized countries spawned protectionist policies against imports from developing countries.[57] Additionally, subsidies from industrialized countries to their own producers caused an oversupply in the world commodity markets, thus driving commodity prices down.[58] The developing countries, generally dependent on commodity exports as their primary source of foreign exchange, found their ability to service their debt substantially impaired.[59] The rapid rise in interest rates in the developed countries compounded the developing countries' debt service difficulties. As the London Interbank Offered Rate (LIBOR)[60] rose above 15 percent, the floating interest rates on the developing country debt increased correspondingly.[61] Thus, the developing countries faced higher periodic interest payments at the same time as their supply of foreign exchange dwindled.

As the recession deepened, the world demand for oil also declined and the inflated oil prices fell;[62] correspondingly, the banks' supplies of petrodollars dwindled.[63] The drop in oil prices, instead of helping oil-importing developing countries meet their debt obligations, primarily affected the ability of oil-exporting developing countries like Indonesia, Mexico, Nigeria, and Venezuela to service their debt, and also removed from the banks their primary source of loanable funds.[64]

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[57] Carvounis, *supra* note 27, at 15. The brunt of the industrialized countries' most severe protectionist policies are directed at the major debtor countries. *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 16 (Box 1.1).

[58] Surplus agricultural products, the result of subsidies in industrialized countries, are often dumped on world markets, depressing prices. Thus, even though developing countries are often the more efficient producers of agricultural products, they end up losing sales. The EEC, Japan, the Nordic countries, and Austria subsidize their exports the most. *See* chart in OECD OBSERVER, Aug.-Sept. 1987, at 7.

[59] Most developing countries depend primarily on one or two commodities for their export income. Thus, if commodity prices are depressed, the countries' major source of foreign exchange is severely diminished.

[60] *See supra* note 49.

[61] *How the Cash Flow Crisis Floored the LDCs*, EUROMONEY, Aug. 1982, at 21 [hereinafter EUROMONEY].

[62] Petroleum prices fell 15 percent from $34 a barrel in 1982 to $29 a barrel in 1983. Folkerts-Landau, *supra* note 35, at 47.

[63] *Id.*

[64] Amuzegar, *supra* note 15, at 146.

As some developing countries experienced increasing difficulty servicing their debt, banks cut credit with an abruptness that precipitated the very liquidity crisis that the banks had feared.[65] Long- and medium-term lending to developing countries slowed dramatically,[66] dropping from $47 billion in 1981 to $25 billion in 1982.[67] Only short-term loans at high, floating interest rates were available.[68] In 1983, with the lending virtually stopped and the developing countries on the brink of default, the debt crisis had arrived.[69]

Both the debtors and the creditors have attempted to avoid the blame for the debt crisis.[70] Debtors blame the world-wide recession, low commodity prices, protectionist policies in industrialized countries, high import prices, record high interest rates, and the sudden cancellation of credit by the commercial banks — all significant factors beyond the control of the debtor nations.[71] Creditors, while acknowledging the significance of some of these factors, place most of the blame on the debtor governments' undisciplined domestic policies,[72] capital flight,[73] and corruption. The World Bank's expla-

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[65] The debt crisis at first was described as a cash flow problem, i.e. a liquidity crisis. The developing country investments were not generating enough foreign exchange through increased imports to service the debt. By cutting credit suddenly to the developing countries, the banks made this cash flow problem much worse. *See* Fishlow, *supra* note 19, at 41.

[66] Medium-term debt increased 20 percent per year from 1970 to 1979 then slowed to 15 percent in 1980 and 1981. EUROMONEY, *supra* note 61, at 23. By 1982 there was a net cash outflow from the developing countries. *Id.* at 29.

[67] Folkerts-Landau, *supra* note 35, at 47.

[68] In Latin America at the beginning of 1981, short-term borrowing was already 41 percent of the total and by the end of the year the proportion had risen to 66 percent. EUROMONEY, *supra* note 61, at 21.

[69] Amuzegar, *supra* note 15, at 142. Looking back at the massive borrowing that occurred in Latin America, commentators have noted: "It is ironic that most countries in Latin America strongly preferred bank loans to foreign equity investment in the 1970's, in pursuit of greater independence from foreign influence, yet would have suffered much less disruption had they chosen the opposite course." B. Balassa, G. Bueno, P. Kuczynski, & M. Simonsen, *Toward Renewed Economic Growth in Latin America*, INST. FOR INT'L ECON., at 28 (1986).

[70] *See* Amuzegar, *supra* note 15, at 143.

[71] *Id.* at 142. *See also* Carvounis, *supra* note 27, at 15.

[72] Not all developing country officials dispute the claim that their policies contributed to the problem. For example, Adrian Lajous, former head of the Mexican Central Bank, concedes that Mexico's borrowing during the 1970's was irresponsible. *See* Wall St. J., Oct. 2, 1987, at 21, col. 3.

However, some offer a strong rebuttal to the creditors' charges:

> While better policies by borrowers would doubtless have made a difference, it is striking that nearly all countries which borrowed commercially are in a similar situation — their debt service exceeds 50 percent of exports and

nation appears closer to the mark; it finds debt-servicing difficulties to have been caused by a combination of poor domestic policies and a deteriorating world environment.[74]

While the 1982 debt crisis is generally attributed to these two aggregate factors, on a more fundamental level, a substantial share of the blame belongs to the regulatory practices of creditors' governments. These governments' bank regulatory agencies paid little attention to the risks in most of the loans being made to developing countries, focusing instead on encouraging the recycling of petrodollars.[75] Paul A. Volker, former Chairman of the U.S. Federal Reserve, explained to Congress that in the United States, "bank examiners were not equipped to evaluate economic conditions and prospects of countries. There was a high degree of variability in the way country lending was handled in examination reports."[76] On the

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> they are unable to meet contractual obligations. This is true both of countries with elected civilian governments and those with military governments. It is true of right-wing, free-market economies, of centrist, statist economies and of socialist economies. It is true of large countries and small countries, of oil exporters and oil importers, of countries long praised for the high quality of their public administration and of countries long criticized for their low level of management.

Weinert, *Coping With LDC Debt*, 38 J. INT'L AFFAIRS 1 (1984). Significantly, only developing countries on the Pacific Rim, most notably South Korea and Taiwan, have managed to avoid debt problems. *See* Amuzegar, *supra* note 15, at 152.

[73] It is estimated that $80 to $100 billion fled Latin America after 1974. Even some of the money borrowed from commercial banks left the developing countries. "Overvalued exchange rates, themselves made possible by the borrowing, made such flight attractive." Kuczynski, *The Outlook for Latin American Debt*, FOREIGN AFFAIRS, Fall 1987, at 129, 143.

[74] *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 13-14. "The debate about whether economic mismanagement by borrowers, imprudent lending by banks or exogenous shocks was primarily responsible for the debt crisis is sterile. All three factors contributed, and it really does not make much difference how the blame is allocated." Weinert, *supra* note 72, at 1.

[75] Elinor G. Constable, Deputy Asst. Secty. For Econ. and Bus. Affairs, Dept. of State, stated:

> For industrialized and developing oil-importing countries alike, the appropriate policy response to [the first oil shock and inflation] would have been a combination of fiscal and monetary restraint. . . . [U.S.] policy did not focus on the need to adjust. Rather, our primary concern was the encouragement of efficient "recycling" of the OPEC surpluses. . . .

Hearings, *supra* note 6, at 57-58.

There is general agreement today that the large commercial banks did not adequately account for sovereign risk in debtor countries, and consequently overexposed themselves. *See* Amuzegar, *supra* note 15, at 143.

[76] *International Financial Markets and Related Problems: Hearings Before the House Comm. On Banking, Finance and Urban Affairs*, 98th Cong., 1st Sess., 52 (1983) [hereinafter *Banking Commission Hearings*].

international level, the Cooke Committee essentially assumed a lender-of-last-resort function, thereby removing normal market restraints on risk-taking in international banking.[77] Consequently, a commercial bank could maintain high levels of loan exposure without adversely affecting its balance sheet, volume of deposits, or the price of its stock.[78]

D. The Containment Strategy

The danger of widespread defaults by major debtors in 1982 suddenly brought home the fact that the commercial banks were dangerously overexposed. Public confidence had to be quickly restored in order to avoid a collapse of the international banking system.[79]

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[77] Folkerts-Landau, *supra* note 35, at 45.

[78] Recognizing the need to strengthen the regulation of U.S. banks' international lending, the Comptroller's Office, the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) formed the Interagency Country Exposure Review Committee (ICERC) in 1979. *See* Bench & Sable, *supra* note 7, at 434. The ICERC implemented a four-part country risk examination system: (1) a statistical reporting system designed to identify country exposures at each bank; (2) an evaluation of each bank's internal system for managing country risk; (3) a series of classifications for sovereign debt not serviced in a timely manner ("substandard", "value impaired", or a "total loss") which may trigger an obligation by the bank to set aside precautionary loan-loss reserves; and (4) a bank examiner review of each bank's large foreign lending exposures. *See id.*, at 435-439. The procedures emphasize diversification as the best measure of protection for banks in their international lending. *Banking Commission Hearings*, *supra* note 76, at 7 (letter from Paul A. Volker, Chairman of the Federal Reserve).

Special loan-loss reserves are required when debt is classified as value impaired. The threat of mandatory increases in reserves (which cut deeply into bank profits) puts additional pressure on banks and their borrowers to resolve debt problems. For example, Brazil paid 3 months of debt service in the fall of 1987 to avoid having its debt classified as value impaired and to gain additional time for negotiations with its creditors.

Charles Bowsher, the Comptroller General, admitted, however, that the country risk examination system has three inherent limitations: bank regulations cannot solve worldwide economic problems; events that affect country risk can develop very quickly with little advanced warning; and bank regulations cannot replace good bank management. *Hearings*, *supra* note 6, at 16. Moreover, Mr. Bowsher felt that the system's objectives were not being clearly communicated to bankers. *Id.* at 18. He noted also that since its implementation in 1979, the system has had no demonstratable impact in restraining the growth in bank lending to countries with potential payment problems. *Id.*

Congress has responded by enacting the International Lending Supervision Act of 1983, 12 U.S.C. §§ 3901-12 (Supp. II 1984)(ILSA), which directs the federal agencies to strengthen their supervision of U.S. banks' international lending. For an analysis of the ILSA, see Bench & Sable, *supra* note 7, at 429.

[79] *See* Kuczynski, *supra* note 73, at 130. The banks were in a precarious position:

With this objective, commercial bankers attempted to characterize the debt crisis as a simple short-term cash flow problem of the developing countries, a liquidity crisis that would be solved in the long-run through growth.[80] This was the basic premise of the containment strategy adopted by the commercial banks and supported by the U.S. Treasury.

The containment strategy sought to enable the major debtor countries to continue servicing their debt through rescheduling, adjustment, and additional financing. Rescheduling involves lengthening loan maturities to postpone principal payments and lower debt service amounts; unfortunately, interest rates were still allowed to float, and this dramatically increased a rescheduled loan's total interest component. Adjustment involves reducing imports and spending, and curtailing credit, politically precarious moves in developing countries which had only just begun to raise standards of living. To force the debtor countries to implement strict adjustment measures, the lending banks required each debtor country to sign a loan agreement with the International Monetary Fund (IMF) as a precondition to rescheduling or additional financing.[81]

"[L]arge private banks typically held Latin American debt equal to two to three times their capital. To register a loss of even 25 percent of their portfolio would imply wiping out one half to three-fourths of their capital. This was clearly impossible." Weinert, *Swapping Third World Debt,* FOREIGN POLICY, Winter 1986-87, at 87. If any bank broke the alliance of the major third world creditors by dumping its debt, i.e. selling it for less than face value, it would be an admission that the banks' assets were overvalued. *See id.*

[80] See EUROMONEY, *supra* note 613, at 25. The banks adopted the dangerous strategy of financing long-term investments with short-term debt. The interest payments created a "snowball effect" that plagued the developing countries, as not enough foreign exchange could be generated in the short-run to meet rising debt service obligations. The commercial bankers argued, however, that in the long-run past capital inflows from the loans of the mid-1970's would stimulate production and exports enough to increase the debtor nations' supplies of foreign exchange. *See* Carvounis, *supra* note 27, at 16.

Today, it is apparent that the debt crisis represents a problem of the long-term solvency of developing countries. The snowball effect cannot be avoided so easily: "As available loan terms stiffen, these countries must borrow a greater and greater portion of their debt on hard terms which of course compounds the total amount of debt which must be remitted in the future and adds to the growth of deficits." *Id.* In 1982, a one percent change in nominal interest rates could increase Latin American debt service costs by almost one billion dollars. In 1981, when interest rates jumped, Latin American net payments of interest and profits increased by $6 billion over 1980. *See* Fishlow, *supra* note 19, at 37.

[81] The banks considered IMF loan agreements with developing countries crucial to the success of the containment strategy. IMF involvement enabled the banks to

Over the next three years, the containment strategy postponed any large-scale defaults. Between 1982 and 1985, more than $140 billion in short- and medium-term loans for some 30 countries were rescheduled.[82] Additionally, the IMF extended $31 billion in new loans to 72 developing countries, and private banks extended another $27 billion,[83] these private loans being primarily "involuntary loans" made to enable debtors to continue servicing the existing debt. Fortunately, interest rates fell back down to normal levels,[84] and this combination of adjustment, rescheduling, and declining interest rates brought the developing countries' total BOP deficit down from $110 billion in 1982 to $44 billion in 1985. In addition, the developing countries' 1982 trade deficit of $50 million rose to a $7 billion trade surplus by 1985.[85]

However, the containment strategy was not without its costs. The austerity measures imposed under the IMF agreements demanded sharp cuts in imports by developing countries, which in turn reduced the export income of industrialized countries.[86] The severe spending cuts in developing countries mandated by these austerity measures caused recessions in these countries which further stalled development.[87] Both agricultural and industrial sectors depended upon capital equipment imported from industrialized countries,[88] and spending cuts forced these sectors to operate less efficiently or cease operating altogether. Gross national product growth in developing countries fell to about 2 percent in the 1980's from an average of 3 percent in the

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force developing countries into severe deflationary adjustments by withholding funds unless the debtor countries complied with the terms of the adjustment agreement. IMF involvement restores the international banking community's confidence that the debtor nation will remain solvent. *See Don't Call the IMF: It's Running Out of Quotas*, EUROMONEY, Aug. 1982, at 51, 52.

[82] *See* Amuzegar, *supra* note 15, at 144.

[83] *Id.* at 143.

[84] *Id.* at 144.

[85] *Id.* at 146. While drastic cuts in imports created much of the trade surplus; high rates of spending in the U.S. also contributed as the demand for inexpensive third world goods increased. The shift in U.S. trade balances with Latin American debtors accounts for over one third of America's annual trade deficit. *Id.*

[86] In 1980, 40 percent of U.S. export income came from sales to developing countries. The $21 billion drop in the U.S. trade balance in the 1980's is nearly equal to the drop in demand for U.S. products in Latin American countries alone. Weinert, *supra* note 72, at 1-2.

[87] For a general discussion of the effects of adjustment on the developing countries see Kuczynski, *supra* note 73, at 130.

[88] *See* Weinert, *supra* note 72, at 3.

1970's and 5 percent in the 1960's.[89] Unemployment levels rose and governments cut social services.[90]

Through these effects, the containment strategy only made the debt crisis more difficult to solve. The strategy operated on the false premise that the debt crisis was merely a short-term cash flow problem rather than a long-term problem of the solvency of the debtor countries. Under the strategy, the debtor countries' supplies of foreign exchange never increased,[91] and rescheduling never reduced the interest burden on their loans. The strategy served only the limited purpose of buying the time necessary for banks to reduce their exposure by either building up reserves or selling off loans.[92] In the interim, the overall debt of the developing world has continued to grow, surpassing the $1 trillion mark in 1987.[93]

When Citicorp, the world's largest lender to the developing countries, announced in May 1987 that it would set aside $3 billion in additional loan-loss reserves, it marked the death of the containment strategy. The $3 billion reserve, approximately one quarter of Citicorp's debt holdings, amounted to an implicit admission that the debt crisis presented a problem of the long-term solvency in debtor nations, and that at least part of the debt will never be repaid.

E. *The Debt-Equity Swap*

At a time when the extension of credit to the developing countries is dwindling,[94] debtor nations and creditor banks are increasingly turning to alternative approaches to manage the debt crisis.[95] In the

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[89] Amuzegar, *supra* note 15, at 145. Seven Latin American countries that maintained strong trade surpluses in 1982 and 1983 experienced gross domestic product growth of *minus* 0.9 percent in 1982 and 3.9 percent in 1983. Weinert, *supra* note 72, at 3.

[90] Kuczynski, *supra* note 73, at 130.

[91] While developing country export volume has risen substantially since 1982, commodity prices remain depressed due to chronic oversupply. *See* WORLD DEVELOPMENT REPORT, *supra* note 15, at 24-25.

[92] In 1986 alone, banks sold $8 billion of Latin American debt on the secondary market. *See generally* Weinert, *supra* note 79, at 85.

[93] Amuzegar, *supra* note 15, at 141.

[94] It took 6 months to raise $7.7 billion for Mexico's recent restructuring. Wall St. J., June 11, 1987, at 6, col. 1.

[95] Two of the most popular alternative debt strategies are the Baker Plan and the Bradley Plan. At the annual fall meeting of the IMF and World Bank in 1985, U.S. Treasury Secretary James Baker announced his "Program for Sustained Growth". *See* 25 I.L.M. 412 (1986). The Baker Plan called for additional economic reforms in the developing countries to improve efficiency and stimulate growth. If developing

summer of 1987, United States Treasury Secretary James Baker offered a "Menu of Options" from which debtors and creditors could choose.[96] Of the options suggested, only the debt-equity swap has received significant attention from both creditors and debtors.

In essence, the debt-equity swap allows a commercial bank to credit a portion of a developing country's debt if the developing country allows in a like amount of direct foreign investment.[97] For example,

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countries adopted such reforms, banks would then be asked to make $20 billion in new loans over a 3-year period, and the World Bank another $9 billion. Unlike the containment strategy, the Baker plan recognized that additional capital inflows were needed to generate sustained growth in the developing countries, and that austerity measures by themselves were ineffective. *See* Amuzegar, *supra* note 15, at 147.

The Baker Plan, however, has itself proved to be ineffective. Commercial banks continue to avoid making any additional new loan commitments. *See* American Banker, Sept. 25, 1987, at 11, col. 1. The $20 billion target for new private loans will probably never be met. Amuzegar, *supra* note 15, at 147. The Baker Plan has been criticized by both creditors and debtors alike. Commercial banks argue that any new loans will merely add to the debt burden and increase the banks' exposure. The Group of 24, on the other hand, representing 130 developing countries, argues that even more loans are needed since the debt cannot be serviced without restoring economic growth. In addition, they suggest interest relief on old debt, and repayment schedules tied to export earnings. *See* 25 I.L.M. 450 (1986).

U.S. Senator Bill Bradley (D-New Jersey) in June, 1986 suggested an alternative strategy that represents a compromise between creditors and debtors. Like the Baker Plan, the Bradley Plan tied $9 billion of new World Bank loans to economic reforms in the developing countries. Unlike the Baker Plan, however, the Bradley Plan does not require new commercial bank loans, calling instead for selective interest rate relief designed to reduce the debt service burden. Ultimately, the interest rate relief would provide more debt relief to the developing countries than the Baker plan. The Bradley Plan provided for $57 billion in debt relief by cutting 3 percentage points off the interest rates of all outstanding private and public debts of 15 debtors for 3 years, and a 3 percent write-down of the loan principal each year for 3 years. *See* Amuzegar, *supra* note 15, at 148-49.

Unfortunately, though earning the support of the developing countries, the Bradley plan has drawn little support in Congress. Since the plan requires banks to absorb losses from lost interest income, it has been labeled "radical". *See* Wall St. J., Sept. 10, 1987, at 32, col. 1. Critics argue that these losses would only be shifted onto taxpayers. Senator Bradley, however, counters that without interest rate relief, additional involuntary loans will be needed to enable debtor nations to continue servicing their debt. Such loans fail to provide new capital inflows necessary for growth and only increase the probability and magnitude of a default. Since the U.S. government would be forced to bail out the banks if major defaults occurred, taxpayers would eventually shoulder an even greater burden. *See* Wall St. J., Sept. 29, 1987, at 39, col. 1.

[96] Wall St. J., Sept. 29, 1987, at 35, col. 1. For a description of many of the new financing techniques for developing countries which are included in Baker's Menus of Options, see Regling, *New Financing Approaches in the Debt Strategy*, FINANCE AND DEVELOPMENT, Mar. 1988, at 6.

[97] A similar technique, employed in corporate reorganizations, requires the con-

a creditor bank might sell $1 million (face value) of a developing country's debt to an intermediary[98] at a discount of 20 percent. The bank credits the debtor country's account $1 million and treats the 20 percent discount as a loss. A foreign investor, interested in making an investment in the debtor country, buys the discounted debt from the intermediary at the same price. The intermediary, on behalf of the foreign investor, presents the canceled debt to the debtor country's central bank, where it is transformed into an equity investment in the debtor country with a value close to the face value of the original loan, with returns to be paid in the local currency.[99] The intermediary receives a fee from the foreign investor for its brokerage services.[100]

The commercial banks, who are the main promoters of debt-equity swaps, argue that the swaps benefit all parties involved.[101] The banks remove the bad debt from their books, create tradeable securities,[102] and the foreign investor receives the benefit of the discount, thereby

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version of an overly large corporate debt into shares of stock. The debt-equity ratio is improved and the interest burden is reduced. *See* Weinert, *supra* note 79, at 89. The well-publicized Chrysler Corporation bailout scheme employed this technique, and lenders eventually benefited. *Id.*

[98] Often the commercial bank arranges the debt-equity swap, pocketing the large brokerage fee itself. Citicorp follows this practice. *See* Marton, *The Debate Over Debt-For-Equity Swaps*, INSTITUTIONAL INVESTOR, Feb. 1987, at 178.

[99] The developing country's central bank negotiates the exchange rate on the debt-equity swap with the foreign investor. Under the Mexican debt-equity swap agreement, the central bank forces foreign investors to share half of the discount they received from the bank by offering a lower exchange rate. *See* Ollard, *The Debt Swappers*, EUROMONEY, Aug. 1986, at 67, 69. Thus, in the example, if the foreign investor wanted to invest in Mexico, the foreign investor would be paid 90 percent of the $1 million note in Mexican currency.

[100] In another variety of this transaction, the lender bank makes the actual investment. In August, 1987, the Federal Reserve Board announced a liberalization of Regulation K which had limited bank ownership of non-financial companies to 20 percent. 12 C.F.R. § 211.5(f)(1988). The revised Regulation K enables banks to acquire, through their subsidiaries, up to 100 percent of foreign financial and non-financial companies. *See* Wall St. J., Aug. 13, 1987, at 3, col. 2. The non-financial companies may only be acquired from a government with a high level of foreign debt and ownership is limited to a maximum of five years. *Id.* Additionally, the non-financial company must be in the process of converting from public to private ownership. Wall St. J., Aug. 14, 1987, at 10, col. 1. According to industry experts, the new ruling will probably cause banks to broaden their holdings to include manufacturers and service companies. *Id.*

[101] Recent Development, *International Debt: Debt-To-Equity Swaps*, 28 HARV. INT'L L. J. 507, 512 (1987).

[102] Some critics of debt-equity swaps are quick to point out another benefit realized by the banks who arrange these swaps: large brokerage fees. The typical fee in 1986 was 1 percent of the face value of the debt swapped. Before swaps became competitive, the brokerage fee ran as high as 4 percent. Marton, *supra* note 98, at 178.

reducing his costs of investment. The banks argue that this encourages additional investment, thereby increasing the capital transfer to developing countries while at the same time canceling part of their debt.[103] Moreover, banks argue, developing countries are provided with a technique to encourage the repatriation, at no cost to them, of capital that had left the countries, by allowing a national with foreign holdings to repatriate his capital at a more favorable exchange rate. Finally, all of these benefits accrue without diminishing the developing countries' supply of foreign currency; thus, the banks argue, preserving the debtors' balance of payments and enhancing their creditworthiness.

The sudden enthusiasm for swapping debt for equity at a discount signals a shift in the lender banks' financial positions. Over the past five years many of these banks have set aside substantial reserves to cover possible losses on loans to developing countries.[104] The larger reserves allow banks to sell their debt at a discount in a debt-equity swap without directly reducing profits as they are reported on their income statements.[105]

The debt-equity swap arrangement has been an integral part of most recent rescheduling agreements.[106] Chile, Mexico, the Philippines,

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[103] Ollard, *supra* note 99, at 69.

[104] The more honest depiction of assets has restored confidence in the banks' financial health even though it has severely cut into their profits. Despite experiencing its most unprofitable quarter ever, when Citicorp announced that $3 billion in reserves would be set aside against loans to developing countries, the price of its stock increased. Wall St. J., May 20, 1987, at 1, col. 6. Soon after Citicorp added $3 billion to its loan-loss reserves, many of the major commercial banks followed suit: Chase Manhattan — $1.6 billion, BankAmerica and Chemical Bank — $1.1 billion, and Manufacturer's Hanover — $1.7 billion. Fifty U.S. banks have reported additions to loan-loss reserves totaling $16.7 billion and second-quarter net losses totaling $12.9 billion. Wall St. J., July 20, 1987, at 2, col. 2.

[105] The week after Citicorp Chairman John S. Reed announced the increase in loan-loss reserves, Citicorp announced that it would aggressively pursue debt-equity swaps. *See* Wall St. J., May 28, 1987, at 6, col. 1. Richard L. Huber, head of Citicorp's investment banking division, explained why the debt-equity swap has suddenly become popular:

> For debt-equity swaps to work, there needs to be a liquid market of debt that can be traded. Until now, most banks haven't been willing to part with those loans, because to do so would have required taking a loss — a no-no when it was imperative to maintain the fiction that all that debt would be repaid. Now that [Citicorp Chairman John S. Reed] has set aside $3 billion to cushion those losses, and other major banks have followed suit, that obstacle is gone.

Bartlett, *The Citi Squeezes Its Lemons*, BUS. WK., June 15, 1987, at 31.

[106] Wall St. J., June 11, 1987, at 6, col. 1. *See also*, Weinert, *supra* note 79.

and a few other debtor countries have together exchanged about $10 billion of foreign bank debt in debt-equity swaps. Chile probably accounts for as much as a third of this total and has reduced its outstanding debt by around 10 percent.[107]

III. ANALYSIS

A. *The Debt-Equity Swap*

Critics of debt-equity swaps voice three principal objections to the practice: first, that hostile attitudes in developing countries towards foreign investment there limit the swaps' effectiveness; second, that the debt-equity swap fails to encourage additional investment because most of the swaps are being completed by investors who already have interests in the host countries and would make the investments regardless of the discount offered in the swap;[108] and third, that the repatriation of profits out of the developing countries over the long run destroys any temporary positive effect on the debtors' balances of payments.[109]

The belief of some critics that developing countries will inevitably maintain their traditionally hostile attitude toward foreign investment seems untenable.[110] The promotion of debt-equity swaps is much more than mere "ideological tutelage" by the governments of industrialized countries as some critics claim.[111] Admittedly, the success of the debt-equity swap depends upon the willingness of the host country to accept foreign investment. However, within the past few years the governments of most developing countries have adopted new pro-foreign investment policies,[112] recognizing the danger of assuming too

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[107] Wall St. J., June 11, 1987, at 6, col. 1.

[108] *See* Marton, *supra* note 98, at 177. Rudiger Dornbush of the Massachusetts Institute of Technology asserts that "In nine out of ten swaps, it is one big rip-off. . . . The investment would have come in anyway, and with a swap the central bank is saddled with paying an unnecessary subsidy to provide the local currency." *Id.*

[109] *See* Kuttner, *Third World Debt: A Flawed Solution*, BUS. WK., Jan. 19, 1987, at 18.

[110] N.Y. Times, Aug. 23, 1987, at 3, col. 1.

[111] *See, e.g.*, Kuttner, *Third World Debt: A Flawed Solution*, BUS. WK., Jan. 19, 1987, at 18.

[112] Venezuela is an excellent example of this shift in attitudes. In the 1970's, as a member of the Andean Pact, it enacted a strict foreign investment code designed to severely limit foreign access to Venezuelan investments. At the time, Venezuela could afford to pursue such a policy, as its income from oil exports was good. The

much external debt. Foreign investment is often the only real alternative source of capital available to them.[113] Nevertheless, modification of public perceptions within developing countries takes time; thus, new foreign investors must proceed responsibly and respect developing countries' sovereignty.

While it is probably true that many investors using swaps often would have invested in the particular developing country anyway, the discount on debt-equity swaps enables these investors to invest greater amounts than otherwise.[114] Moreover, many critics ignore the fact that the developing country directly participates in the debt-equity swap. If the debtor nation's central bank believes that a particular foreign investment would enter anyway, it may simply refuse to make the swap.[115] Also, if a sudden need for foreign currency arises, the developing country may postpone debt-equity swaps temporarily, and consider offering to foreign investors a preferential exchange rate at a like discount so as not to lose the investment.

The objection that the repatriation of profits will nullify any positive effect that the debt-equity swap will have on the debtor nation's balance of payments ignores the foreign exchange benefits of direct foreign investment. Through its export earnings, the enterprise will naturally increase the foreign exchange of the host country, or al-

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situation changed in the early 1980's when oil prices slumped and Venezuela, dependent upon oil revenues for foreign exchange, experienced its own debt crisis. After undergoing restructuring and severe austerity measures, Venezuela has changed its attitude towards direct foreign investment. In 1986, Venezuela liberalized its foreign investment regulations and Venezuela will likely ratify the Andean Pact's Decision 220, the new pro-foreign investment code, which will replace Decision 24. *See* Frances, *After Boosting Reserves U.S. Banks Are Less Likely To Grant New Latin Loans*, Christ. Sci. Monitor, June 4, 1987, at 18, col. 1.

[113] Advanced developing countries frequently must choose between external financing or direct foreign investment. *See supra* notes 18-22 and accompanying text.

[114] "Sure, the investment might have come in anyway," admits Jay Newman, Senior Vice President of Shearson Lehman Brothers, "[b]ut the swap adds that additional $20 million to $30 million to it." Marton, *supra* note 98, at 177.

[115] Or it may split the discount with the foreign investor. Mexico uses this method. *See* Ollard, *supra* note 99, at 72. If the debtor nation's central bank has difficulty identifying new foreign investment, the developing country may encourage U.S. banks to take full equity positions in debtor state enterprises under the new liberalized Regulation K. *See supra* note 100. Since U.S. banking regulations would not permit the U.S. bank to invest otherwise, this would guarantee that the debt-equity swap resulted in new investment. Furthermore, under the new Regulation K, the bank must divest its holdings in 5 years, minimizing the danger that the developing country would permanently lose control of an important sector of its economy. The state may simply repurchase the enterprise in 5 years or allow it to be sold to local investors.

ternatively the enterprise will save foreign exchange through its domestic sales by providing goods and services that would otherwise have been imported. Thus, as a result of the direct foreign investment, foreign exchange accumulates within the host country and its balance of payments improves. If the enterprise has earned a profit, the balance of payments will already have been improved beyond the amount that can be repatriated as profit;[116] if the foreign-owned enterprise is unprofitable, the host country will not lose foreign exchange because there will be no profits to repatriate.[117]

Nevertheless, despite the arguments in favor of debt-equity swaps, excessive use of swaps will aggravate inflation in the developing countries.[118] Issuing domestic currency to the foreign investor expands the developing country's money supply, which increases aggregate demand, and thus makes necessary an expansion in output to avoid further inflation. Yet, because output frequently cannot be expanded sufficiently many developing countries must restrict the amount of swaps in specific time periods,[119] further restricting the debt-equity swaps' effectiveness as a debt strategy. In 1986, the swaps eliminated only $5 billion of nearly $800 billion in developing country debt.[120] Judging by the capital inflows during the boom years of the late 1970's, experts estimate that debt-equity swaps at today's prices can eliminate only $8 billion in debt annually in Latin America, despite aggressive campaigns to locate new investment opportunities.[121]

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[116] "A debtor country normally has a fixed interest burden. No matter how the country is performing it must meet its debt service obligations. Debt-equity swaps replace the fixed interest burden with more variable and usually lower outflow of dividends derived from production and profits. . . ." Kuczynski, *supra* note 73, at 149.

[117] By contrast, a state enterprise must service its debt even if the enterprise is unprofitable, thus depressing the developing country's balance of payments further.

[118] William R. Cline of the Institute for International Economics points out: "Because external debt is large relative to the domestic money supply, large scale [debt-equity] conversions could involve inflationary monetary expansion." Wall St. J., June 11, 1987, at 6, col. 1.

[119] *See* French, *Mexico's Capital Idea*, EUROMONEY, Sept. 1986, at 167, 170. Another approach is for the central bank to sell bonds to decrease the money supply. But this just replaces external debt with internal, which many economists feel is more dangerous because internal debt generally carries a higher interest rate. *See* N.Y. Times, May 4, 1987, at D10, col. 4; *A Lesson from Chile*, ECONOMIST, Mar. 7, 1987, at 87, 88.

[120] N.Y. Times, June 1, 1987, at D1, D3, col. 1.

[121] Kuczynski, *supra* note 73, at 145. Additionally, debt-equity swaps may encourage capital flight if people using the swaps are not adequately supervised. A simple example will illustrate how this could occur. Suppose a Chilean manufacturer used

B. Criteria For A New Debt Strategy

Many who sympathize with the struggle of the developing countries believe that large write-offs or defaults are the only realistic solution to the debt crisis.[122] Others argue that the reverse is true: large scale write-offs or defaults would signify a failure to find a solution to the debt crisis and would impair future borrowing for the debtor nations.[123] Both positions have merit. Given the present low levels of foreign investment in developing countries, a large scale write-off or default would likely end capital inflows and endanger economic development. Debtor countries could be forced to conduct international business on a cash basis, stifling trade.[124] On the other hand, few people argue that the debt is actually worth 100 cents on the dollar, and many agree that creditor banks should receive something less than the book value of their loans as part of an equitable debt strategy.[125]

A comprehensive long-term debt strategy that reduces advanced developing countries' outstanding debt and revives net capital inflows

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the foreign exchange he obtained through exports to purchase Chilean debt from Citicorp at 70 percent of its face value in local currency, used the local currency to purchase dollars in the parallel market, and invested his dollars abroad. The Chilean exporter's profit from the swap would be 20/70, or 29 percent, less intermediation fees and exchange losses. With such large profits available, the debtor nation's central bank must insure that the domestic currency an investor receives in the swap will be invested in the country and not reconverted in the parallel market for investment abroad. *See* American Banker, Sept. 25, 1987, at 21, col. 2.

[122] *See* Kuttner, *Third World Debt: A Flawed Solution*, BUS. WK., Jan. 19, 1987, at 18. *See also*, Marton, *supra* note 98, at 177.

[123]
> Opponents of debt forgiveness, most notably the Treasury Department, the Federal Reserve Board, and commercial banks, contend that such a measure fails on two counts: morally, because it would penalize faithful debt-servicing clients and damage the LDC's own future credit ratings, and financially, because it would weaken the banking system and world financial markets, of which the developing countries are an integral part. Bankers and their academic supporters believe that debt cancellation would undermine the borrowing countries' incentives for sound economic policies. Forcing banks to suffer losses, they hold, would hurt the LDC's own credit ratings and result in little or no fresh private lending to the LDC's.

Amuzegar, *supra* note 15, at 153. "Cajoling banks to lend new money is difficult enough in today's circumstances; it would be impossible if combined with forced debt write-downs. No lender would willingly make new loans knowing that those loans would be immediately marked down below face value." Weinert, *supra* note 79, at 94.

[124] Kuczynski, *supra* note 73, at 129-30.

[125] The new approach in debt negotiations is for banks to sell the debt at a discount, thus reducing the debtor nations' total debt burden. N.Y. Times, Oct. 4, 1988, at D1, col. 3.

must be implemented quickly in order to save these countries from default and restore economic growth. The goals for a successful debt strategy must include: (1) arranging long-term, flexible loan-service agreements with realistic and attainable payment obligations; (2) restoring international confidence in debtors' solvency to revive net capital inflows without resorting to heavy-handed, obtrusive, and politically difficult IMF agreements; and (3) regulating future private lending to developing countries to avoid the recurrence of similar debt problems.

Such a program would address the past mistakes of the containment strategy, which focused solely on short-term balance of payments deficits through "a minimum of financing and a maximum of adjustment,"[126] and pursuant to which commercial bankers merely lengthened maturities and postponed principal payments, doing nothing to alleviate the high interest burden and restore capital inflows.[127]

A comprehensive long-term debt strategy requires a shift in emphasis from the service of debt to economic development; the former will not be possible without the latter.[128] Presently, rising interest rates, protectionism, and falling commodity prices all directly affect a debtor nation's ability to service its debt. To ensure realistic debt service obligations that allow for economic growth, a debtor nation's repayment schedule must adjust for deteriorating external economic conditions. Otherwise, a debtor must continually borrow just to make interest payments. Flexible debt service obligations allow real progress to be made toward debt reduction, and also make debtor countries more amenable to instituting further economic reforms.[129]

While debtor nations cannot control external economic conditions, they can affect their internal economic performance and, pursuant to the second goal above, debtor nations must take steps to restore international confidence in their solvency and prospects for long-term

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[126] Amuzegar, *supra* note 15, at 144.

[127] *See supra* notes 79-93 and accompanying text.

[128] Amuzegar has suggested two basic rules for a debt strategy: "First, both debtors and creditors must commit to pursuing high employment growth devoid of a strict ideological underpinning. Second, both sides must accept reciprocal responsibility for each other's economic fortunes." Amuzegar, *supra* note 15, at 156.

[129] Tying debt service to external economic conditions has certain international political advantages for debtor countries as well: commercial bankers become "foreign economic ambassadors" for their debtor governments. For example, if protectionism continues to gain popularity in the U.S. Congress, U.S. bankers holding developing country debt will want to protect their debtor countries' export markets, and therefore will likely lobby against protectionist measures.

economic growth. Only if this confidence is restored will capital inflows — particularly direct foreign investment — be revived.[130]

A debt strategy that relies on monitoring by foreign governments, commercial banks, or international agencies like the IMF should be avoided for two reasons. First, a foreign agency, while not subject to domestic political pressures to overspend, is less sensitive to the limits of adjustment measures. Second, a foreign agency will often cause a great deal of political discomfort for the debtor country government. Debtor government officials are seen as weak, and often their political careers are sacrificed,[131] the outside interference being perceived as a deprivation of sovereignty. Instead, a more viable solution would be to devise a market mechanism that encourages the efficient use of resources and penalizes excessive spending.

C. *Securitization of Debt*

The swapping of advanced-developing-country debt for some form of high-yielding securities, and the development of a mature and active secondary market for these securities should be the basis of the new comprehensive market-based debt strategy.[132] The goal is to create a market mechanism that meets the second and third criteria above (restoring international confidence in debtors' solvency and regulating future private lending), while still managing to satisfy the first (achieving realistic debt service obligations). The securities created must have relatively high yields in order to facilitate the development and active functioning of a secondary market.

The market mechanism would regulate lending as follows: if the capital invested in the developing country is not used efficiently, the debtor country's growth prospects diminish, as do the investor's prospects of realizing high yields on the debtor country's securities. Low-yielding securities will inhibit the debtor country's ability to sell more securities, thus effectively restricting credit until the debtor country makes necessary economic reforms.[133]

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[130] Kuczynski, *supra* note 73, at 138.

[131] The former Brazilian Minister of Finance, Luiz Carlos Bresser Pereira, found himself in the typical position for developing country finance ministers: caught between quick-spending politicians at home and foreign creditors demanding that more restrictive monetary policies be implemented. *See* Wall St. J., Nov. 4, 1987, at 33, col. 1.

[132] Richard S. Weinert suggested a third-world-debt-for-government-bonds swap. He suggested that the bonds be issued by the World Bank or creditor governments. Weinert, *supra* note 79, at 96-97.

[133] Such price sensitivity to debtor nations' economic policies has already occurred in the secondary third world loan market. *See id.*, at 85.

Such a market mechanism would absorb minor fluctuations in the yield of the securities so that the debtor country's creditworthiness would remain undamaged. If the return falls slightly, the price on the bonds will simply adjust downward as demand shifts to competing investments until the return is brought back up to the levels of the competing investments. If the market price of the debtor country's securities drops too low, then the country's credit would contract. This consequence would provide the incentive for the debtor country to pursue sound domestic economic policies. Significantly, even after the debt crisis arrived and developing countries were unable to continue servicing their debt, these countries still made interest payments on bonds held by investors other than banks, "so as not to damage their reputation in the bond markets."[134]

An active secondary market in these securities must be developed and maintained for the proper functioning of the market mechanism. With an actively functioning secondary market, security prices will respond quickly to changes within the developing country, and this market mechanism will encourage the efficient use of capital resources within the developing countries, thus facilitating new capital inflows and economic growth over the long-term.

This market-based debt strategy to some extent takes the commercial banks out of the business of sovereign lending and forces developing countries to use the same sources of capital as developed countries. If commercial banks wanted to pursue more sovereign lending, they would be forced to offer more favorable terms than the developing countries could obtain in the securities markets. Such competition is healthy and improves the overall efficiency of the system. Although some commercial banks would undoubtedly object to such a strategy, other commercial banks that have substantial investment banking services (such as the J. P. Morgan Corporation) would likely support it, because they could earn profits by dealing in the new securities.

Market-based regulation of private lending to developing countries has other important advantages over traditional forms of regulation. Market-based regulation is devoid of the perceived ideological tutelage by creditor-country governments and the IMF. The developing countries would be free to organize their economies as they wish as long as suitable economic performance is maintained, and this would be more acceptable politically in the debtor countries. More importantly,

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[134] WORLD BANK, WORLD DEVELOPMENT REPORT 1985, at 121.

a market mechanism would regulate private lending to developing countries much more efficiently than any administrative agency because prices on the securities would respond immediately to changes in economic conditions within the debtor countries. Such performance-sensitive regulation is necessary to alleviate the excessive swings in international lending to developing countries.

Securitization of debt is not a new idea. In 1985, Argentina offered "exit bonds" for smaller bank creditors who wanted to liquidate their loans.[135] The exit bonds failed to sell, however, because the discounts that Argentina required from the banks were too steep and the banks believed that they could obtain a better deal in other ways.[136] Brazil also forwarded a debt securitization plan[137] in September, 1987, in the form of a voluntary "long-term approach" that would allow banks to swap their loans for tradeable long-term bonds.[138] Because the Brazilian bonds' par value would equal the face value of the debt,[139] the banks would not have been required to swap their debt at a discount, and this factor made the Brazilian plan more attractive to banks than Argentina's had been two years before. In addition, the new bonds would have been more marketable than the old debt, reducing the commercial banks' risks in holding the securitized debt, and Brazil indicated that the yield on these bonds

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[135] *See* N.Y. Times, May 5, 1987, at D1, col. 2.

[136] *See* ECONOMIST, Sept. 19, 1987, at 87; Kuczynski, *supra* note 73, at 133, n. 2.

[137] Brazil is an attractive country in which to attempt a debt securitization strategy. Of all the advanced developing countries, Brazil is the most industrialized and has more opportunities for investment. Since Brazil made this proposal, Mexico has followed with its own plan for securitization of its debt. *See infra* text accompanying notes 149-57.

[138] The voluntary long-term approach was presented to a committee of fourteen international banks in Washington at the end of September, 1987 after being endorsed by U.S. Treasury Secretary James Baker. Wall St. J., Sept. 29, 1987, at 35, col. 4. The voluntary long-term approach was one of two options that Brazil had offered the banks. The first option, a "conventional approach", asked that the debt be rescheduled at an interest rate margin of no more than LIBOR. At the time, the standard interest rate in reschedulings with Mexico and the Philippines was 13/16 of a percentage point above LIBOR. ECONOMIST, Sept. 19, 1987, at 87. Giving Brazil a more favorable rate would cause other debtors to demand renegotiations. A London banker commented on the effect of offering a special interest rate concession to one debtor country: "No bank is going to accept that . . . it would open a Pandora's box." Wall St. J., Sept. 28, 1987, at 29, col. 1. Under either option Brazil requested $10.4 billion to help cover bank debt interest payments through the end of 1989. *See* Wall St. J., Sept. 29, 1987, at 35, col. 4. *See also* Wall St. J., Sept. 29, 1987, at 39, col. 3.

[139] Wall St. J., Sept. 29, 1987, at 39, col. 3.

would be increased if Brazil's economic performance improved significantly.

However, the commercial banks showed only lukewarm interest in the Brazilian bond offer. The mere promise of higher yields was not enough to entice the commercial banks; in order to make the bonds attractive, their yields must be high enough to compete with less-risky but lower-yielding securities in the industrialized world.[140]

Brazil's securitization of debt strategy would require several additional features to fulfill the criteria of the comprehensive debt strategy proposed herein and to ensure participation by the commercial banks. To achieve realistic and attainable debt service obligations, Brazil should not allow creditor banks to swap their debt at a zero discount, especially when Brazilian debt is being traded on the secondary loan market for 50 cents on the dollar.[141] Brazil must take advantage of every opportunity to reduce its debt payments to a more manageable level. In addition, the Brazilian proposal should provide for automatic interest deferral when external economic conditions make it difficult for Brazil to meet these payments.[142] This could be accomplished by tying the bond interest payments to Brazil's trade balance. If Brazil's trade balance worsened due to external economic conditions,[143] then less interest would be paid and the yield on the bonds would drop; if this balance improved, Brazil may decide to distribute some or all of its additional foreign exchange as interest, increasing the yield and the marketability of the bonds. If the bond's yield is already attractive to investors, instead of paying additional interest, Brazil may decide to use the additional foreign exchange to purchase some of its debt on the secondary loan market and retire some of its total debt burden.[144]

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[140] Nevertheless, in June, 1988, Brazil agreed to end its moratorium on interest payments while its creditors agreed to loan Brazil $5.2 billion and restructure Brazil's debt at lower interest rates. The agreement was the first of its kind not to be conditioned upon an IMF agreement with Brazil. Brazil also agreed to allow a menu of options for banks to reduce their debt including debt-equity swaps, exit bonds, and securitization of debt. Berg, *Brazil Debt Pact Called Innovative*, N.Y. Times, June 23, 1988, at D1, col. 3.

[141] *Id.*

[142] The Brazilian proposal only allowed bond interest payments to increase.

[143] A multinational financial authority would determine when a drop in a debtor's trade surplus resulted from external economic conditions beyond the debtor's power to control. *See infra* text accompanying notes 161-62.

[144] Brazil could also purchase its own bonds to maintain their market price. To protect bondholders, however, Brazil must agree never to buy back its bonds when they are selling at a discount. Otherwise, Brazil could take advantage of low prices on its bonds due to its own inefficiencies.

However, automatic interest deferrals, even if limited to declines in a developing country's trade surplus caused by external economic conditions, will make that country's bonds less attractive to investors, and such deferrals are thus counter-productive in attempts to create an active secondary market in these securities. A conflict, therefore, arises between the desire to protect a developing country from adverse external economic conditions and the desire to create an active secondary market for its bonds.

The solution is to develop some type of guarantee for the bonds without destroying the market mechanism in the process. This can be accomplished by guaranteeing the payment of any interest deferred due to *external* economic conditions. In this way the developing country's internal economic performance will still be reflected in the price of the bonds. While there are numerous methods in which to guarantee interest payments, only three will be discussed here: (1) having bondholders swap their debt for equity in the developing country; (2) having creditor governments pay the interest; or (3) having debtor governments pay the interest using their foreign exchange reserves held by the IMF.

The first method borrows from the corporate finance instrument of convertible corporate bonds. Under this method, the developing country would agree to allow its bondholders to swap their bonds for equity investments in that country if a default occurs. This "convertible upon default" guarantee provides the developing country with an additional incentive to keep its interest obligations current. A default would result in massive direct foreign investment arranged through debt-equity swaps. This type of guarantee, however, would not fully secure the government bonds. The convertability of these bonds would be subject to the same limitations as debt-equity swaps.[145]

If the automatic interest deferral is a result of external economic problems, some experts argue that the fair solution is to have the creditor governments or the World Bank guarantee to pay the deferred interest.[146] Brazil's finance minister, Luiz Carlos Bresser Pereira, has indicated that he would like to see the World Bank offer such a guarantee.[147] The reaction to this suggestion, however, has been gen-

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[145] *See supra* text accompanying notes 108-21.

[146] Amuzegar, *supra* note 15, at 156-57.

[147] Melloan, *Brazil Still Gropes for the Right Debt-Formula*, Wall St. J., Sept. 29, 1987, at 39, col. 3.

erally negative. Many politicians within the creditor governments feel that the guarantee would be perceived as bailing out the banks, although this attitude seems to be slowly changing.[148]

The Mexican government has successfully implemented a debt securitization strategy that offers a creditor government's guarantee.[149] The guarantee, however, is limited to paying the bond's face value at maturity. On December 29, 1987, the U.S. Treasury agreed to issue up to $10 billion worth of 20-year zero-coupon bonds to Mexico for up to $2 billion.[150] Mexico then offered to swap new Mexican bonds for its old debt at a substantial discount. The Mexican bonds offered higher interest rates than the old debt and are guaranteed by the U.S. Treasury bonds. Creditors were asked to submit bids on the amount of old Mexican debt they would be willing to swap and at what discount.

Unfortunately, the major U.S. commercial banks refused to participate.[151] These banks felt that the new Mexican bonds were still not marketable because only the principal was guaranteed. To trade the bonds, the banks would have to discount them an additional 20 to 25 percent. This would mean that the banks could only offer a 20 to 25 percent discount in the debt-for-bonds swap offer; otherwise, bank losses would exceed 50 percent, at which point it would have been better for the banks to unload their debt on the secondary loan market — where Mexican debt trades at 50 cents on the dollar.[152]

In addition, a recent Securities and Exchange Commission ruling[153] made participation very risky for the bigger creditors, even if their bids were not accepted by Mexico. The Commission now requires any bank that offers to swap its debt at a discount to immediately write off as a loss the discounted amount or to increase bank loan-loss reserves by the same amount.[154]

While the Mexican plan failed to receive the support of major U.S. banks, some large European banks and many regional U.S. banks did participate.[155] The European banks participated because they were

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[148] *Id.*

[149] Wall St. J., Jan. 8, 1988, at 2, col. 2.

[150] A large discount from face value is offered on the zero coupon bonds because they do not pay interest. *Id.*

[151] Wall St. J., Jan. 8, 1988, at 2, col. 2.

[152] *Id.*

[153] SEC Staff Accounting Bulletin No. 75; *reprinted in* American Banker, Jan. 7, 1988, at 10, col. 1.

[154] *Id.*

[155] Wall St. J., Feb. 26, 1988, at 2, col. 2.

required to expand their loan-loss reserves to as much as 70 percent. Large U.S. and British banks, by comparison, are only required to have reserves of 25 to 30 percent. Swapping the debt at a 50 percent discount thus enabled continental European banks to recoup some of the loss from their excess reserves. The U.S. regional banks participated because they have insufficient capital bases to continue participating in developing country lending.[156] The Mexican strategy has therefore been called a "qualified success" since Mexico did manage to write off $3 billion of its debt — although it fell far short of the $10 billion projected.[157]

The third method of guaranteeing interest payments was proposed at the annual World Bank-IMF meeting in the fall of 1988. Japanese delegates suggested that the advanced developing countries' foreign exchange reserves held by the IMF could be used to guarantee interest on bond issues.[158] This proposal, however, met with considerable political resistance. The United States objected strongly because the plan gives the IMF additional powers at a time when U.S. influence over the IMF is waning.[159] Nevertheless, the Japanese guarantee scheme is feasible and should be given serious consideration.

In summary, securitization of debt will, at a minimum, be an important component of future attempts to arrive at a debt strategy. If used in a manner similar to that described above, securitization of debt could become the basis of a comprehensive, long-term debt strategy that regulates future private lending to developing countries. If the securities are marketable so that an active secondary market develops, a market mechanism will emerge that encourages developing countries to utilize their resources efficiently. Through this process, international confidence in debtors' solvency will be restored without resorting to problematic IMF agreements.

To achieve realistic debt service amounts, however, the bond interest payments must be automatically deferred in response to external economic conditions that adversely effect the debtor nations' trade balances. The key to maintaining the marketability of the bonds while allowing an automatic interest deferral is to provide a guarantee that

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[156] *See id.*

[157] *Id.*

[158] Mossberg, *Brady Warns IMF and Japan on New Plans*, Wall St. J., Sept. 28, 1988, at 21, col. 1. Only the most advanced developing countries such as Brazil could guarantee a bond issue in this manner. Most developing countries have insufficient foreign exchange reserves. *Id.*

[159] *Id.*

the interest on the bonds will be paid regardless of external economic conditions. However, so as not to destroy the market mechanism's effect, the interest deferral and corresponding guarantee must be in response to external economic conditions only. Bond prices must respond freely to the debtor country's internal economic performance for the market mechanism to work.[160]

D. *Creating A Multilateral Financial Authority*

A multilateral financial authority will be necessary to manage the debt strategy proposed herein. The authority's duties should be specific and strictly limited so as not to interfere with the functioning of the market mechanism. The authority should (1) decide whether or not a decline in a debtor's trade surplus is due to external economic conditions; and (2) pay the interest deferred on bonds as a result of such a decline.

Congress recently proposed the creation of a similar authority. As originally conceived, the International Debt Management Act required the Secretary of the Treasury to begin negotiations with other creditor governments to create a multilateral financial authority. The Act described a multilateral financial authority that would purchase sovereign debt of less-developed countries from private creditors at an appropriate discount. This debt could then be either resold to the debtor country at the same discount, swapped for equity assets in the debtor country, securitized by the debt authority, or merely held by the authority as the new creditor of the debtor country. The modified version which finally was passed by Congress merely directs the Secretary of the Treasury to study the feasibility and advisability of establishing an International Debt Management Authority and report back to Congress with the results.[161]

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[160] Kuczynski lists three key requirements for a successful deferral scheme: political viability in the creditor countries, financial viability for the major bank lenders, and real cash-flow relief for the debtors. Kuczynski, *supra* note 73, at 141. The debt strategy proposed herein meets all three requirements. Because the bonds would only be guaranteed for the loss of interest due to external economic forces and banks would be required to securitize their debt at a substantial discount, creditor governments could not be accused of giving debtors a free ride or bailing out the banks. Moreover, the banks would only take a one-time loss, likely not much more than the 20 to 30 percent they have already set aside in loan-loss reserves. Finally, debtor countries would benefit from an immediate debt reduction, a corresponding reduction in their interest burden, and a much greater freedom to use their foreign exchange for economic development.

[161] The International Debt Management Act, as originally conceived, failed to pass

The International Debt Management Act describes an authority with powers much more extensive than necessary. Consequently, the Reagan Administration strongly opposed the proposed authority. Former Treasury Secretary James Baker, Federal Reserve Board Chairman Alan Greenspan and World Bank President Barber Conable all oppose the concept of a sweeping, all-inclusive institution that would buy up debt.[162]

The multilateral financial authority proposed herein would be more likely to receive the broad support necessary, because much smaller capital contributions would be needed, and because such an authority, would not buy up debt and thus would less likely be perceived as bailing out the banks.

IV. CONCLUSION

The international debt crisis is likely to confound those seeking "black letter" law in the field of banking regulation. In the United States, for example, banks must obey a long list of rules and regulations established by the FDIC, the Comptroller's Office, and the Federal Reserve. But on the international level, legally binding rules and regulations "are the exception rather than the rule."[163] Governments have typically ignored the need for comprehensive, uniform international bank regulations; instead, individual governments attempt to separately regulate the international banking activities of banks chartered in their countries.[164]

Congress. The new version is much less pioneering in scope. If the Secretary of the Treasury determines that initiation of international discussions to create an international debt management authority would (1) materially increase the debt discount, (2) materially increase the probability of default, or (3) materially enhance the likelihood of debt service failure or disruption, the Secretary should report his determination to Congress and not initiate any international discussions. Omnibus Trade and Competiveness Act of 1988, Pub. L. 100-418, § 3111, 102 STAT. 137, 22 U.S.C. § 5331 (1988).

The Act requires debtor governments to substantially commit themselves to economic policies designed to improve resource utilization and minimize capital flight, and to prepare an economic management plan that sustains economic growth and allows debtors to meet their restructured debt obligations. Moreover, the Act requires that countries with strong current account surpluses (presumably this refers to Japan) should provide greater financial support for the authority. *Id.*

[162] *See* Truell & Mossberg, *Executive to Propose World Debt Plan*, Wall St. J., Feb. 29, 1988, at 2, col. 2.

[163] Bench & Sable, *supra* note 7, at 429.

[164] It is encouraging to note that there has been a softening of governments' positions recently. Following a bilateral agreement between the United States and

Several fundamental weaknesses in the current fragmented supervisory system of private international lending to developing countries are now apparent: domestic bank regulators cannot prevent excessive swings in international bank lending to developing countries; commercial banks are unable to adequately measure the risks involved in lending to the developing countries; and the IMF cannot adequately supervise the debtor nations' economic policies.[165] Because of these weaknesses, the debt crisis has reached a near critical stage with over $1 trillion of developing country debt outstanding.

A long-term comprehensive debt strategy is needed and must be adopted quickly. The securitization of debt strategy proposed herein shifts the focus of debt relief from the servicing of debt to fostering the economic development of the developing countries, recognizing that the former cannot be realized without the latter.

It is difficult to be optimistic when discussing the debt crisis, given the constraints on both debtors and creditors and the enormity of the numbers involved. However, in 1987 creditors for the first time publicly recognized that Third World debt is partially uncollectible. Creditors now seem willing to accept some losses in order to chip away at the debt mountain. Some have also indicated that they are willing to try some unconventional approaches, as the recent emergence of market-based strategies such as debt-equity swaps and debt securitization illustrates. Debtors, for their part, are opening their economies to more direct foreign investment and have offered innovative proposals in an attempt to honor their commitments. Thus, the time is ripe for negotiating a long-term, comprehensive debt strategy. One thing is certain, allowing private lending to developing countries to continue unregulated will make the debt mountain insurmountable.

Bradley K. Boyd

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the United Kingdom on minimum capital adequacy standards for all banks in both countries, the Cooke Committee successfully adopted its own minimum capital adequacy standards in June, 1988. Nash, *12 Countries Want Banks to Increase Capital*, N.Y. Times, Dec. 11, 1987, at A1, col. 2. As a result, commercial banks will be able to compete on a level playing field internationally, no longer helped or hindered by varying domestic capital requirements.

[165] *See* Friesen, *Regulatory Issues Arise with Globalization of Financial Markets*, American Banker, July 31, 1987, at 4.