The legal framework for debt/equity swaps and the political risk aspects

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This conference may be focusing on a financial innovation just before the wave crest. How important is the innovation of the debt/equity swaps? What contribution will it make to the working out of the debt crisis? What are the unresolved issues which could hamper or distort the evolution of an orderly market?

Possibly my role is to douse this subject with a dose of cold water. I look at it from the perspective of the developing country, to many of which we have been acting as advisers.

In a way, I can justify the claim that, in an earlier *Euromoney* conference and in a book on default and rescheduling of corporate and sovereign borrowers in difficulty that was put out by *Euromoney*, we first advanced the analogies between corporate debt workouts and the sovereign debt rescheduling mess. Using the illustration of Chapter 11 of the US Bankruptcy Law and the system of court supervisory restructurings, involving debt/equity swaps, priorities for providers of new money and restructuring of existing debts of all creditors — banks, capital market instrument holders, suppliers and governments — we contrasted in the book the formless mess of the ad hoc approach to debt rescheduling for government or sovereign borrowers with the structured system of workouts in the corporate context.

Since that date — 1983/1984 — we have regrettably soldiered on with the ad hoc approach, with leaders of the OECD countries repeatedly claiming since 1982 that the debt crisis was gradually being resolved by devices such as multi-year reschedulings, new money facilities and the Paris Club efforts. In 1985 we all welcomed the Baker initiative and its advocacy of development conditionality — new money in return for structural adjustment. Yet without a legal framework and an agreed OECD set of uniform rules on provisions by banks and write-down guidelines on tax treatment of provisions and losses and on capital adequacy, did anyone really think that debts could be put on a sufficiently long-term basis to enable less developed countries to pay interest and principal on the due dates, have renewed access to the capital markets and obtain funds for legitimate development requirements? How could the responsible money centre banks continue to provide new money without an orderly framework, especially when, in their own domestic markets, they were facing other crises arising from problems in agriculture, energy and property lending, to say nothing of the extraordinary calls for capital they faced as a result of deregulation, Big Bang and competition from investment banks and disintermediation?

Citicorp finally decided that the ad hoc approach and the IMF-led solutions were not going to work. The OECD governments were not doing their bit to contribute to making Baker work. New money cannot responsibly be thrown after old when the secondary LDC debt market has shown, however imperfectly, that it is hardly likely to be worth 100 cents in a dollar. The failure of the OECD governments to lead and to establish a workable legal framework for orderly restructuring against some basis of certainty and stability was in effect a cop-out rather than a workout.

In the period 1973 to 1979, the banks operated in a wide-open market which saw governments happily leave commercial banks to recycle OPEC surpluses to the less developed countries. Insufficient, even ill-conceived, projects of governments or state enterprises of LDCs were not enough to absorb the bank surpluses of the OPEC countries and so we got ourselves into the sovereign debt crisis.

What do we find, after Citicorp? A sudden enthusiastic rush by all of us to a menu approach to the debt crisis, with some banks agreeing to debt reschedulings and to new money, others taking exit bonds and, hopefully, an element taking to the use of debt/equity swaps as a method of reducing or managing their

debt portfolio. As a result, the recent *Financial Times* article on this subject headlined — I believe correctly — its story on debt/equity swaps saying that they have now "come out of the closet".

Now that this concept is out of the closet, what truths emerge? In the short space available to me I can make but a few basic points.

First, the legal framework for equity investment in less developed countries is still far from satisfactory. Second, there are real and perhaps growing political risks associated with the potential rush by banks to swapping their own debt for equity or providing openings to their clients to make investments using debt that they hold. Third, there are real limits to the capacity of LDCs to cope with the inflationary implications of this development and LDCs have an interest in not allowing this fashion to divert people's attention from the need for long-term reschedulings and new money to contribute to sound adjustment and economic development plans.

First, a word about the market — if one can call it a market. It seems to me that the secondary market in LDC debt has become an important one for the commercial banks, which are also eager to establish themselves in the debt/equity swap business. Trading in LDC debt probably totalled about 5 GUSD in 1986, some 3 GUSD more than in 1985, and another 2 GUSD or so increase — if not more — is probably expected to take place in 1987. Most of these transactions were made so as to rearrange bank-loan portfolios. However, it is estimated that as much as 40% formed part of an increasing number of debt/equity transactions. The secondary market has been estimated by observers to turn over annually only 1% to 2% of LDC debt outstanding with foreign banks, yet every bank is compelled to be a player in the market, to service potential debt/equity swap clients. As a result, the three-year-old secondary market in LDC debt could be said to have become overbooked.

Countries which have so far established debt/equity conversion programmes include Chile, Costa Rica, Ecuador, Mexico, the Philippines, Brazil, Venezuela and Argentina. Colombia, the Dominican Republic, Uruguay, Jamaica and Peru have programmes well developed and about to be announced. The increasing competition has, I am told by some of my colleagues, brought lower spreads already in the more liquid markets, ie, countries that have a pretty advanced scheme. Lesser-known debt from some smaller Latin American and African countries may still be suffering from the imperfect market.

LDC debt is difficult to price. Not only are the borrowers temperamental but many of the buyers and sellers are in the market for very different reasons. Some are companies looking for eligible types of debt to swap into equity for well thought-out projects. Others are banks whose aim is to restructure their portfolios. One thing that is clear is that even the most liquid LDC markets can be distorted by just one single transaction. When Citibank is said to have gone shopping for some 62 MUSD of Mexican debt for the Nissan Company to swap into a car plant project, the market reportedly moved from 3% to 4%.

There are other influences. For example, Chilean debt, which owes its high price — again according to observers — to the successful debt/equity swap programme, may reach a price ceiling where Chilean companies buying dollars on the parallel foreign exchange market no longer find it profitable to use those markets to buy back their own debt. Conversely, there are probably forces that will prevent prices from falling too low, stemming from the fact that many banks still book their paper at above market value and are unlikely to be sellers until the market price nears their book price or face value minus provisions. If that ever happens, another factor could come into play — a flooding of the market with sellers. If the banks wrote down their paper to market price, it could have the effect of pushing the market price down dramatically and I am told by market-watchers that it is for this reason, amongst others, that the recent decision by Citicorp is viewed with great interest. It is clear that we are still in a field of unpredictable outcomes.

LDC governments have had an historic post-colonial or anti-North American suspicion of direct foreign investment and of multinational corporations in particular. During the 1960s and 1970s, the ready availability of debt finance at reasonable rates, given the rate of inflation, saw many LDCs develop mining, oil and manufacturing industries on the basis of state corporations. Nationalisations with inadequate compensation were frequent and the legal climate for protection of foreign investment deteriorated under blows from policy decisions taken at the level of the United Nations and the inability to articulate a legal framework or code of behaviour designed to provide assurance and certainty to private investors. The big oil and mining companies fought for their rights, as they saw them, but the trend moved increasingly towards new forms of investment, i.e., other than direct equity investment, designed to minimise political risk.

The World Bank, with its policy of acting as a lender of last resort and the idea that the bank should be lending only if the capital markets were not fulfilling their function with respect to a member country, endeavoured to restore some order to the investment climate, refusing to lend where governments expropriated or breached contracts without adequate compensation or defaulted on debt.

The World Bank eventually institutionalised this overseeing role into the International Center for the Settlement of Investment Disputes Convention, providing a treaty basis for arbitra-

tion of investment disputes. (Incidentally, very few countries in Latin America signed or ratified that convention.) It tried without success in the 1960s to develop a multilateral investment guarantee system.

LDCs, however, while offering tax and other incentives to private foreign investment, did little to change some of their more disturbing rules and regulations — ie, negative rules and regulations — since their state companies found it relatively easy to access funds with a government guarantee and easy to market their production in a period of commodity boom. Banks, ready to lend, were in the circumstances politically acceptable partners in this process whilst the multinational corporations were politically unacceptable.

Certain LDCs did see benefits in encouraging private foreign investment on what they deemed to be an acceptable basis to secure help in accessing technology and markets as well as management, but frequently this was done on the basis of a local, or even governmental, majority ownership. The rules and restrictions they imposed still apply today and, by definition, are unlikely to be changed rapidly to facilitate the debt/equity swaps or make them easier to organise.

What are the restrictions and incentives that apply, against the background of which debt/equity swaps will have to be organised?

Very briefly, there are seven types: first, non-price regulation of business activity; second, foreign exchange controls and incentives; third, credit controls; fourth, financial guarantees, although now the financial guarantees of many LDCs are probably not worth very much; fifth, tax incentives and, I may add, disincentives; sixth, monetary grants or subsidies, again difficult to provide when a government is under an IMF programme; seventh, grants or subsidies in kind, where again the same comments would apply.

On the non-price regulation front, perhaps the most pervasive set of general as well as specific governmental economic interventions in developing countries is the application of non-price regulations, limiting the right of business establishments to control factor inputs or controlling product outputs. Exemptions from general regulations are often treated as a form of specific incentive. Regulation of business establishments includes restrictions on entry into particular activities; restrictions on foreign ownership; requirements or inducements for open ownership and concepts of a fair rate of return profit regulation, often accomplished through tax or remittance policies. Regulations and related incentives on the side of factor inputs include controlled factor prices; tariff exemptions or reductions on capital equipment; local content requirements; local employment requirements; environmental controls and control over the source, choice and level of payment for technology. Product output regulations include price controls; tariff or quota protections and safety or other product standards.

On foreign exchange requirements and incentives, those are fairly well understood but the existence of exchange controls allows countries to maintain exchange rate differentials from those set by free market forces. This may be committed to some extent by the IMF but, where that does prevail or is reintroduced in a later period, access to exchange markets can represent substantial subsidies whereas required transactions such as the surrender of export receipts at controlled rates may imply substantial penalties. Exchange restrictions often play a critical role in the application of other restrictions or regulations. For example, the rate of return regulation is most often applied through ceilings on allowed profit remittances. Local sourcing requirements are enforced by denying access to foreign exchange. To some extent, foreign exchange restrictions have a general impact, since they affect all firms engaged in international trade.

Those are just two general areas of regulation which still exist and will have to be dealt with, even in the context of private foreign investment.

There is a set of incentives in each country and these are set in the rules and regulations. I should like to turn to the value of those incentives and the possibilities of manipulation of the restrictions, ie, the subject of political risk.

Investors or banks interested in debt/equity conversion programmes face the need to comprehend and master the intricacies of the foreign investment rules and regulations that I have outlined. They also have to face the political risk which investors have faced and the lessons of bitter experience which have led to capital flight by local investors and disinvestment by foreign private investors. These cannot be overlooked in any euphoria over the prospects for debt/equity conversions by banks or their clients.

As legal advisers to multinational corporations will attest, securing an acceptable investment agreement from an LDC government is a time-consuming and laborious task. There are no shortcuts. While equity may be preferable to debt for some LDCs that have learned the lessons of adjustment, they need to be able to ensure that the investment moves into sound projects; that local investors are treated fairly and that their export opportunities, as a country, are enhanced by the investment.

The international environment for direct investment is currently not a happy one. The United States debt problem and the rising threats of protectionism do little to encourage investment in Third World manufacturing or extractive industries. This is particularly the case for commodities, textiles and certain chemical exports. The environment of rescheduling and structural adjustment through which the LDCs are now going is itself likely to have a negative influence on

foreign private investment. It creates a climate of uncertainly which reduces confidence in the prospects for an overall positive performance by the LDC and accordingly serves to discourage private investment. Let us face it. Private foreign investment and debt/equity swaps are unlikely to solve or, indeed, contribute significantly to working out LDC problems. The lack of certainty, therefore, will remain. It is against that atmosphere that you are investing for 10 years or longer.

The absorptive capacity of LDCs for new investment is, in any case, very limited. We must also bear in mind that there remain residual political risks, even where an LDC has acceptable rules and regulations on foreign investment and you can work out an acceptable package of new investment and debt/equity conversion and where this can be arranged to meet all the existing rules and obtain all the available guarantees and incentives offered by a government. All these rules and assurances can be changed and the risk of such changes is greater where a government is under the political pressures of debt rescheduling and the pressures of adjustment.

Such adjustment programmes affect the general population adversely and create hardship. The risks of sudden, adverse changes in the rules and regulations governing foreign investment are, if anything, heightened in a democracy. Who knows what the policy of Turkey will be after Premier Ozal or in Mexico if the long-standing government political party loses power? Brazil has illustrated these problems of democracy very well.

How would one set about overcoming these political risks? Are there mechanisms in place to help alleviate them prior to putting these debt/equity conversions into place in a responsible way?

Risk is inherent in economic decision-making. The investment decision, which requires estimates of returns many years ahead if done responsibly, involves obvious risks which are particularly acute when the investment is realised in another country. This is partly because a degree of ignorance about the foreign country tends to make the project appear riskier, but also because foreign investment adds to all the normal risks of fluctuating exchange rates and undoubted political risk associated with the very fact that the ownership is foreign. I suspect this will become heightened by the fact the ownership may be in the hands of banks, which are viewed by some developing countries as part and parcel of their problems.

Political risks include the risk of arbitrary or discriminatory actions taken by a host government; expropriation without adequate compensation or breach of contract, as well as losses resulting from wars or civil disturbances, either in the host country or in an adjacent country through which transport has to go and, especially in the case of foreign investment, restrictions on currency transfer. One can also think of other risks, less commonly cited, since outside the control of the host government, such as the introduction of barriers for access to established export markets.

Thus political risk is present in all countries but it is in the case of the LDCs that it is most usually cited as the factor inhibiting foreign investments.

In the context of the emphasis currently being put by the World Bank and by the United States, the United Kingdom and the rest of the OECD on removing barriers to private foreign investment and on the need to encourage private investment as a means of promoting development, special attention should be given to overcoming political risk. However, most commentators, I believe, consider that economic and financial factors are likely to be the main determinants of investment decisions, with political risk considerations playing an additional role. Large multinational corporations may be expected to take political risk in their stride because of the geographical spread of their investments and to resort to new forms of investment to minimise their exposure. That includes avoiding direct equity investment. Nevertheless, the risk is there and it will probably be particularly acute for smaller, medium-scale companies which might be thought to be the ones to wish to leverage their investment with access to the debt/equity market.

We heard reference to the adoption of the Multilateral Investment Guarantee Agreement. The Agreement has been signed and ratified by the required number of countries in order to come into effect but I think the main problem that is to be faced in getting the treaty, will be to get authorisation or appropriation legislation through before October and the next IMF meeting. If the US has not taken the necessary legislative steps to get the treaty into effect, the treaty may lapse and have to be resubmitted to all member governments. However, it is the only prospect on the agenda for addressing some of the unresolved issues of political risk.

I think that the International Finance Corporation's guaranteed return of investment principal programme is also a step in the right direction in contributing to a solution, as are a series of bilateral treaties which have been established between OECD countries and the LDCs. The OECD national programmes for investment insurance against political risk, however, suffer from the fact that decisions on providing cover are linked to the Paris Club reschedulings and guarantees against political risk on equity investments are viewed as being part of the same pool of risk as the guarantees of bank lending or supplier credits which have been subject to rescheduling. Thus there are still some gaps on the export credit front.

To sum up, the dose of cold water which I have been trying to administer, in case anybody is engaging in euphoria, the debt/equity swap concept is not going to provide a quick fix. Banks, as a result of rescheduling and the negotia-

tions that have taken place over the past few years between debtors and creditor banks, have become increasingly politicised. Whereas in the sixties and seventies it was the multinationals who were the bad boys, now in many LDCs the banks are viewed with a great deal of suspicion and the process of debt/equity swaps is probably going to heighten the politicisation.

There is the trend towards build, own and operate projects, or build, own and transfer projects — the idea that contractors can own the plant that they build, can finance it under their own credit and eventually repay the debt and transfer the plant to the country. The people involved in such exercises and those who may use the debt/equity swap conversion to help them in such investment or in new investments that they propose as part of a global strategy will all have to face the same issues which the manufacturers and mining and oil companies faced in the sixties and seventies. They will have to avoid making the same mistakes that were made during that period.

The legal, political and economic framework for a sensible and rational use of the debt/equity scheme is not, therefore, in place. Consequently, in my judgment it does not provide for a significant role in the near term for debt/equity conversions to make a major contribution to the working out of the LDC debt problem. I hope that those who push it for immediate, quick profit realise that, by doing so, they could be of real disservice to the developing countries which are trying manfully to engage in proper structural adjustment.

There will be a role in those limited cases, where debt/equity conversions will take place, for banks, lawyers and governments to work together to provide limited, well thought-out packages that will work. The World Bank and IFC will be able to help in this regard; particularly the World Bank's structural adjustment lending programme, if it can be linked to an orderly use of the debt/equity concept. However, I think its primary role could well be in helping in situations where the structural adjustment programme calls for reforms of state enterprises, which I identified earlier as being part of the problem. If a government is moving to reform the enterprise; to restructure its debt; to partially privatise it, to bring in responsible foreign management and marketing know-how; in that kind of exercise I believe the debt/equity scheme can make an invaluable contribution. We are talking about partial or eventual full privatisation.

The Institute for International Finance has recently produced a paper which makes the case for just this kind of responsible organisation of the debt/equity swap system on an across-the-board basis. I think we all welcome that type of initiative. It is that kind of set-up, which may provide very limited assistance in making a significant contribution to the debt crisis, that possibly provides us with the most hope.