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The Transformative Potential of a Secondary Market: Emerging Markets Debt Trading from 1983 to 1989

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Abstract

This Article chronicles the evolution of the secondary market in the debt of less developed countries, now known as Emerging Markets, in its first six years of development. The secondary market was important because it provided the debt for use in debt-equity swaps and debt buy-backs and facilitated portfolio adjustment by banks and other measures that helped to lessen the burdens of the crisis on creditors and debtors. The Article goes through the chronology of the development of the Emerging Markets, emphasizing the key events and factors contributing to its development and the evolving characteristics of the market.

THE TRANSFORMATIVE POTENTIAL OF A SECONDARY MARKET: EMERGING MARKETS DEBT TRADING FROM 1983 TO 1989

*Ross P. Buckley**

INTRODUCTION

In August 1982, Mexico announced the suspension of principal payments on its foreign debt. The debt crisis had begun.¹ The banks stopped lending to Latin America debtors and, within a year, twenty-seven countries had commenced the rescheduling of their debt.² Within the same period, banks had begun to swap their loans to Latin American sovereigns between each other, and two enterprising individuals had established brokerages to facilitate such trading. The secondary market in the debt of less developed countries, now known as the Emerging Markets, had also begun.

This Article chronicles the evolution of this major financial market in its first six years of development. The secondary market was important because it provided the debt for use in debt-equity swaps and debt buy-backs and facilitated portfolio adjustment by banks and other measures that helped to lessen the burdens of the crisis on creditors and debtors. The market played a significant role in the history and amelioration of the debt crisis.

The other principal reason for this research is so that the "mystery [which] shrouds the origins of the eurocurrency markets"³ will not also envelop the origins of this market. We need to understand the history of this important market and because

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1. DARRELL DELAMAIDE, *DEBT SHOCK* 6 (1984). Rescheduling negotiations continued periodically throughout the 1980s until Mexico's debt was securitized under the Brady Plan in 1990. The debt negotiators could then rest their vocal chords, at least until late 1994.

2. PHILLIP A. WELLONS, *PASSING THE BUCK - BANKS, GOVERNMENTS AND THIRD WORLD DEBT* 225 (1987).

3. Hal S. Scott & Phillip A. Wellons, *INTERNATIONAL FINANCE - TRANSACTIONS, POLICY AND REGULATION* 493 (2d ed. 1995).

the market's founders still work in it, its beginnings have been able to be reconstructed.

The evolution of the market will be considered in the following three periods.

- (i) Birth: 1982 to May 1985;
- (ii) Infancy: May 1985 to May 1987; and
- (iii) Childhood: May 1987 to March 1989.

The study of the evolution of the market will be continued in a further Article,⁴ which will complete the first decade of development by analyzing two later periods:

- (iv) Adolescence: March 1989 to October 1991; and
- (v) Young Adulthood: October 1991 to December 1993.

This Article does not consider the regulation of the market and the role of the Emerging Markets Traders Association.⁵

I. BIRTH OF THE MARKET: 1982 - May 1985

A secondary market for the discounted debt of Lesser Developed Countries ("LDCs") and their corporations had "existed on a relatively small scale since well before the onset of the crisis in 1982."⁶ The market in the 1970s was tiny and was "almost exclusively . . . a vehicle through which creditor banks could manage their developing country portfolios, e.g., by debt-debt swaps with other banks either by way of outright assignment or by sub-participations."⁷ This function was almost entirely carried out by the banks themselves with the assistance of some small brokerages that tended to specialize in less commonly exchanged debt.⁸ A number of actual transactions will be considered first in an attempt to convey the nature and flavor of the origins of the post-1982 secondary market.

4. See Ross P. Buckley, *The Facilitation of the Brady Plan: Emerging Markets Debt Trading from 1989 to 1993*, 21 FORDHAM INT'L L. J. (forthcoming 1998)

5. See *LDC Traders Group Launched*, 858 INT'L FIN. REV., Dec 22, 1990, at 23. The LDC Debt Traders Association was formed in December, 1990 and changed its name to the Emerging Markets Traders Association in June 1992. See Chamberlin, *Regulating the LDC debt markets*, INT'L FIN. L. REV., August 1992, at 16.

6. UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, DEBT EQUITY CONVERSIONS - A GUIDE FOR DECISION MAKERS 18 (1990) [hereinafter DEBT EQUITY CONVERSIONS].

7. *Id.*

8. See Linda Corman, *Selling the Third World*, INT'L BUS 1988. For instance, Turan Corporation was formed in 1978 and traded Turkish and other debt in the late 1970s and early 1980s. *Id.*

A. Early Transactions

The first transaction in what was to become the modern market actually preceded the debt crisis by some months. As a result of the commencement of the Falklands War in April 1982,⁹ Bankers Trust reviewed the credit lines it had extended to Banco Rio de la Plata and discovered that the Argentine bank had drawn almost US\$80 million on a US\$40 million credit line. Bankers Trust insisted on repayment of the overdraft. Banco Rio did not have the funds. The two banks crafted a deal in which Banco Rio gave US\$80 million of Mexican government debt in exchange for US\$40 million of Argentine government debt and US\$40 million cash from Bankers Trust.¹⁰ Because Argentina was at war, its debt was considered less valuable than Mexico's. The US\$40 million in cash was then used to pay down the overdrawn credit line.¹¹

Accounting considerations played a major role in this transaction. The exchange of US\$80 million of Mexican debt for US\$40 million of Argentine debt and US\$40 million cash was attractive as the face values exchanged were equal. As the debt would have been on each party's books at face value this meant no writedowns had to be taken or additions made to provisions for doubtful loans. If the face values had not been equal, each bank's accountants might have asked unpleasant questions such as, "Which asset is worth less than 100 cents on the dollar, and why aren't the balance of those assets in your portfolio being held on the books at that discounted price?" Here we see compliance with accounting niceties so that losses do not have to be recorded — but this came at a price. Bankers Trust was repaid its credit line at the cost of paying virtually full face value for US\$40 million of Mexican paper¹² — in hindsight a very expensive transaction.

The quest to avoid writedowns and comply with accounting requirements would lead foreign banks into even more financially dubious transactions. In the first half of 1983, Banco Rio de la Plata was involved in a number of transactions in which

9. See *Will Two Weeks Steaming Let Off The Pressure?*, *ECONOMIST*, Apr. 10, 1982, at 21.

10. See Interview with Giacomo de Filippis, Chairman of Giadefi, Inc., in New York City (Apr. 22, 1993) [hereinafter *de Filippis Interview*].

11. See *id.*

12. See *id.* The values of Argentine and Mexican debt were soon to be similar. *Id.*

U.S. banks gave private sector Mexican paper plus cash to Banco Rio in exchange for public sector Mexican debt. The U.S. banks wished to get out of private sector debt (against which it was feared provisions would have to be made) into public sector debt which, backed by the sovereign, was anticipated would never require loan loss provisions.¹³

The financially disastrous aspects of these transactions were the prices, and hence the ratios, at which the exchanges were made. For instance, a bank wishing to avoid provisions on a private sector loan of US\$370,000 would have given the US\$370,000 of private sector paper plus US\$2,900,000 cash for US\$3,270,000 of public sector paper.¹⁴ Accounting principles ruled. So as to match the face values of debt and cash exchanged and avoid provisions on US\$370,000 of private sector loans, the bank had increased its exposure to the region eight-fold.

Not all of the earliest transactions in this market proved to be poor decisions no matter how bizarre they may appear today. In one transaction, a bank had US\$2 to US\$3 million dollars of Nicaraguan loans worth, perhaps, five cents on the dollar.¹⁵ To avoid taking the loss, the bank acquired over six times as much three-year paper of the Venezuelan Ministry of Defense. This paper paid interest at twenty percent of which the bank allocated nine percent as its yield on it and sixteen percent to cover the lost capital on the Nicaraguan debt (which is why six times as much Venezuelan paper was acquired). The exceptional interest rate doubtless betokened exceptional risk, but the Venezuelan Ministry of Defense met its payments on the paper and the bank covered its losses in Nicaragua.¹⁶

Because of these accounting driven transactions the exposure of major U.S. banks increased in 1982, 1983, and 1984 beyond the extent of "voluntary" new lending required in the reschedulings. This increase was to the benefit of some of the

13. *See id.* A more complete ignorance of the region's economic history would be difficult to attain. *Id.*

14. *See id.*

15. *See* William Ollard, *The Debt Swappers*, *EUROMONEY*, Aug. 1986, at 67, 74.

16. *See id.* Of course, if Venezuela had defaulted the bank would have increased its exposure to the region by over six times. A contributing factor to such transactions lies in the reward structures and career paths of the individual bankers involved. Exceptional risks make sense if they can put off a day of reckoning until, with any luck, the individual banker will have been promoted to a new position (perhaps even in a different country) within the bank or will have moved to another institution. *Id.*

smaller German banks and U.S. regional banks which had the capital, courage, and foresight to sell their portfolios and take the loss of twelve to twenty percent of face value of the loans. Given the later prices of the loans, this was a very wise move indeed. In the words of Lee Buchheit,

“[f]ortunate indeed are those bankers who in 1983 sold off their Argentine exposure at a 15 or 20% discount although, at the time, this was accompanied by a good deal of hand-wringing, tooth-gnashing and piteous wailing about the cruelty of international lending.”¹⁷

Another type of transaction that kept the brokers active in 1983 was the repurchase of their own debt by a number of the more astute Mexican companies. In broad terms, a Mexican private sector company would secure an agreement with its creditors to exchange Mexican sovereign debt for their own indebtedness.¹⁸ The company would then purchase Mexican paper at about eighty cents on the dollar, using the services of a broker to locate the paper. Some creditors¹⁹ were prepared to take the loss onto their balance sheet and exchange something like US\$300,000-400,000 of Mexican government paper for one million dollars of the company's indebtedness.²⁰ As the reschedulings progressed, most private sector obligations in Mexico became government obligations. So, with hindsight, the creditors had given away sixty to seventy percent of the face value of the loans for nothing.²¹ Many of the Mexican borrowers who retired their debt in this manner were financially secure and never defaulted on any of their loans (although their loans were restructured anyway).²² It is a tempting, yet potentially expensive, practice for banks to treat all corporate entities from the one jurisdiction alike — in the opinion of Jack de Filippis, up to

17. See Lee C. Buchheit, *Return of the Living Debt*, INT'L FIN. L. REV., at 28 (1990).

18. See de Filippis Interview, *supra* note 10.

19. This is particularly true when the creditor's exposure to that debtor was being liquidated by the transaction, and so no provisions would have to be made for other loans to that debtor in the creditor's portfolio.

20. See Debt Equity Conversions, *supra* note 6, at 18. This trend to swap out of private sector loans and into public sector ones at this stage is said to have accelerated after the widely-publicized problems of the Mexican Alfa group. See *id.* at 18; see also de Filippis Interview, *supra* note 10.

21. See de Filippis Interview, *supra* note 10.

22. See *id.*; see also Interview with Michael Pettis, Managing Director at Bear Stearns & Co, in New York City (Apr. 24, 1993) [hereinafter Pettis Interview I].

US\$1,000,000,000 of Mexican debt may have been retired in this manner in these years.²³

In summary, in these first years of the market, those who acted on the economic fundamentals and sold their loans for cash early benefited greatly; those who acted for the appearance of their balance sheets and entered into swaps of their loans, often acquiring more debt in the process, paid a heavy price²⁴

B. *Impetus for the Market*

Four major factors facilitated the evolution from the ad hoc inter-bank transfers of before 1982 to the beginnings of a secondary market in 1983 and 1984.²⁵ These were:

1. the willingness of a small but growing group of banks to sell their debt outright at a substantial discount from face value;²⁶
2. the desire of some banks to adjust their LDC loan portfolios through loan swaps;²⁷
3. the progressive amalgamation of the debt into a smaller number of loan instruments by virtue of the rescheduling process²⁸ this made documentation of the swaps simpler,

23. See de Filippis Interview, *supra* note 10 (providing one person's uncorroborated opinion). This remains the tendency of bankers — Australian corporate issuers endured some years of restricted access to the Euro-markets after Bond Corporation became the first issuer to default in the prestigious Euro-DeutscheMark market. From the distance of Europe, all Australian corporations were tarred with the same brush no matter how conservative their accounting policies or strong their balance sheets. See Helen E. Hartnell, Address delivered at the Eighteenth Annual International Trade Law Conference in Canberra 17-19 (October 18-19, 1991) (on file with the *Fordham International Law Journal*).

24. Given that the crisis has been largely ameliorated now and interest has mostly been paid throughout the intervening period, it is arguable that such banks may have been as well off retaining these loans. Against this is the capital or interest rate reductions which the conversion of the loans into Brady Bonds in the late 1980s or early 1990s required, plus the further principal discounts required for the sale of those Brady bonds in the secondary market. Add to these discounts the management time required to deal with this issue and those banks which liquidated their small exposures to the region early made, with hindsight, an excellent decision.

25. It was not until some years after 1984 that the market had evolved sufficiently to be described as a financial market.

26. See Debt Equity Conversions, *supra* note 6, at 18; See also Lee C. Buchheit, *Legal Considerations in Debt Swapping: Planning and Documentation 2* (Apr. 25, 1989) (unpublished manuscript, on file with the *Fordham International Law Journal*).

27. See Debt Equity Conversions, *supra* note 6, at 18; see also Buchheit, *supra* note 26.

28. See Debt Equity Conversions, *supra* note 6, at 18; see also Buchheit, *supra* note 26.

cheaper, and quicker than otherwise would have been the case; and

4. the gradual simplification of transfer procedures for the debt which was facilitated by the standardisation of the transfer provisions in the rescheduled loan agreements.

The first two factors above will be considered further. Factors three and four were the product of the rescheduling process and are beyond the scope of this Article.²⁹

1. Outright Sale of Debt by Banks

Only banks with small exposures to the region or large loan loss reserves could afford to take the losses involved in the outright sale of their debt. In the first category were many of the U.S. regional banks which had only become involved in a few international loans in the late seventies. In the second category, and often also in the first, were many of the smaller German banks which likewise were latecomers to the international lending game and were further bolstered by the tendency of most German banks to have rather large hidden reserves.³⁰

Other banks could not afford the losses involved in an outright sale because a sale for cash necessitated that the loss on that transaction be taken onto the books³¹ and possibly that the balance of the bank's loans to that borrower would have to be written down to the same extent by the taking of loan-loss provi-

29. See Ross P. Buckley, *Rescheduling as the Groundwork for the Secondary Market in Emerging Markets Debt* (forthcoming *Denver Journal International of Law*) (considering these factors).

30. See Wellons, *supra* note 2, at 253; see also HAY & PAUL, REGULATION AND TAXATION OF COMMERCIAL BANKS 195, World Bank Technical Paper No. 158 (1991). German banks commonly established extensive hidden reserves by (i) the use of historic cost accounting, (ii) writing down the value of certain assets, and (iii) creating excessive provisions against bad debts. *Id.* The large German banks publicly increased their reserves early in the crisis. See *Dresdner Tops Up Its Reserves*, FIN. TIMES, Dec. 30, 1982, at 22; see also Stuart Fleming, *Commerzbank to Set Aside DM 500 m Bad Debt Provisions*, FIN. TIMES, Nov. 30, 1983. Deutsche bank claimed in 1983 that its provisions amounted to between 20% and 40% of their exposure to all highly indebted countries and 100% of its loans to Poland and Yugoslavia. See Wellons, *supra* note 2, at 194. The German government assisted its banks by (a) making the provisions tax deductible for five years pending actual loss, and (b) by easing interest rates on deposits without easing the rates on borrowing, so that the banks enjoyed a wide and very profitable spread which could be used to build provisions. *Id.* at 193-94.

31. This assumes the debt was carried on the bank's books at full face value, which was almost always the case.

sions.³² Most of the larger banks could not run such a risk — the required provisions would have exceeded their total capital.

Nonetheless, had there been more cash buyers in the early days, there would have been more cash sales.³³ Right from the beginning, supply exceeded demand — an imbalance that was to characterize most of the market's history.³⁴

Giacomo de Filippis established his brokerage, Giadefi Inc., in July 1983.³⁵ His first transactions involved acting for a number of smaller German banks with minor exposures that they could afford to sell outright.³⁶ This was typically done through a swap with a U.S. bank in which the German bank would, for example, sell US\$10 million of public sector debt for US\$1.1 million of private sector debt and US\$8.9 million cash.³⁷ The most commonly traded debt at this time was that of Mexico.³⁸ Giadefi would arrange such transactions for a fee of one or two percent of the face value of the loans, or, sometimes for the private sector paper. De Filippis recalls selling some private sector Mexican paper acquired in this way to a canny investor³⁹ for eight cents on the dollar.⁴⁰

The investor who purchased private sector Mexican paper

32. Loan loss provisions are reserves against bad debts taken by setting aside a portion of earnings and thus impact a bank's profitability when taken. Whether provisions would have to be made for the balance of the bank's loans to that borrower depended upon the perspective of that bank's auditors — it was to be many years before the accounting profession settled upon the appropriate conventions to govern such situations.

33. See Jay H. Newman, *LDC Debt: The Secondary Market, the Banks, and New Investment in the Developing Countries*, COLUM. J. WORLD BUS. 69, 70 (1986).

34. See analysis of the effects on the market of the round of provisioning triggered by Citibank's major loan loss provision in May, 1987. See *infra* note 256 and accompanying text.

35. See de Filippis Interview, *supra* note 10.

36. German banks were assisted in selling non-performing loans by their tendency to have relatively large undisclosed reserves and by the tax deductibility conferred on those reserves in 1983. See Fleming, *supra* note 30 (discussing German banks' accounting practices).

37. See de Filippis Interview, *supra* note 10 (suggesting why, having lost World War II, Germany has gone on to win peace).

38. See *id.*

39. As the transfer of most of the debt was restricted by the original loan agreements to "banks or financial institutions," the investor would have had to fit that description. A corporation formed to invest in LDC debt and newly incorporated in a tax haven would probably have satisfied this "financial institution" requirement.

40. That same investor is living to rue the day that he sold loans for eight cents on the dollar that within two years were trading at about seven times that price.

at eight percent of face value had only to receive one annual interest payment to recoup the cost of the purchase — and the interest payments have continued unabated to this day. There is a lesson here for investors with spare capital during future financial crises.⁴¹

Conversely, the U.S. bank acquiring the Mexican public sector debt made a disastrous purchase. Soon after the transaction was made, the values of the private and public sector loans were virtually the same. During the rescheduling process, the loans were combined into one loan instrument with the sovereign as either obligor or guarantor. Therefore, in the case of De Filipis, the bank paid full face value for US\$8.9 million of Mexican paper which, in three years, would be trading on the market for fifty to sixty cents on the dollar.⁴²

2. Portfolio Adjustment by Banks

During 1983 and 1984, U.S. banks that could not or would not sell their LDC loans outright had two options. Option One was to sit tight, lend as little new money as possible without forcing the borrowers into default,⁴³ and wait out the crisis hoping that growth in LDC economies would permit repayment or that growth in bank capital would make the problem manageable. Most U.S. banks followed this course of action. Option Two was for the banks to rearrange their portfolios of loans to the region. Passivity is difficult for Type A personalities in the face of a crisis, so Option Two was quite popular, especially among banks with smaller exposures to the region for which portfolio adjustment was feasible.⁴⁴

There were four principal reasons for a bank to adjust its portfolio. First, the bank assessed the relative creditworthiness of different countries. Different bankers had different views “as to which rescheduling countries stood the best chance of com-

41. Admittedly, these are extreme prices from a nascent market. The uncharacteristically low swap price of eight cents on the dollar occurred when the market for Mexican paper had just opened. Once the market was established, debt on which interest was being paid never traded below 30 cents on the dollar. Pettis Interview I, *supra* note 22.

42. *Id.*

43. This option was because of the lack of foreign currency with which to service the loans.

44. The exposures of the major international banks were so large that the banks tended to leave them and not try to finesse the composition of their portfolios.

ing out of the tunnel first."⁴⁵ Accordingly, a bank might choose to concentrate its exposure to risk in a small number of countries.⁴⁶ This was the most common reason for portfolio adjustment.⁴⁷

Second, many Latin American banks chose to focus their exposure on the market that they knew best — their own. Hence, a number of Argentine banks, where possible, exchanged their Chilean, Brazilian, and Mexican loans, for those of Argentina.⁴⁸ The third reason for choosing to adjust their portfolio ran counter to the first reason. If the bank was unsure of which countries' economies would improve first, and wary of allocating its risk exposure to only one or two nations, the bank could choose to balance its risk exposure across a number of LDCs in the region.⁴⁹

The fourth and final reason for portfolio adjustment was that a large number of small exposures to borrowers in numerous countries was too expensive to manage and administer. Smaller banks, in particular, could not afford to devote teams of senior executives to LDC debt. The solution was to focus lending to one or two countries.⁵⁰ As Ollard wrote in 1986, "it is simpler to have \$8 million out to a single borrower in Brazil, for example, than to keep track of \$4 million in Chile, \$3 million in Columbia and \$1 million in Ecuador."⁵¹

It was estimated that in this period three of every four debt swaps were purely for portfolio adjustment purposes.⁵²

45. See Buchheit, *supra* note 17, at 28.

46. See Debt Equity Conversions, *supra* note 6, at 18; see also House, *Documenting and Implementing a Loan Swap*, INT'L FIN. L. REV. 29 (Oct. 1984); Interview with Martin Benegas-Lynch, International Treasurer, Banco Santander, New York City (Apr. 22, 1993) [hereinafter Benegas-Lynch Interview].

47. See Roberts & Remolona, *Debt Swaps: A Technique in Developing Country Finance*, in FINANCE FOR DEVELOPING COUNTRIES - ALTERNATIVE SOURCES OF FINANCE - DEBT SWAPS 21 (1987).

48. See de Filippis Interview, *supra* note 10.

49. See Benegas-Lynch Interview, *supra* note 46; see also Interview with Mary Tobin, Senior Staff Writer, *International Financing Review*, New York City (Apr. 21, 1993) [hereinafter Tobin Interview].

50. See Clark, *Deals Available to a Bank with LDC Debt*, in THIRD WORLD DEBT - MANAGING THE CONSEQUENCES 107 (S. Griffith-Jones ed. 1989) [hereinafter THIRD WORLD DEBT].

51. See Ollard, *supra* note 15, at 74.

52. See Martin W. Schubert, Address at the XLII Annual Plenary Meeting Mexico-U.S. Business Committee 10 (Nov 4-7, 1987) (on file with the *Fordham International Law Journal*).

C. Market Characteristics

From 1983 until early 1985, the market was characterized by four major features: Hand-crafted, individually documented transactions; structuring of the trades as ratio swaps; absence of market structure and rules; and confidentiality. Each feature will be considered separately.

1. Hand-crafted, Individually Documented Transactions

Each transaction in this period was put together individually as there were few willing buyers and sellers. It was a telephone market. Upon a seller approaching a broker, the broker would often call every other market participant seeking a buyer. Structuring trades required considerable time and effort, while margins were commensurately, perhaps more than commensurately, high. It was common for a broker, when asked to sell some debt for client, to quote a figure and if the prospective buyer was willing to pay three or four *percentage points* higher, then this was pure profit for the broker.⁵³ For example, a seller might receive sixty-one cents on the dollar for debt for which the buyer paid sixty-five cents, with the margin, some 6.6% of the seller's price, going to the broker. Such transactions were possible because of the extreme thinness of the market and the absence of publicly quoted secondary market prices.⁵⁴ For traders accustomed to spreads measured in basis points,⁵⁵ not percentage points, this was heady stuff. For traders accustomed to twenty trades per hour, rather than one or two trades a week, it was a difficult market.

Typical transaction sizes were not large, relative to what was to come, and exchanges of debt in the US\$1 million to US\$4 million range were common.

There was no central location for trading. Transactions took place on the phone lines between traders in New York City

53. Martin W. Schubert pointed out that "there are numerous cases where intermediary banks have added 4 to 5% commissions to the purchase price of the debt in dealing with the unsuspecting multinational" investor in a debt-equity conversion." See Martin W. Schubert, Address delivered at the Washington University's International Affairs Program Seminar, 20 (Feb. 25, 1988) (on file with *Fordham International Law Journal*).

54. *Id.*

55. A basis point is one-hundredth of a percentage point.

and Lazard Brothers and Libra Bank in London.⁵⁶ There were, at most, a dozen active traders.⁵⁷ Transactions often required extended periods of time and brokers would often call every other broker and potential source of debt a number of times over a period of weeks before he or she would conclude the deal.⁵⁸

At this stage, most traders had the documentation for each transaction individually prepared and negotiated by their lawyers. Each law firm had their own standard form assignment agreements which "showed a significant level of drafting individuality."⁵⁹

2. Trades Structured as Ratio Swaps

The typical transaction in this period was structured as a "ratio swap" to avoid any need to make loan-loss provisions.⁶⁰ In a ratio swap, \$X of higher priced-debt is traded for \$Y of lower priced-debt plus \$Z cash, where $X = Y + Z$.⁶¹ Because of the equality in the face values of debt exchanged, loan-loss provisions were not required. These swaps were also known as "par exchanges."⁶² Thus, in 1983 and 1984, accountants were still willing to treat one dollar of Brazilian debt, which traded at a substantial market discount, as equal to one U.S. dollar.

3. Absence of market structure and rules

In practice, the market was, at this stage, a free-for-all. No

56. See Lenny Glynn, *The Lull in LDC Loan Swaps*, INSTITUTIONAL INVESTOR, Sept. 1985, at 201.

57. See *id.* (quoting Giacomo de Filippis' view).

58. As an example of the thinness of the market, one trader offered a tranche of debt for sale at 8.30 a.m. By 9.30 a.m. he received a call offering to sell him the debt he had offered only one hour earlier! He later discovered that the potential buyer, to whom he had spoken, had offered the debt for sale to a second trader who had offered it to a third trader who was then offering it back to the original vendor. Only when a chain of transactions like this was in place would each trade be confirmed by telex. See Interview with a former trader with JP Morgan and other trading houses, New York City (April 19, 1993) (interviewee's name withheld on request).

59. See Buchheit, *supra* note 26.

60. See de Filippis Interview, *supra* note 10; see also Interview with Martin Schubert, Chairman of European InterAmerican Finance Group, New York City (April 22, 1993) [hereinafter Schubert Interview].

61. See de Filippis Interview, *supra* note 10 (matching author's own experience in the market in 1987 and 1988).

62. See Buchheit, *supra* note 26, at 2.

body viewed tranches of loans as securities, and the hand-crafted nature of each swap meant that the loans did not trade like securities.⁶³ Accordingly, few bothered to comply with the U.S. securities laws. The market was not reliable, as some brokers would withdraw from verbal trades, even those they had confirmed.⁶⁴ It was a typical "cowboy" market — he who was quickest on the draw and had the best inside information, won.

4. Confidentiality

The need for confidentiality was a product of the politically sensitive nature of banks selling their LDC loans, and the capacity for transactions to move the market. The principal reason for confidentiality was that large transactions could move the market and would do so more readily if counterparties knew the identity of the purchaser or seller, and thus could form conclusions about why that party may be doing that deal.⁶⁵ However, banks were also sensitive to allegations they were abandoning some sovereign borrowers.⁶⁶ Bankers Trust was heavily criticized for its 1983 swap of US\$100 million of Brazilian debt and US\$90 million cash for US\$190 million of Mexican debt from Banco Real.⁶⁷ This swap was exceptionally large in 1983 and attracted a great deal of publicity.⁶⁸ Many bankers felt this swap sat ill with Bankers Trust's role in soliciting new money from other banks as part of the restructurings.⁶⁹

During those years, it was more common than not for brokers to keep the identity of their clients secret. A marketing brochure promoting the LDC swap expertise of Shearson Lehman Brothers discussed confidentiality ten times in its four page introduction.⁷⁰ Swaps would often be documented between one party and the broker for the other party, or even between the two brokers. The debt transferred immediately thereafter to the respective parties.

63. It is highly unlikely that the traded parts of loans were securities within the meaning of the Securities Acts at this time.

64. See Glynn, *supra* note 56, at 201 (quoting Martin Schubert).

65. See Pettis Interview I, *supra* note 22.

66. See Glynn, *supra* note 56, at 201.

67. See Ollard, *supra* note 15, at 74.

68. See *id.*

69. See Glynn, *supra* note 56, at 197.

70. See *id.* at 200-01.

Under the terms of the relevant loan agreements, transfers had to be notified to the agent bank and the consent of the borrower obtained so that these parties would learn the identity of the eventual holder of the debt, as was necessary so interest could be paid. Nonetheless, secrecy was common. Banks could not avoid the borrower learning of their debt sales, but often sought to prevent this information from becoming common market knowledge at the time of the sale.⁷¹

Furthermore, secondary market prices were a closely kept secret. Brokers would not readily quote indicative prices⁷² for the reasons given above and because the market was too thin to permit their accurate prediction. A broker could, at best, give a customer a rough estimate of the range within which certain debt may be bought or sold. For anything more accurate, the broker would have to attempt to make the purchase or sale on the open market.

It has been estimated that debt with a face value of US\$500-US\$700 million was traded in the market in 1983,⁷³ rising to US\$2 - US\$2.5 billion in 1984.⁷⁴ The absence of reliable sources means these figures are probably little more than estimates, albeit well informed ones. The most commonly traded loans were those of Brazil and Mexico.⁷⁵

D. Participants

In February 1983, the European Interamerican Finance Corporation ("Eurinam") was formed by Martin Schubert to

71. A silent participation in the debt would have been completely confidential and avoided the need to notify the borrower. These were used at times but suffered from the large disadvantages that the transferor remained the lender of record and thus (i) would receive the interest payments (and have to account for these to the participant) and (ii) would not be relieved of the 'new money obligations' associated with the loan. For as long as the 1982 exposures were used as the basis for 'new money' calls, this latter factor was insignificant but most transferring banks were at least hopeful of being able to avoid 'new money' calls on transferred loans at some time in the future.

72. See Glynn, *supra* note 56, at 201.

73. Interview by Smith Barney Research with Martin W. Schubert [hereinafter Schubert Interview II] (on file with *Fordham International Law Journal*)

74. See *In the spotlight*, *supra* note 73. The US\$2 - US\$2.5 billion estimate was made by Schubert, in *BankNotes*, *supra*. Wallenstein estimated 1984 volume at US\$2 billion. See Wallenstein, *Debt-Equity Country Funds: Problems and Prospects in THIRD WORLD DEBT*, *supra* note 50, at 32.

75. See Schubert Interview I, *supra* note 60; Wallenstein, *supra* note 74; Pettis Interview I, *supra* note 22.

serve as a broker of Latin American debt.⁷⁶ Five months later, Giadefi Inc. was formed by Giacomo de Filippis for the same purpose.⁷⁷ The establishment of these specialist brokerages in 1983 marks the birth of the modern secondary market.

Schubert and de Filippis were each well placed to see the coming opportunity. In 1982, Schubert was president of Rosenthal International Ltd., a small merchant bank he had helped spin off a fabric factoring concern in the 1960s.⁷⁸ De Filippis was treasurer of Banco Rio de la Plata.⁷⁹ Each man saw the need for LDC loan brokers and established their own small brokerage house; a risk each was richly rewarded for taking.⁸⁰

These earliest days of the market were well adapted for small, innovative, risk-taking brokers. Hence, the small independent houses such as Eurinam, Giadefi and, to a lesser extent, Turan Corporation⁸¹ all played a significant role. In early 1984,⁸² Eurinam entered into a joint venture with Singer & Friedlander Ltd of London which lasted until July 1991.⁸³ Banco Rio de la Plata and a number of other Latin American banks were involved from the beginning in swapping and trading their own portfolios to raise credit. Banco Rio de la Plata was the first Latin American bank to extend this role to brokering deals for others and was in the secondary market from the beginning.⁸⁴

76. See Schubert Interview I, *supra* note 60; see also Gewirtz, *Bankers Cool to Discounted Debt Proposal*, INT'L HERALD TRIBUNE, Apr. 11, 1983 (discussing founding of Eurinam); Pearlman, *Martin Schubert Strikes Back*, INSTITUTIONAL INVESTOR, June, 1983; Edwin A. Finn Jr, *There Goes the Neighborhood*, FORBES, June 29, 1987, at 35.

77. See de Filippis Interview, *supra* note 10. De Filippis maintains that his was the first corporation established exclusively to facilitate swaps of this debt, implying that Eurinam was established to serve a broader purpose and only specialized in this market as it grew. *Id.*

78. See Glynn, *supra* note 56, at 201.

79. See de Filippis Interview, *supra* note 10; Ollard, *supra* note 15, at 75.

80. See Benegas-Lynch Interview, *supra* note 46 (confirming surmise, at least with respect to de Filippis).

81. See Turan "Tombstone" announcement, WALL ST. J., Jan. 21, 1992. Turan Corporation bills itself as "the world's oldest and largest independent dealer in Third World Debt." *Id.* It was formed by a lawyer, Robert P Smith, in 1978. See Linda Corman, *Selling the Third World*, INT'L BUS., Apr. 1989.

82. See Martin Schubert, Speech at the Hospitality Industry Investment Conference, New York, New York 1 (June 3-5, 1990) (on file with the *Fordham International Law Journal*).

83. See *Changing Times*, 29 LATIN FINANCE 8 (1991); see also *Joint-Venture Agreement Changed* 886 INT'L FIN. REV. July 13, 1991 at 31.

84. See de Filippis Interview, *supra* note 10; Schubert Interview, *supra* note 60. In one early transaction, Banco Rio acquired US\$10 million of notes issued by a Mexican

The first European bank into the market was Nederlandsche Middenstandsbank, universally known as NMB, and now part of ING Barings. They claim to have been involved in trading LDC debt since September 1982.⁸⁵ This early start was to serve NMB well. It was to become one of the major traders of LDC debt. By the late 1980s, NMB and Libra were the only significant traders which were not major U.S. investment or commercial banks.⁸⁶

At this time, some of the major U.S. commercial banks likewise established "swap units", often of only one or two people, to handle the disposition of some of their own assets.⁸⁷ However, the U.S. banks were much slower than some of their Latin counterparts in permitting those units to represent other parties. The high profile of the 1983 swap between Bankers Trust and Banco Real attracted other banks and brokerage houses to the business. In 1984 Bear Stearns & Co, Shearson Lehman Brothers and Salomon Brothers all established or augmented specialised swap units.⁸⁸

E. *Impact of the Market*

The impact of the market in these years was twofold. Firstly, it afforded an exit route for those banks with small exposures upon which they could afford to take the losses or those far-sighted banks willing and able to absorb losses on larger holdings of debt to be free of their LDC debt exposure. Secondly, and more significantly for there were few banks in the former category,⁸⁹ the market permitted portfolio adjustment for banks.

With the exception of the debt-equity scheme implemented by Brazil in 1983⁹⁰ for which the market supplied most of the

company and guaranteed by a Mexican bank for 75 cents on the dollar and swapped the notes with a U.S. bank for US\$1.1 million of Mexican private sector debt, then considered almost worthless, and US\$8.9 million in cash. See de Filippis Interview, *supra* note 10.

85. See Mary Tobin, *Innovations May Dampen Debt Crisis*, UNITED PRESS INT'L, Feb. 5, 1988. It would be remarkable and surprising if NMB was actually brokering loan swaps one month after the announcement of the debt crisis.

86.

87. For instance, by 1985, Bankers Trust had four people in its swap unit.

88. Glynn, *supra* note 56, at 197.

89. During this period, none of the major British, Canadian, or U.S. banks could afford to take the losses involved in selling their loans.

90. Derek Asiedu-Akrofi, *A Comparative Analysis of Debt Equity Swap Programs in Five Major Debtor Countries*, 12 HASTINGS INT'L & COMP. L. REV. 537, 546 (1989).

debt, the market had little impact on the debtor nations in these years.

II. THE MARKET IN INFANCY: May 1985 to May 1987

A. Major Events in this Period

This period of the market's development began with the issuance of an accounting guideline which was to have a significant impact on the activities of U.S. banks in the market for many years to come.

1. May 1985 Accounting Guideline

In May 1985, the American Institute of Certified Public Accountants ("AICPA") issued an opinion notice which, while noting that valuation for non-cash swaps is "highly judgmental," suggested that when a swap involved credits to financially troubled countries "the estimated fair value of the consideration received will generally be less than the recorded investment in the consideration paid" in which case "a loss should be recognised."⁹¹

This accounting guideline would appear to have made ratio swaps no longer effective to avoid writedowns on swaps of credit-impaired assets and the market had been built on ratio swaps.⁹² However, the guideline only applied to U.S. banks. European banks, which did not have to incur writedowns on ratio swaps,⁹³ came to represent an increasing proportion of sellers. Furthermore, even though the opinion notice provided that "in the course of preparing financial statements, a bank must review the loan portfolio in order to assess the adequacy of the allowance for loan losses,"⁹⁴ there remained doubts about whether the balance of a bank's portfolio to a debtor would have to be written down to the extent of the loss taken on a swap.

Clearly, private sector debtors from the one country are separate entities and a loss on a swap of a loan to one need not

91. See *Notice to Practitioners Accounting for Foreign Loan Swaps*, reprinted in CPA Letter (Special Supplement), May 27, 1985, at 31 [hereinafter *Notice to Practitioners*].

92. See Glynn, *supra* note 56, at 198 (noting in September 1985 that virtually all swaps done in 1984 were done as what I have termed ratio swaps and without banks taking any write-downs).

93. Finneran, Remarks at a conference sponsored by The Heritage Foundation, Center for International Economic Growth (Jan. 21 1987) in *DEBT/EQUITY CONVERSION - A STRATEGY FOR EASING THE THIRD WORLD DEBT* 29 (1989).

94. See *Notice to Practitioners*, *supra* note 91, at 31.

impact the book value of one's loans to another. However, in the words of Roberts and Remolona, "with public sector debt, . . . it is not always obvious whether the loans to one parastatal should be treated separately from loans to the central government or to another parastatal."⁹⁵ Doubtless the argument was that the sovereign may permit some of its parastatals to fall into default while remaining current on its own debts and/or those of other parastatals. This was a thin argument given that virtually all loans to parastatals were now the subject of a sovereign guarantee but it was an argument nonetheless and the banks were going to have to be carried, kicking and screaming, to the wall on this one.⁹⁶

An early draft of the opinion notice declared that in most loan swaps there should be a "general presumption" of loss, as banks were required to mark loans to "fair market value."⁹⁷ This horrified most loan swappers and brokers. A vigorous opposition to this wording was mounted, led by Shearson Lehman Brothers and joined by many regional banks. They alleged that the money center banks had pushed for the strong "presumption of loss" language in the notice to hobble the market because they were unhappy that the emerging market publicly exposed a real value for their vast portfolios of LDC debt and, in time, would lead to inexorable pressure for realistic loan loss reserves to be taken on those portfolios. One swap unit head is reported to have said angrily, "They tried to railroad through this presumption of loss language."⁹⁸ A Citicorp official was reported as saying, "the idea that we pushed for some new ruling to stop swaps is ridiculous. These are not 'new' accounting rules, they are simply a codification of long-standing practice."⁹⁹ It is true these rules were simply commonsense and what one

95. See Roberts & Remolona, *supra* note 47, at 26. A February 1986 publication of the IMF noted that the opinion notice "does not necessarily carry implications for valuation of a bank's other loan claims on that country." See Maxwell Watson & Russell Kincaid, *International Capital markets - Developments and Prospects*, OCCASIONAL PAPER No. 43, 57 (1986).

96. See Glynn, *supra* note 56, at 198. Virtually all private sector loans were guaranteed by the sovereign under the restructuring agreements. See Buchheit, *Legal issues in trading sovereign debt*, INT'L FIN. L. REV. 17, 19 (February 1986) (considering effect of opinion notice); see also Newman, *supra* note 33, at 69-70; Roberts & Remolona, *supra* note 47, at 25; Watson & Kincaid, *supra* note 95, at 57.

97. See Glynn, *supra* note 56, at 198.

98. *Id.*

99. *Id.*

would expect from prudent auditors. However, they were new — the long-standing practice of most U.S. banks active in the market before May 1985 had been to enter into ratio swaps with equal face values of debt and cash exchanged and, as a result, take no loss onto their books. In the end, the potent “general presumption” language was deleted from the final draft although the “fair value” language remained.

Only days after the AICPA notice, the Comptroller of the Currency elected to throw some of the federally chartered banks over his shoulder and carry them to the wall of financial rectitude.¹⁰⁰ The Comptroller’s circular resurrected the dreaded ‘presumption’ language, as follows:

The estimated fair value of the consideration given and received in a loan swap must be determined. Certain foreign countries are currently experiencing financial difficulties. For exchanges involving loans to debtors of such countries, it is presumed the estimated fair values will be less than the respective face values of the loans and other consideration. Assuming the general presumption is not overcome, this would result in a loss on the swap.¹⁰¹

The circular went even further and suggested that after a swap a bank should reconsider its loan loss provisions for similar credits remaining in its portfolio although it did not require that the valuation of the swapped assets be applied to the balance of the portfolio.¹⁰²

The effect of asset trades leading to a mandatory writedown of the balance of one’s portfolio of loans to that borrower is known in the industry as “portfolio contamination.”¹⁰³ This is a curious term. ‘Contamination’ is defined as the action of rendering something impure by contact or mixture.¹⁰⁴ In this case, the impure contact was with a value for these loans determined by their sale and purchase in a market.¹⁰⁵

100. The Comptroller has jurisdiction over federally chartered banks. Accordingly, his banking circular did not affect state incorporated banks such as Citibank, Chase Manhattan, and Morgan Guaranty.

101. Comptroller of the Currency, *Accounting for Loan Swaps*, BANKING CIRCULAR No. 200, May 22, 1985, reprinted in 3 BANKING L. REP. (CCH) ¶ 51,145 (Sept. 30, 1988).

102. Buchheit, *supra* note 96, at 17, 19.

103. See Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 2 U. ILL. L. REV. 401, 411 (1988) (considering this effect).

104. See OXFORD ENGLISH DICTIONARY 184 (1st ed. 1982).

105. The market was argued by many to be a very inaccurate guide to the loans’

Terminology notwithstanding, the common approach of major U.S. banks to this risk of portfolio contamination was a strict segregation of the bank's own portfolio from the activities of its loan swap unit. Banks typically would not permit the swap unit to swap or sell any loans from the bank's own portfolio. If the unit needed certain assets for a particular transaction, it had to find them elsewhere.¹⁰⁶ Generally Accepted Accounting Principles in the U.S. did not require mark-to-market accounting for assets held to maturity in a loan or investment portfolio, only assets in trading portfolios were generally required to be marked to their market value.¹⁰⁷ Many of the assets in the bank's own portfolio and those traded by its loan swap unit would have been utterly indistinguishable — yet this fine distinction did work to prevent 'contamination' of the banks' own portfolios with their market values in these years.

2. Mexican Troubles

The next major events to affect the market occurred in Mexico. In September 1985, Mexico fell out of compliance with its International Monetary Fund ("IMF") economic reform program. Many people have long thought the IMF behaves with the self-certainty of private divine guidance. When, a few days later, two earthquakes shook the country¹⁰⁸ and the price of oil plummeted over sixty percent between November 1985 and April

real values. However, traders typically see these arguments as fatuous. Their view is that an assets' true value is the price at which buyers and sellers are prepared to trade it. See Pettis Interview I, *supra* note 22. Whatever perspective one takes, the market value of these debts was certainly a closer approximation to their "real value" than the almost full face value at which most U.S. banks were still carrying these loans.

106. In Michael Pettis' words, "Many times I had to pay to borrow assets from Chase, while the Chase traders had to pay to borrow equivalent assets from my bank. What a magnificent waste of money!" See Interview with Michael Pettis, Managing Director of Bear Stearns & Co, New York City, Feb. 20, 1996 [hereinafter Pettis Interview II].

107. See Robert R. Bench, Deputy Comptroller of the Currency, Statement before the Senate Subcommittee on International Finance and Monetary Policy of the Committee on Banking, Housing and Urban Affairs, Washington, D.C. (April 2, 1987), in 6 O.C.C. Q.J. 21 (1987); see also Brooks, *Should Banks Mark It to Market? Depository Institutions' Accounting Treatment for Debt Investment Securities* 11 ANN. REV. BANKING. L. 425 (1992).

108. See R.A. Pastor, *The Debt Crisis: A Financial or a Development Problem*, in LATIN AMERICA'S DEBT CRISIS - ADJUSTING TO THE PAST OR PLANNING FOR THE FUTURE 13 (1987).

1986,¹⁰⁹ it must have been tempting to believe that the IMF did indeed have a direct line to the Almighty. Normally these two events would have caused a precipitate decline in the prices for Mexican debt. However, the debt was trading at around eighty cents on the dollar in June and October, 1985 and fell to around fifty-five cents in April 1986.¹¹⁰ Most other nations' debts lost between five and ten cents on the dollar in this period so Mexican debt was relatively resilient in the face of these two setbacks.¹¹¹ The reason for this resilience was the demand for the debt in debt-equity conversions.

3. The Baker Plan

In October of 1985, at the joint meeting of the IMF and the World Bank in Seoul, South Korea, U.S. Treasury Secretary James Baker announced his "Program for Sustained Growth" for the most highly indebted nations.¹¹² This program was immediately dubbed the "Baker Plan" and became the nucleus of the U.S. government's debt policy for the following three years.¹¹³ The plan proposed that, over the next three years, the commercial banks were to provide new loans of US\$20 billion: US\$7 billion from U.S. banks and US\$13 billion from non-U.S. banks, and the official agencies, particularly the World Bank and the Inter-American Development Bank, were to provide a further US\$9 billion.¹¹⁴ The official loans were to be tied to policy reforms in the debtor nations. These included trade and investment liberalization, tax reform, budget cuts, elimination of gov-

109. *See id.* Oil and gas accounted for about seventy percent of Mexico's exports in 1984. The price of oil fell from US\$30.80 for one barrel of West Texas intermediate crude on November 21, 1985 to US\$11.50 on April 2, 1986. *Id.*

110. *See* Peter Montagnon, *An Impasse That is Difficult to Resolve*, *FIN. TIMES*, Sept. 26, 1986, at 1 (providing special supplement on Peru with price table whose source is Finance Ministry in Lima).

111. *Id.*

112. The fifteen nations targeted by the Baker Plan were Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela and Yugoslavia (as it then was). A comparison with the *World Debt Tables* shows that these were not the fifteen most highly indebted, financially troubled countries in the world — the influence of U.S. policy and its concern with its "own backyard" in Latin America is evident in the choice of nations.

113. *See* Carmichael, *The Debt Crisis: Where Do We Stand After Seven Years?* 4 *RES. OBSERVER* 121, 125 (1989); *see also* *Mexican Kick-off to The Baker Plan Highlights Switch to Growth* 642 *INT'L FIN. REV.* Oct 4, 1986 at 2930.

114. *See* Goldman, *Confronting Third World Debt: The Baker and Bradley Plans*, 559 *BACKGROUNDERS* Jan. 22, 1987, at 5-6.

ernment subsidies, large scale privatization, cuts in minimum wages and liberalization of domestic financial markets.¹¹⁵ In a subsequent interview, Secretary Baker summarized his plan by saying that the "increased financing not only will ease current debt servicing difficulties, but will facilitate and support domestic policy changes to increase economic growth."¹¹⁶

The Baker Plan aimed at defeating the debt crisis through long-term growth in the debtor nations (as opposed to the short-term stabilization programs of the preceding three years).¹¹⁷ With hindsight it bought time and precious little else. Neither the commercial banks nor the official agencies came close to lending the targeted amounts of fresh funds.¹¹⁸ Probably the most important aspect of the plan was that it amounted to an explicit acknowledgment by the governments of the developed world that any resolution to the debt crisis required their involvement.¹¹⁹

By early 1987 the Baker Plan was beginning to unravel as regional U.S. and continental European banks began increasingly to resist lending new money to the debtors.¹²⁰ As reported

115. *Id.* Carmichael, *supra* note 113, at 125.

116. *See* Goldman, *supra* note 114, at 6.

117. *See* William Cline, *From Baker to Brady: Managing International Debt*, in FINANCE AND THE INTERNATIONAL ECONOMY 85, 85-86 (R. O'Brien & I. Iversen eds., 1990).

118. *Id.* at 87-88. Cline acknowledges that new money loans fell far short of the targets but argues that the US\$26 billion in debt conversion and reduction in the three years of the Baker Plan should be added to the bank's contributions to the region. While some banks incurred losses on selling the debt for use in the conversions and debt buy-backs, the funds provided to acquire the debt came from the investors (in the case of conversions) and the debtor nations (in the case of buy-backs). His interpretation and application of these figures is far too favorable to the commercial banks. The generally accepted position is that the major commercial banks "were not able to mobilize anything close to the US\$20 billion in new money facilities expected of them as part of the Baker initiative." *But see* UNITED NATIONS COMMISSION FOR LATIN AMERICA & THE CARRIBEAN & UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, TRANSNATIONAL BANK BEHAVIOUR AND THE INTERNATIONAL DEBT CRISIS 16 (1989) [hereinafter ECLAC/CTC]; *see also* Alberto Gonzalo Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 77 (1991).

119. *See* DEBS, ROBERTS & REMOLONA, FINANCE FOR DEVELOPING COUNTRIES - ALTERNATIVE SOURCES OF FINANCE - DEBT SWAPS 13 (1987). The Plan attracted criticism due to the governmental involvement. "Once U.S. commercial banks are part of a package designed by the government and supranational financial organizations, bankers acquire a de facto claim on the taxpayers in the event the loans go bad." Paul Craig Roberts, *Debt Upon Debt*, WALL ST. J. June 25, 1986.

120. *See* Charles F. McCoy & Peter Truell, *Lending Imbroglia: Worries Deepen Again On Third World Debt As Brazil Stops Paying* WALL ST. J. Mar. 3, 1987; *See also* Mexico — Rescue package announced 632 INT'L FIN. REV. 2208, July 26, 1986.

in the *Wall Street Journal* in March 1987, "35 to 40 [U.S.] regional banks have been refusing to cough up their share of new money for the rocky Mexico restructuring begun last fall" and "European banks . . . are less inclined to throw good money after bad to keep credits alive."¹²¹

The regional U.S. and continental European banks objecting to the new money merry-go-round were the same banks that had sold their exposures on the secondary market. The market had given them an alternative to endless new money calls — the liquidation of their LDC debt portfolios.¹²² The secondary market provided the regional U.S. and European banks¹²³ with a back door out of the debt crisis to which the major banks did not have a key.

4. Peru's Debt Service Limits

In 1985, Alan Garcia came to power in Peru as its new President and promptly announced that Peru would limit its debt service payments on medium and long-term debt to ten percent of exports.¹²⁴ The howls of protest from the banking community were particularly strident as the bankers saw this as a dangerous precedent.¹²⁵ The banks slashed Peru's trade credit lines and strove to isolate the nation and brand it a pariah.¹²⁶ The price of Peru's debt on the secondary market fell from around sixty per-

121. See McCoy and Truell, *supra* note 120. This resistance by smaller U.S. banks was no doubt strengthened by the "rather acute schizophrenia" which was afflicting U.S. bank regulatory policy. See Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401 (1988). In Buchheit's words, "[a] regional banker may on one day receive a telephone call from a bank regulator asking why he or she is not participating in the latest new money loan for country X. The next day, a bank examiner may call asking why the bank's capital ratio is so low in relation to the bank's exposure to debtors like country X." *Id.*

122. This is an alternative not open to the major banks with their massive exposures.

123. See Benegas-Lynch Interview, *supra* note 46. Most of the Swiss banks, which had small exposures to LDCs, quietly sold their entire portfolios in 1985 and 1986. Banco Santander of Spain did likewise in 1986. *Id.*

124. See Montagnon, *supra* note 110.

125. *Id.* The precedent was even the more dangerous because of its apparent reasonableness. A total repudiation of the debt would have lacked credibility in the international community; this proposal, particularly if repayments were increased to say 20% of exports, had the capacity to appeal to other debtor governments and a sufficient appearance of reasonableness and balance to make savage criticism of it difficult to sustain in the international polis.

126. *Id.*

cent in February 1985 to twenty percent by April 1986.¹²⁷ Other debtors, however, declined to follow Peru's lead. 1986 was thus a relatively peaceful year which saw a doubling in secondary market activity. The peace lasted until February 1987.

5. Brazil's Payment Freeze

On February 20, 1987 Brazil announced that it was temporarily suspending interest payments on about US\$67 billion of private foreign debt and effectively freezing about US\$15 billion of short-term credits and money-market deposits by foreign banks.¹²⁸ The Brazilian finance minister noted that in the years since 1983 Brazil had paid US\$45 billion in interest and received only US\$11 billion in fresh funds.¹²⁹ The Brazilian government was also concerned that it had not received from the banks a generous restructuring package similar to Mexico.¹³⁰

The international banking community was shocked. From 1984 to 1986 Brazil's GDP had risen 5.7%, 8.3%, and 8.2%, respectively.¹³¹ It appeared to be leading the region into recovery with growth rates approaching three times the average for the ten principal Baker countries. However, this growth was mostly in the private sector and was of little assistance with the public sector's indebtedness. At the time Brazil was at pains to stress that this moratorium was temporary — in fact interest repayments were not resumed until early 1988¹³² and arrears of interest were not paid until late 1988.¹³³

B. *Impetus for the Market*

The process of portfolio adjustment discussed previously

127. See *id.*, table, citing Ministry of Finance, Lima.

128. See *Brazil Calls the Shots*, 662 INT'L FIN. REV., Feb 28, 1986 at 667; McCoy & Truell, *supra* note 120, and Pastor, *supra* note 108, at 14.

129. See Pastor, *supra* note 108, at 14.

130. See ECLAC/CTC, *supra* note 118, at 133.

131. See *World Financial Markets*, *supra* at 2.

132. See Peter Truell, *Bolivia Buys Back Nearly Half of Its Debt to Banks at a Fraction of the Face Value*, WALL ST. J., Mar. 18, 1988. (stating that Brazil paid US\$356 million on February 2 and a further US\$530 million on March 3, 1988).

133. See Phillip T. Sudo, *Chase Announces Plan to Fortify LDC Reserve*, AM. BANKER, Jan. 24, 1989, at 3 (stating that Brazil repaid balance of outstanding interest in fourth quarter of 1988); see Peter Truell, *Big Banks See Bonanza in Fourth Quarter — Brazil's Catch-Up on Interest Payments is Main Reason*, WALL ST. J., Oct. 26, 1988 (explaining that payment of over one year's interest resulted in extremely profitable fourth quarter for most major U.S. banks).

continued throughout this period. Historically, European banks felt more comfortable with East European exposures and U.S. banks more comfortable with Latin American exposures.¹³⁴ Accordingly, in this period a good deal of portfolio adjustment occurred along these lines. For instance, a U.S. bank might give Polish debt in exchange for Brazilian debt from a European bank.¹³⁵

There were five additional factors which provided further impetus for loan trading between 1985 and 1987. These were different regulatory treatment in different countries; the growing realization that the 'new money' calls of 1983 and 1984 were not one-off events and were likely to be a way of life for years to come; swaps to take advantage of the taxation status of the debt; the swapping of perpetual floating rate notes for LDC debt in 1987; and the expansion in some countries of debt-equity conversion schemes which provided a use for the debt.

The most influential of the five factors, by far, was the demand created by the conversion of these loans into equity under debt-equity swaps. Each factor will be considered.

1. Different Regulatory Treatment Between Countries

In this period, some nations began to require that mandatory provisions be made for loans to borrowers in certain countries. There was, however, no consistent approach by the bank regulators of different countries; thus, banks in one nation were required to take provisions against loans to a different basket of countries than banks in another nation. This gave rise to swap activity: banks swapped out of loans for which provisions were required by their home regulator into loans for which mandatory provisions were not required.¹³⁶

2. The Persistence of New Money Calls

Some banks sold their loans principally to avoid the periodic requests for fresh funds.¹³⁷ These obligations (to make

134. See *Write-down - The crucible for a US\$350 bn loan swap market?*, 674 INT'L FIN. REV. May 23, 1987 at 1685.

135. *Id.*

136. See Buchheit, *supra* note 96, at 17-18. But see Pettis Interview I, *supra* note 22. In the words of Michael Pettis, "In a sense, the banks were 'arbitraging' the differences in the regulatory regimes." *Id.*

137. See Watson & Kincaid, *supra* note 95, at 62.

fresh loans based on a percentage of one's exposure) were not legally enforceable but intense pressure from other banks and central bank regulators made non-compliance very difficult. The new money was needed so debtor nations could meet their interest payments. In 1983 and 1984, many believed the new money packages were one-off affairs, not to be repeated.¹³⁸ Experience had disabused banks of this illusion by 1985¹³⁹ and many banks wished to be rid of these obligations.

However, there was no standard practice for the treatment of transferred loans in new money packages.¹⁴⁰ The base for the calculation of the new money obligations usually remained the banks' relative exposures in late 1982, so that subsequent loan sales and swaps did not assist.¹⁴¹ During 1987, the practice of calculating new money obligations as a proportion of 1982 exposures was increasingly challenged by non-U.S. banks, which had been most active in the secondary market, as the practice failed to reward banks that had sold or swapped these exposures off their books.¹⁴²

3. Tax Swaps

Some swaps were tax-driven. For example, a Dutch bank doing business in New York swapped its Mexican sovereign debt that carried tax receipts for debt without receipts.¹⁴³ The re-

138. See Buchheit, *You'll Never Eat Lunch in This Conference Room Again* INT'L FIN. L. REV., April 1992 at 11.

139. Indeed, new money was required periodically throughout the 1980s and into the 1990s to facilitate debt service.

140. See Watson & Kincaid, *supra* note 95, at 62. Thus, as part of Mexico's 1987 rescheduling, the bank creditors of Mexico as of August 22, 1982 were "invited" to participate in a new money loan to the extent of 12.9% of their exposure on that date in 1982. See Lee C. Buchheit, *Alternative Techniques in Sovereign Debt Restructuring*, UNI. ILL. L. REV. 371, 374 (1988). The absence of an accepted practice for dealing with the basis for calculation of new money calls is highlighted by a *Wall Street Journal* article in March 1987 which reports the "ludicrous game of hide-and-seek" which had followed the sale by Republic Bank of New York of some millions of dollars of Mexican loans. Republic, pointing to the sale, had refused to contribute new money funding but, citing confidentiality, declined to disclose the identity of the buyer of the loans, for which the other banks had thus been searching. See McCoy & Truell, *supra* note 120. A more typical story is that of Bank of Boston which had initially refused to contribute new money to the Mexico restructuring but ultimately relented and did so because of considerable pressure from Citicorp, other major banks, and the U.S. Federal Reserve. *Id.*

141. See Schubert, *DEBT/EQUITY CONVERSION*, *supra* note 93, at 5, 7.

142. See ECLAC/CTC, *supra* note 118, at 137.

143. See Roberts & Remolona, *supra* note 47, at 15, 22.

ceipts evidenced the payment of withholding tax within Mexico on the interest and entitled the bearer to tax credits in other jurisdictions.¹⁴⁴ The Dutch bank's tax exposure in New York was low and so it could make little use of the receipts. Tax swaps were transactions to effect the sale of a tax benefit.¹⁴⁵ The face value of debt exchanged in tax swaps in 1985 may have approached US\$1 billion.¹⁴⁶

4. The Exchange of Perpetual Floating Rate Notes for LDC Debt

Perpetual floating rate notes ("FRNs") had been popular in the United Kingdom and Commonwealth countries. They were issued by institutions of solid financial standing but, as they never matured, had some of the characteristics of equities.¹⁴⁷ In short, perpetual FRNs were trendy instruments that had fallen from favor and tended to trade at a discount of ten to thirty percent from face value.¹⁴⁸ This discount facilitated their exchange for LDC loans. In 1987 such swaps became very popular and were described as "the hottest thing in town."¹⁴⁹ At times, the junk bonds of U.S. corporations and the debt of financially troubled U.S. corporations such as Western Union, Pan Am, Eastern Airlines, and Dome Petroleum,¹⁵⁰ were included in the mix. However, this proved more problematic as default on this debt was a real, short-term possibility that was not the case with LDC

144. See generally Schubert, *A Critical Appraisal of the Changing Secondary Market for Discounted Third World Debt*, Address delivered at the Debt-Equity / Swap Market Conference sponsored by the Institute for International Research, New York City, October 19-20, 1987, at 13 (on file with the *Fordham International Law Journal*) [hereinafter Schubert Address] (discussing tax sweeps); see also Schubert, *Risky Business: Prospects of U.S. Trade and Investment in Latin America*, Address delivered at Washington University's International Affairs Program Seminar, Washington University, St. Louis, Feb. 25, 1988, at 10 (on file with the *Fordham International Law Journal*).

145. See Newman, *supra* note 33, at 70.

146. See Glynn, *supra* note 56, at 201-02 (citing figure as participant's estimates).

147. See *The Perpetual FRN Market Rests in Peace*, 662 INT'L FIN. REV., Feb 28, 1987 at 693.

148. *Id.*

149. See *Citicorp's Write-down - The crucible for a US\$350 bn loan swap market?*, 674 INT'L FIN. REV., May 23, 1987 at 1684. For instance, in March 1987 a U.S. investment bank was offering the swap of US\$10 million of perpetual notes issued by a well-known and major British bank for US\$7.5 million of Mexican debt and US\$2.5 million of Chilean debt or for US\$7 million of the debt of the Ivory Coast and US\$10 million cash. See *Perpetuals vs the Ivory Coast* 666 INT'L FIN. REV., Mar. 28, 1987, at 1042.

150. See Schubert Address, *supra* note 144, at 10-11.

debt and perpetual FRNs.¹⁵¹

Swapping perpetual FRNs for LDC debt introduced fresh money into the LDC debt equation and provided an acceptable exit vehicle for some banks concerned with reducing their exposures to LDCs. By the end of 1987, however, swaps into perpetual FRNs had fallen from favor due to accounting valuation problems.¹⁵²

5. The Expansion of Debt-Equity Conversion Schemes

Debt-equity schemes permit the conversion of debt into equity in local industries. Their attraction for investors and debtor nations is that the secondary market discount is "recaptured" and divided between them.

In a typical scheme the central bank of the debtor nation announces that debt can be swapped at a certain rate for equity in local businesses or used for capital investments in the debtor nation. The rate of exchange of debt for equity may be set by the central bank (for instance, the central bank may stipulate that it will retain 12 cents on the dollar so that, for every dollar of debt tendered, the investor receives local currency to the value of 88 cents). Alternatively, the rate may be set by an auction so that investors bid for the right to convert debt into equity and those willing to accept the largest discounts receive the right to convert their debt.¹⁵³

The attraction of these schemes is that the investor who has received, in my example, 88 cents worth of pesos for one dollar of debt, may typically have paid only 50 to 60 cents for that dollar of debt on the secondary market. For example, in late 1986, Mexican government debt was trading at 57 cents on the dollar and Mexico was taking an average redemption discount of 11

151. See Martin Schubert, *A Practical Exit Approach to LDC Debt. A Critical Appraisal of the Secondary Market and Alternative Exit Possibilities for Regional Banks*, Address delivered at the ABA International Banking Policy Forum, 1987, Washington, D.C., Sept. 25-27, 1987, at 11 (discussing swapping of LDC debt for perpetual FRNs); see also Schubert Address, *supra* note 144.

152. See Martin Schubert, *A Debt Strategy for International Commercial Banks in 1988*, Address delivered at a conference of the Bankers' Association for Foreign Trade, Washington, D.C., Jan. 24-26, 1988, at 10.

153. See Martin Schubert, *Trading Debt for Equity*, *BANKER*, Feb. 1987, at 18; see also Schubert, *Third World Debt as a Trading and Investment Tool*, *Countertrade & Barter*, April/May 1987, at 38.

percent.¹⁵⁴ If one allows three cents on the dollar for the fees of the trader who assembles the package of convertible debt the investor obtains 89 cents worth of pesos for every 60 cents spent — an increase in their buying power of over 48%.¹⁵⁵

In effect, a debt-equity swap results in a preferential exchange rate for the foreign investor.¹⁵⁶ In exchange for such a preference there are usually limitations. Often, eligible investment is limited to certain industries and has to meet certain requirements. There are usually limitations on the repatriation of capital and the remittance of dividends.¹⁵⁷ Furthermore, many countries nominate only a portion of their outstanding indebtedness to be eligible for conversion into equity.

Some appreciation of the scale of these schemes in this period can be acquired from the following table which gives the amounts of debt authorized for conversion into equity as of April 1987.¹⁵⁸

DEBT - EQUITY CONVERSIONS
(MILLIONS OF U.S. DOLLARS FACE VALUE OF DEBT)

Country	Total ¹⁵⁹	Period of Program
Argentina	500	February to August, 1985
Brazil	2,300	Since 1982
Chile	1,200	Since June 1985
Mexico	950	Since May 1986

The introduction and/or expansion of these debt-equity schemes in 1986 revived the secondary market.¹⁶⁰ As we shall

154. See Roberts & Remolona, *supra* note 47, at 23.

155. This example is modified from the one given by Roberts & Remolona, *supra* note 47, to take account of the higher trader's fees and transaction costs which were typical in the market at that time from the author's experience.

156. See Roberts & Remolona, *supra* note 47, at 23. For an analysis of the preferential exchange rate involved in debt-equity swaps, see Anayiotos & De Pinies, *The Secondary Market and the International Debt Problem*, 18 *WORLD DEV.* 1655, 1657 (1990).

157. See Remarks of Pardo in DEBT/EQUITY CONVERSION, *supra* note 93, at 48 (discussing the Chilean scheme for which capital could not be remitted in first ten years of investment and dividends could only begin to be remitted in fifth year, and then at a controlled rate).

158. Roberts & Remolona, *supra* note 47, at 23.

159. This column records the total conversions authorized, for instance, in Mexico's case as at April 1987, US\$722 million of debt had been converted out of the US\$950 million authorized for conversion.

160. See *Philippines — Debt to equity*, 632 *INT'L FIN. REV.*, July 26, 1986, at 2208.

see, market activity had slowed in 1985 due to the accounting ruling affecting U.S. banks. The need to assemble debt eligible for conversion into equity fueled a great deal of activity in 1986 and 1987. Typically an investor would approach one of the major debt traders and ask them to assemble a package of convertible debt. It was extremely rare to find all the required debt in the hands of sellers willing to sell for cash, as most debt was with the major banks that were not selling or swapping from their own portfolios.¹⁶¹ Accordingly, the trader would have to arrange a series of swaps.

For instance, the trader might find that some of the eligible Chilean debt which her client required was held by Party A. Party A might only have been willing to exchange its loans for Venezuelan debt. The trader would have then gone and located Venezuelan debt, perhaps with Party B who wanted Argentine debt in exchange. The trader knew she was able to acquire Argentine debt for cash from a U.S. regional bank wishing to reduce its exposure. She would arrange that and then implement the series of swaps. The final result is that about¹⁶² three times as much debt had been swapped or sold,¹⁶³ in three apparently unrelated transactions, to facilitate one debt-equity conversion.¹⁶⁴ To collate a large parcel of debt, a trader may have had to undertake such a series of swaps with many parties.¹⁶⁵ Each debt-equity conversion would generate many secondary market

The Philippines announced its scheme in mid-1986. *See generally* Asiedu-Akrofi, *supra* note 90, at 549-50 (providing consideration of these schemes).

161. *See* Schubert, in *DEBT/EQUITY CONVERSION*, *supra* note 93, at 12.

162. The amounts of debt exchanged depends on the relative prices.

163. This is aimed at by eliminating the double counting in the swap transactions.

164. Citicorp's Write-down - The crucible for a US\$350 bn loan swap market?, 674 *INT'L FIN. REV.*, May 23, 1987, at 1685 [hereinafter *Citicorp's Write Down*] (presenting examples of similar chain of swap and sale transactions to assemble package of convertible debt required for conversion). The example given by Salomon Brothers involved Romanian Swiss Franc and Romanian U.S. Dollar loans, Yugoslavian U.S. Dollar loans and Chilean U.S. Dollar loans together with banks from France, Sweden, and Bahrain. The example given in the text is far more prosaic and realistic based on the author's experience in the market at this time and on the volumes of various loans traded in the market. The Salomon Brothers example would have been an exceptionally rare transaction — still one must expect traders to want to make this business appear more complex and exotic than it really was. *Id.*

165. *See* Roberts & Remolona, *supra* note 47, at 17 (noting in this period that "the volume of cash sales would still likely be much less than a quarter of the gross total of swaps."); *see also* *Citicorp's Write-down*, *supra* note 164, at 1686 (noting that there was little "cash appetite" in the market at this time).

transactions as the entire package of eligible debt was assembled.¹⁶⁶ As Roberts & Remolona wrote in 1987:

before 1985, probably three of four swaps were debt-debt swaps that did not end in a debt conversion. But this pattern is changing dramatically; . . . debt-debt swaps are increasingly becoming just links in a chain of transactions leading to debt-equity . . . swaps.¹⁶⁷

C. *Market Characteristics*

The four principal characteristics of the preceding two-year period were identified as the hand-crafted nature of transactions, the structuring of trades as ratio swaps, an absence of structure and rules, and confidentiality. All except ratio swaps remained prominent features of the market in this period. Ratio swaps, as we have seen, were of declining importance for U.S. banks but were still utilized at times by European banks.¹⁶⁸ Increasingly, during these two years, the form of the market was dictated by the ultimate demand for the debt for use in debt-equity swaps. Each current principal characteristic will be considered separately.

1. Demand for Debt for Debt-Equity Conversions

As seen above, the demand for conversion of debt into equity was the principal impetus for market activity particularly in 1986 and early 1987. It resulted in long chains of swaps as traders positioned the required amounts of eligible debt with investors. Naturally, in a demand-driven market such as this one, the announcement of the implementation of a debt-equity scheme had a very buoyant effect on prices.

2. Hand-Crafted Transactions

As Ollard wrote in 1986, "arranging swaps is still a tricky, fiddly business, determining exactly how much loan to, say, a Venezuelan private sector company is worth in terms of Brazilian

166. As only certain debt was eligible for conversion into equity it was common at this time to see swaps of Chilean public debt for Chilean public debt — to the undiscerning eye it would appear that parties were swapping like for like. In fact, they were acquiring eligible debt in exchange for non-eligible debt (and typically paying a premium for the privilege).

167. See Roberts & Remolona, *supra* note 47, at 19.

168. See Buchheit, *supra* note 26.

public sector debt."¹⁶⁹ And, one might add, repeating the process many times over for many different countries' debt in assembling the package of debt required for a conversion.

There were three special types of swaps in this period: "Libra swaps", "Japanese swaps", and ratio swaps. Libra swaps were so-called because they were designed to accommodate the somewhat odd accounting rules of Libra Bank, a consortium bank based in London. If US\$100 of the debt of country A, trading at fifty percent face value, was exchanged for the debt of country B, trading at seventy percent, in a Libra swap, the parties would each exchange US\$100 face value of the debts and Libra bank would then pay or receive a "fee" of US\$20. This enabled Libra to not alter the value at which it held the balance of the relevant debt on its books. Such a device would not have worked in the United States: there the accountancy guidelines would treat a significant amount like fifteen percent not as a fee but as an indication that the value of at least one type of debt was impaired.¹⁷⁰

Japanese swaps were so-called because they were designed to accommodate Japan's accounting rules. Under such a swap, the face value of the assets acquired, including cash, had to equal the face value of assets sold. With the same values for the debt of A and B, such a swap would see US\$100 of country B debt swapped for US\$60 of country A debt plus US\$40 cash.¹⁷¹

Ratio swaps were so-called because the relative amounts of debt exchanged was determined by the ratio of their prices. They have already been considered.¹⁷² A variant on a ratio swap, when two different assets were being exchanged for one, was also possible. If country C's debt trades at sixty-five percent, then US\$100 of C would be exchanged for US\$60 of B and US\$40 of A plus a cash fee of US\$3. Provided the fee was a "reasonable" amount, commonly considered to be up to five percent, then the equality of face values worked in some jurisdictions to avoid writedowns.¹⁷³

169. See Ollard, *supra* note 15, at 67, 73.

170. See Pettis Interview II, *supra* note 106.

171. *Id.*

172. See *supra* note 60 and accompanying text.

173. See Pettis Interview II, *supra* note 106.

3. Absence of Structure and Rules

Apart from the impetus towards truth in accounting, provided by the AICPA opinion letter and the Comptroller of the Currency's banking circular in May 1985, there was little change in market practices during this period. There was a broader range of publicly identified traders but the practices of the traders remained a free-for-all.

Furthermore, the market remained extremely thin. In the words of the Deputy Comptroller of the Currency in January, 1987:

applying the term "secondary market" for LDC loans can be very misleading and confuse important related issues, such as asset valuation and accounting treatment. The term secondary market conjures images of depth, breadth, volume, rate and yield structures, homogenous instruments-borrowers-terms-rates-legal underpinnings, and primary market makers. Little of this infrastructure is found in the LDC debt market. . . . the secondary market is a bazaar and not an institutionalized arrangement that should be used as a proxy for valuing assets totaling over US\$400 billion.¹⁷⁴

In short, the scarcity of buyers still resulted in a market too thin and volatile to deserve the title.

4. Confidentiality

The preoccupation with not appearing to be "selling off a customer's paper"¹⁷⁵ still existed for many banks, especially in the earlier part of this period.¹⁷⁶ Few banks were prepared to signal they had lost confidence in the financial prospects of a country¹⁷⁷ and few major banks were keen for the market values of the debt in their portfolios to be widely known. Accordingly, transactions in which the counterparty sheltered its identity behind its broker were common, and most major banks eschewed publicity for the market. Towards the end of this period an arti-

174. See Bench, *Deputy Comptroller of the Currency*, in *DEBT/EQUITY CONVERSION*, *supra* note 93, at 60.

175. See Buchheit, *supra* note 96, at 17.

176. See Glynn, *supra* note 92, at 201. In September 1985, Glynn noted that most investment banks still would not "even hint at the number of debt swaps they've done or the dollar volume involved" — perhaps because they were doing less business than they were holding themselves out to be. *Id.*

177. See Buchheit, *supra* note 96, at 17.

cle in *The Wall Street Journal* noted that "the market's higher public profile is becoming a minor embarrassment."¹⁷⁸ It is instructive that the table of debt prices in this article listed Salomon Brothers and Merrill Lynch as its source, two brokerages without their own portfolios of loans to the region.¹⁷⁹

By late 1986, it was certainly true that "trading in debt assets has certainly come out of the early years' 'closet like' secretive atmosphere. Quotations for various types of debt are now practically public knowledge."¹⁸⁰ Tables of prices initially began to appear in the professional journals¹⁸¹ and, by 1986, in newspapers.¹⁸²

The most common estimate of market volume in 1986 was that US\$5 billion, face value, of debt was traded (eliminating the double counting potential of swaps).¹⁸³ This represented an increase of 100% from 1985 for which most estimates of market volume are in the US\$2.5 billion¹⁸⁴ to US\$3 billion¹⁸⁵ range. Nonetheless these volumes represented a tiny fraction of the total outstanding indebtedness of the Baker fifteen highly indebted countries.¹⁸⁶ Nonetheless, this market trading played a major role in providing the debt for debt-equity swaps and in the

178. See S. Karene Witcher & Richard B. Schmitt, *Growing Market in Third World Debt Raises Questions on the Loans' Value*, WALL ST. J., Oct. 7, 1986, at 21 col 1.

179. *Id.* A different table which gave prices every three months from February 1985 until July 1986 appeared in an article in the *Financial Times* in September 1986. It gave its source as the Ministry of Finance, Lima, Peru. See Montagnon, *supra* note 110, at 3.

180. See Schubert Address, *supra* note 144, at 6.

181. One such journal is the *International Financing Review*.

182. See, e.g., Montagnon, *supra* note 110; see also Witcher & Schmitt, *supra* note 178.

183. See Witcher & Schmitt, *supra* note 178; Newman, *supra* note 33, at 70; Schubert Address, *supra* note 144, at 5. Roberts & Remolona have estimated that US\$5 billion of debt was traded in 1986 after netting out debt-debt swaps ultimately linked to debt-equity conversion. See Roberts & Remolona, *supra* note 95, at 19. An article in *International Financing Review* estimated the secondary market trading volume in 1986 at US\$8 billion and Wallenstein estimated it at US\$7 billion — but these sources did not specify that the double counting effect of swaps had been eliminated, and if it was not, these estimates can be seen as a confirmation of the above US\$5 billion estimates. See *Citicorp's Write-down*, *supra* note 168, at 1684; Wallenstein, *supra* note 74, at 32.

184. See Witcher & Schmitt, *supra* note 178.

185. See Newman, *supra* note 33, at 70. Wallenstein's estimate for 1985 was US\$4 billion. See Wallenstein, *supra* note 74, at 32.

186. See *supra* note 112 (listing fifteen countries targeted by Baker Plan). These fifteen countries are the ones most commonly considered.

portfolio adjustment of regional U.S. and continental European banks.

The most heavily traded debt was that of Brazil (before February 1987), Chile, and Mexico.¹⁸⁷ Towards the end of this period when the Chilean and Mexican debt-equity schemes were in full swing, these countries' loans accounted for about two-thirds of the total volume of the market.¹⁸⁸ The other nations' debts in which there was regular trading in this period included Argentina, Ecuador, Ivory Coast, Morocco, Philippines, Poland, Romania, Venezuela, and Yugoslavia.¹⁸⁹

From mid-1985 onwards, indicative prices began to appear in professional journals¹⁹⁰ and, in 1986, in newspapers.¹⁹¹ However, these prices were historical and of questionable accuracy.¹⁹² Even those prices commonly quoted by brokers to customers were strictly indicative¹⁹³ — a firm quote from a broker was a rarity throughout most of this period.¹⁹⁴ By the end of this period, quoted prices were fairly accurate and tight for Chilean and Mexican debt.¹⁹⁵ At the other end of the spectrum, the quoted prices for Jamaican, Peruvian,¹⁹⁶ or Zairean debt were purely nominal.¹⁹⁷

The typical size of transactions for commonly traded debt was in the US\$2 million to US\$5 million range.¹⁹⁸ Spreads for brokers remained generous ranging from one to two percent for larger parcels of regularly traded debt up to five percent for smaller transactions in less frequently traded assets.¹⁹⁹ However,

187. See Roberts & Remolona, *supra* note 47, at 20.

188. See *Citicorp's Write-down*, *supra* note 164, at 1685.

189. *Id.*

190. See, e.g., *International Financing Review*.

191. See Witcher & Schmitt, *supra* note 178 (providing examples of tables of prices).

192. The level of confidentiality in the market was such that there was no way to accurately confirm these prices.

193. See *Citicorp's Write-down*, *supra* note 164, at 1685. It was said at the end of this period that "the price list is more an indication, a starting point for negotiations." *Id.*

194. See Roberts & Remolona, *supra* note 47, at 21.

195. See *Citicorp's Write-down*, *supra* note 164, at 1685.

196. For instance, Drexel Burnham Lambert bought some Peruvian debt in early 1987 at ten cents on the dollar when the market price was supposedly twenty to twenty-five percent. However, the seller was keen and clearly they were the only buyer to be found. See Finneran, remarks in *DEBT/EQUITY CONVERSION*, *supra* note 93, at 35.

197. See *Citicorp's Write-down*, *supra* note 164, at 1686.

198. See Roberts & Remolona, *supra* note 47, at 20.

199. See *id.*

the scarcity of buyers and the need to assemble complicated chains of swaps to be able to effect one transaction, meant that traders worked hard for their profits.

D. Participants

By early 1987, many of the major U.S. commercial and investment banks, and quite a few European ones, had formed asset swap departments to act as brokers.²⁰⁰ Some of the more active brokers at this time included Bankers Trust, Bear Sterns, Banco Rio de la Plata, Chase Manhattan, Citicorp, Eurinam/Singer & Friedlander,²⁰¹ Lazards, Libra, JP Morgan, Nederlandsche Middenstandsbank, and Shearson Lehman.²⁰² Other brokerages, which could well also belong in the above list, included Salomon Brothers and Merrill Lynch.²⁰³ Towards the end of this period boutique brokers, such as Eurinam and Giadefi, saw their market share begin to go into a decline from which it has never recovered.²⁰⁴ As the size of transactions increased, and traders increasingly began to take positions to facilitate the assembly of large packages of debt for debt-equity conversions, traders' capital became increasingly important.

The principal suppliers of debt throughout this period remained the smaller continental European and regional U.S. banks.²⁰⁵ In addition, one large Japanese bank, one major U.S. money center bank (for a brief period) and a number of Latin

200. See Schubert Address, *supra* note 144, at 6.

201. Schubert's Eurinam formed a joint venture with Singer & Friedlander of London in 1984, in the quest for greater global coverage and more capital.

202. See Ollard, *supra* note 15, at 74 (providing, except for J.P. Morgan, this list of active brokers). J.P. Morgan established its loan trading unit in 1985, and was quite active by early 1987. See Benegas-Lynch Interview, *supra* note 46.

203. See Witcher & Schmitt, *supra* note 178. There are simply no figures for the volumes of trades for individual brokerages at this time, or for many years to come. These estimates are based on the opinions of market participants. Merrill Lynch formed its unusually named 'International Exposure Management Group' in May 1986 and claimed to have traded US\$500 million of LDC debt in the balance of 1986 and US\$1.5 billion in 1987. See *Third World Debt — Watch Out Securitisation is on its Way*, 703 INT'L FIN. REV. 3876, Dec. 12, 1987.

204. See Roberts & Remolona, *supra* note 47, at 20.

205. See Huhne, *Some Lessons of the Debt Crisis: Never Again?*, in INTERNATIONAL ECONOMICS AND FINANCIAL MARKETS - THE AMEX BANK REVIEW PRIZE ESSAYS 85, 93 (1989); John Liscio, *How Banks Dump Their 'Toxic Waste'*, BARRON'S, Mar. 16, 1987; Roberts & Remolona, *supra* note 47, at 20; Schubert Address, *supra* note 144; Sebastian R. Sperber, *Debt-Equity Swapping: Reconsidering Accounting Guidelines*, 26 COLUM. J. TRANSN'T'L. L. 377, 395 (1988).

American banks all supplied debt at various times.²⁰⁶ At the end of this period, it was estimated that some 250 banks and fifty non-financial corporations were involved in the trading of this debt.²⁰⁷ The latter were a new group of participants in the market — investors in LDCs who chose to inject their capital via debt-equity swaps and thus had to come to the market for the debt.²⁰⁸ These included Bayer, Dow Chemical, IBM, Proctor & Gamble,²⁰⁹ Chrysler, Ford, Nissan, Volkswagen,²¹⁰ and Bankers Trust investing for its own account.²¹¹ The effects of the secondary market were being more widely felt.

E. *Impact of the Market*

The principal impact of the market in this period was the harsh light of reality it shone on bank behavior throughout the rescheduling years. In the words of Martin Schubert,

From an historical perspective, the secondary market in LDC debt has probably brought more realism than any other single development to the quicksand-like dilemma which the LDCs and lending banks [have] found themselves in.²¹²

The regulators and bankers involved in the rescheduling negotiations tended to resent the market as it reduced their bargaining power with the debtor nations²¹³ — an independent market which valued the loans at a deep discount was a strong argument for debt forgiveness.²¹⁴ Many major banks were also anxious that the growth of the market over time would provide a realistic basis for the valuation of these assets and lead to a revision of the accounting policy that permitted these assets to not

206. See Roberts & Remolona, *supra* note 47, at 20; see also *How Debt Crisis "Trading" is Becoming More Sophisticated*, 603 INT'L FIN. REV., Jan 4, 1986 at 16.

207. See *Citicorp's Write-down*, *supra* note 164, at 1684.

208. See *id.*

209. See Schubert Address, *supra* note 144, at 9.

210. See Asiedu-Akrofi, *supra* note 91, at 556.

211. See William G. Foulke, remarks in DEBT/EQUITY CONVERSION, *supra* note 93, at 35, 38.

212. Martin W. Schubert, *The Secondary Market for LDC Debt — The Expected Impact of a Brady Type Initiative 5*, Address delivered at the Latin American Financial Strategies Conference, New York City (June 20-21, 1989) (on file with the *Fordham International Law Journal*).

213. The market also reduced their bargaining power with recalcitrant smaller banks who did not wish to advance new money in the reschedulings because the market gave these smaller banks an alternative to lending new money — sell their loans.

214. See *The Making of a Market*, INSTITUTIONAL INVESTOR, Apr. 1994, at 66.

be carried at market value.²¹⁵

One aspect of the realism brought to the debt imbroglio by the secondary market was to the pricing of the shares of the creditor banks. Musumeci and Sinkey conducted a detailed study comparing the effect in the stock market on bank share prices of Mexico's announcement in August 1982 and Brazil's announcement in February 1987 of the suspension of debt servicing.²¹⁶ Their conclusion was that the stock market reacted more efficiently, accurately, and rationally to the Brazilian announcement in 1987 than to the Mexican announcement which heralded the advent of the crisis and that the secondary market in LDC debt had a major role to play in that more informed and rational reaction. In their words,

On balance, we think that LDC disclosure requirements and the development of the secondary markets for LDC debt have contributed to the efficiency of pricing [bank holding company] equities.²¹⁷

A further aspect of the realism brought by the market can be seen clearly in hindsight. In early January 1986 Chilean debt was trading at sixty-five to sixty-nine percent of face value and Argentine debt at sixty-two to sixty-six percent. An article in the *International Financing Review* at the time pointed out that the market was highly inefficient which "means that banks and investors who can estimate the risk . . . can find significant potential for profit."²¹⁸ The article went on to point out that the debt of Chile with low prices for its major export, copper, and a higher debt service ratio should have been priced much lower than Argentina's. In the author's words "Rather than reflect relative risk — which is clearly lower for Argentina — the price differential stems from"²¹⁹ the debt buy-back schemes which Chile had in place. The article emphasized that these schemes could be discontinued at any time and that Chilean debt was overvalued. With the benefit of hindsight, we know that Chilean debt held its

215. See Buchheit, *supra* note 103, at 401, 411.

216. See Musumeci & Sinkey, *The International Debt Crisis, Investor Contagion, and Bank Security Returns in 1987: The Brazilian Experience*, 22 J. MONEY, CREDIT & BANKING 209 (1990).

217. See *id.* at 219.

218. See *How Debt Crisis "Trading" is Becoming More Sophisticated*, 603 INT'L FIN. REV. 16, Jan 4, 1986.

219. See *id.*

value in this range for the rest of the decade²²⁰ while Argentine debt, by decade's end, was trading at less than twelve percent of face value.²²¹ Indeed, Chile's economy was so strong that it never required the debt relief of a Brady-style restructuring. The market was inaccurate and inefficient, but less so than the expert commentators.

A further measure of the impact of the market in these early years is to be found from a study done by Keefe, Bruyette & Woods, Inc in 1986. It revealed that from the first quarter of 1983 to the first quarter of 1986, the nine largest U.S. banks increased their exposure to the five largest Latin American debtor nations by 7.8% to US\$46.7 billion; the next fifteen largest U.S. banks reduced their exposure by 10.2% to US\$13 billion and the next 170 largest U.S. banks reduced their exposure some 8.5% to US\$12.6 billion.²²² All banks participated pretty well ratably in the reschedulings and the extensions of new money in this period. Accordingly, the principal reason that the mid-sized and smaller U.S. banks were able to reduce their exposure to the region, beyond the natural increase from new money loans, was their preparedness to sell debt through the market.²²³ The nine major banks were not able to participate in the secondary market for the accounting reasons considered, so their exposure increased. As Jay Newman wrote in late 1986, "the tools offered by this market have provided the basis for a quiet revolution in banking."²²⁴ However, a more noisy revolution was just around the corner — and one of its seeds was the ever-greater publicity given to the secondary market prices of these debts.

220. On January 11, 1990, Chilean debt was trading at between 61.5 and 63.5 cents on the dollar. See *Price indications for value impaired debt*, 809 INT'L FIN. REV. 26, Jan 13, 1989.

221. See *Argentina and Brazil Push LDC Debt Index Down* 781 INT'L FIN. REV. 27, June 24, 1989; See also *Secondary market report*, 807 INT'L FIN. REV. 29, Dec 23, 1989.

222. See Witcher & Schmitt, *supra* note 178.

223. Another way to view this is that the debt used in the conversions into equity came principally from the European banks and those U.S. banks with medium to small exposures to Latin America — it virtually never came from any of the leader banks which had done the most to facilitate the lending boom of the 1970s.

224. See Newman, *supra* note 33, at 70.

III. THE HAPPY YEARS OF CHILDHOOD: May 1987 to March 1989

A. Major Events in this Period

This period begins with major U.S. banks taking their first substantial loan loss provisions on their LDC debt portfolios. This step was to have a dramatic long-term effect on the supply of loans to the secondary market.

1. May 1987: Banks Increase Loan Loss Reserves

On May 20, 1987 the Chairman of Citicorp, John Reed, announced that his bank would add US\$3 billion to its loan loss reserves,²²⁵ to reflect its exposure to LDC debtors²²⁶ and increase its total reserves to US\$5 billion.²²⁷ This move resulted in a US\$2.5 billion loss for the quarter,²²⁸ an expected US\$1 billion loss for the year,²²⁹ and left the nation's largest bank with reserves of about twenty-six percent of its LDC loans.²³⁰ Reed announced that the increase in reserves "relates to our decision to restructure our current exposure through debt/equity swaps, sales and other measures."²³¹

This addition to loan loss reserves was the first concession to reality in the accounting treatment of the LDC loans in the portfolio of a major U.S. bank.²³² If secondary market prices are

225. An interesting question is whether Citicorp's debt traders had any advance notice of this move and had gone short as a result.

226. See *Citicorp Debt Writeoffs - John Reed's US\$2.5 Billion Gamble Meets Grudging Admiration*, 674 INT'L FIN. REV. 1683, May 23, 1987 [hereinafter *Citicorp Debt Writeoffs*]; Truell & Guenther, *Move, Initiated by Citicorp, Could Lead to Rate Rise for Consumers, Business*, WALL ST. J., May 21, 1987.

227. See *Citicorp Debt Writeoffs*, *supra* note 226.

228. See *id.*

229. See *id.*

230. See Jaclyn Fierman, *John Reed's Bold Stroke*, FORTUNE, June 22, 1987, at 30.

231. See Phillip T. Sudo & Andrew Albert, *Citicorp: Facing Up To Latin Debt*, AM. BANKER, May 21, 1987, at 1. In an interview two days later, Reed restated his plans in these terms: "What I would like to do, over the next two or three years, is use some piece of my total reserve for the accounting associated with debt-equity swaps, loan sales, and so forth. I would guess that we might be able to change around various billions of dollars of our exposure, somewhere between one billion and five billion." Fierman, *supra* note 230, at 29. Citicorp was widely reported as intending to unload US\$5 billion of debt over the next three years. *Id.* at 30; *Citicorp's Write-down*, *supra* note 164, at 1684. See also Peter Truell, *Citicorp Plans to Shed Big Part of Loans to Third World Through Swaps, Sales*, WALL ST. J., May 22, 1987.

232. J.P. Morgan, however, may well have been quietly accumulating even larger reserves for quite some time before this. See Pettis Interview I, *supra* note 22.

taken as the value of the loans, this addition to reserves fell far short of marking Citicorp's loans to market. At the time of the announcement, Argentine debt was trading at fifty-eight to sixty percent, Brazil at sixty-one to sixty-three percent and Mexico at fifty to 59.5 percent.²³³ The only significant borrowers whose debt was trading at discounts of twenty-six percent or less were Colombia, whose debt traded at eighty-four to eighty-six percent and Venezuela, at seventy-two to seventy-four percent.²³⁴ Nonetheless, in the words of the headline from *Fortune*, this was indeed "John Reed's Bold Stroke."²³⁵

2. The Effect of the Secondary Market on the May Reserves

Citicorp's decision to restructure its debt through swaps into equity and sales was only one of the reasons for this decision. There were at least five other contributing factors including (i) Citicorp's dissatisfaction with the small interest margins and large new money loan forced upon them by the Federal Reserve²³⁶ in Mexico's recent restructuring package;²³⁷ (ii) Brazil's recent suspension of interest payments and lack of a coherent economic plan;²³⁸ (iii) sluggish economic growth in the U.S. and abroad;²³⁹ (iv) the low values ascribed to bank stocks by the stock market;²⁴⁰ and (v) the differences in debt policies of U.S. regional and money center banks. The secondary market had a substantial influence on factors (iv) and (v), which will be considered in more depth.

a. Stock Market Valuation of Bank Stocks

Bank stocks were valued lowly by the stock market — the price-earnings multiples of major banks were forty percent of the average multiples for Standard & Poor's 500 stock index.²⁴¹ The major reason for this was the LDC exposures of the banks. The prices in the secondary market highlighted a value for the loans

233. See *LDC debt prices*, 674 INT'L FIN. REV., May 23, 1987, 1686.

234. *Id.*

235. See Fierman, *supra* note 230, at 26.

236. See ECLAC/CTC, *supra* note 118.

237. See Truell, *supra* note 231.

238. *See id.*

239. *See id.*

240. See Fierman, *supra* note 230, at 28.

241. *See id.*

and a magnitude for the undisclosed losses. The stock markets "couldn't ignore the hard evidence provided by the secondary market, where most Third World debt dumped by European and small U.S. banks trades at around 65% of face value."²⁴²

Citicorp read the market correctly on this point. The market welcomed this unusual step towards truth in accounting and Citicorp's share price jumped US\$2.50 to US\$53.125 on the day of the announcement²⁴³ and increased a further US\$2.25 in the following week.²⁴⁴

b. Contrast with Regional Banks' Debt Policies

Many U.S. regional banks had reserves to the extent of the secondary market discounts and had sold some or all of their loans in the secondary market. The accounting stance of the money center banks had denied them this opportunity, an opportunity in which Citibank now saw real merit.²⁴⁵ These additions to loan loss reserves were necessary if the major banks were to have the capacity to follow their smaller cousins' lead and either sell or convert into equity some of their loans. Speaking like a true trader, de Filippis said of this decision by Citibank:

It's good for one single reason. Up to now, whatever made sense didn't get done because of regulatory or accounting guidelines. To the extent banks can do whatever they want without consulting Arthur Andersen all the time, that should create more activity in the market.²⁴⁶

c. A Sixth Motive for Citicorp's Decision?

There may have been a sixth motive for Citicorp's decision to increase its loan loss reserves, as this decision increased the pressure upon some of Citicorp's major competitors. These additions to loan loss reserves came from shareholders equity. Accordingly, they affected profits and shareholders equity, but not

242. *See id.*

243. *See* Truell & Guenther, *supra* note 226.

244. *See* Fierman, *supra* note 230, at 27. In the words of a loan broker at the time, "Citicorp . . . takes a US\$3 billion hit and its value goes up. What kind of message does that send to financial America? It says to the other money centers, you guys are missing the boat." Sudo & Albert, *supra* note 231, at 1.

245. *See* Truell, *supra* note 231.

246. *See* Sudo & Albert, *supra* 231, at 2.

cash flow.²⁴⁷ For a profitable bank with a healthy capital base like Citicorp, reduced shareholders equity was not a problem and could be rebuilt from retained earnings in the coming years.²⁴⁸ However, for less profitable banks with slimmer capital bases, like Manufacturers Hanover and BankAmerica, the cost of copying this move would be high; equity capital could become so eroded that the market may lose confidence in the bank.²⁴⁹ Accordingly, this move by Citicorp was seen as particularly aggressive by some of its less well capitalized competitors.²⁵⁰

BankAmerica followed suit and announced that it was increasing its loan loss reserve by US\$1.1 billion to US\$3.3 billion in total.²⁵¹ The response of the stock market was decidedly different from that which greeted Citicorp's announcement — BankAmerica's stock price fell twenty-five cents to US\$11.25. While the move gave it one of the strongest loan loss reserve ratios in the United States, shareholders equity was severely depleted and the stock market responded to this weakness. Most other U.S. money center banks also followed Citicorp's lead.²⁵² A total of US\$15 billion was soon added to loan loss reserves by fifty of the nation's largest banks.²⁵³ The consequences of Citicorp's action were not limited to the United States. The major U.K. banks made large loan loss provisions shortly thereafter,²⁵⁴

247. See Fierman, *supra* note 230, at 27.

248. See *id.*

249. Indeed, there was some doubt as to whether special purpose reserves, which these in effect were, should count along with general reserves as primary capital. Accordingly, there was the further risk that if such reserves were held not to be primary capital, these moves would have severely eroded the capital of less profitable banks which followed Citicorp's lead. See *Operations of National Banks* 7 O. C. C. Q. J. 5, 6 (1988).

250. See John Liscio, *Truth in Lending — Or What Has Citicorp Wrought*, BARRONS, May 25, 1987; Peter Truell, *Borrowing Trouble: Banks' Reserve Action May Make Debt Crisis Even More Vexatious*, WALL ST. J., July 2, 1987.

251. See William Hall, *Bank America Confronts a Capital Issue*, FIN. TIMES, June 10, 1987, at 30.

252. Chase Manhattan increased its reserves in the week following Citicorp's announcement by US\$1.6 billion. See Fierman, *supra* note 230, at 26; *Commercial Banks Move Centre Stage*, 675 INT'L FIN. REV., May 30, 1987, at 1779; Truell, *supra* note 250; *American Express Bank Ltd to Add US\$600 Million to Loan Loss Reserve*, BUS. WIRE, June 18, 1987 (listing major lenders and their additions to reserves in 1987).

253. Mary Tobin, *Third World Debt Picture Unchanged; Bank's Loan Loss Provisions*, UNITED PRESS INT'L, Aug. 2, 1987.

254. See S. Griffith-Jones, *A History of Debt Crisis Management in THIRD WORLD DEBT*, *supra* note 50, at 11.

typically in the twenty-five to thirty percent range.²⁵⁵

Reserves are distinct from write-offs. A reserve provides a cushion against which to set off future losses from the sales or swaps of loans at less than book value. An adequate reserve makes loan sales more likely as the reduction in profits has already been taken. This wave of additions to reserves was caused in part by pressures arising from the prices in the secondary market. In their turn, these same additions to reserves were to affect the secondary market profoundly.

3. The Effect of the May Reserves on the Market

In addition to triggering a wave of provisions among other banks, these provisions by Citicorp had three major effects. First, the move strengthened Citicorp's position in negotiations with debtor nations as it had already taken some of the potential losses from an interest moratorium onto its balance sheet.²⁵⁶ Second, the move spelled the end for the Baker Plan²⁵⁷ as it made further new loans to the region much more difficult to justify.²⁵⁸ Third, and most importantly from the perspective of this study, the added supply of loans sent market prices into a downward spiral which in turn sent market volumes into an upward spiral. This effect is now considered.

At the time, commentators said, "Citicorp's strategy will lead to a big increase in the size and importance of the secondary loan market in particular."²⁵⁹ This was predictable as this was the first time a money center bank had announced its intention to sell its own loans through the secondary market.²⁶⁰ The general effect on prices of a potentially dramatic increase in supply of the loans was also predictable although the extent of the effect took some by surprise.

By mid-July of 1987, before Citicorp had sold any of its own loans, most debt prices had decreased by about five cents on the

255. *Id.* at 13.

256. See Fierman, *supra* note 230, at 26-27; Truell, *supra* note 250; *Citicorp Debt Writeoffs*, *supra* note 226, at 1684.

257. See Liscio, *supra* note 250.

258. See Fierman, *supra* note 230, at 27. Bank directors now had to approve new loans to borrowers against whom substantial provisions had been made. See *Citicorp Debt Writeoffs*, *supra* note 226, at 1683.

259. See Truell, *supra* note 231.

260. See *Citicorp's Write-down*, *supra* note 164, at 1685.

dollar.²⁶¹ The prospect of major banks selling their debt prompted other lenders to offload their paper before the rush.²⁶²

By August, prices had fallen even further. Argentina was down to forty-five to forty-six cents from fifty-eight to sixty, Brazil was down to forty-six to forty eight from sixty-two to sixty-five (although its suspension of interest payments contributed greatly to this fall) and Mexico was trading at forty-nine to fifty cents from around fifty-eight cents at the time of Citicorp's announcement.²⁶³ Chile's price, because of its debt-equity scheme and general economic health was holding up pretty well,²⁶⁴ but Ecuador, for instance, was down around fifteen cents on the dollar.²⁶⁵

Furthermore, as early as August, the proportion of cash sales in the secondary market was on the rise, as opposed to the loan swaps which had dominated the pre-May market.²⁶⁶

Citicorp's addition of US\$3 billion to its reserves represented about twenty percent of its US\$14.9 billion exposure to LDCs.²⁶⁷ Six months after the move by Citicorp, secondary market prices for the nine most heavily traded nations' debts²⁶⁸ had fallen on average 22.1%.²⁶⁹ The fall in secondary market prices had already eclipsed the provisions made by Citicorp in May. From a prudential perspective, the provisions had been entirely self-defeating — the increased supply of debt consequent upon these provisions had led to falls in prices which had eroded away

261. See Sanford Rose, *Random Thoughts*, AM. BANKER, July 14, 1987, at 1.

262. See *id.*

263. See Tobin, *supra* note 253.

264. See *id.* Chilean debt was trading at 60-63 cents down from 67-70 cents at the time of the announcement. *Id.*

265. See *id.*

266. See *id.* Martin Schubert was quoted as saying "[b]efore Reed, most secondary market transactions were swaps for the purpose of arranging portfolios and not cash sales . . . since then, sales are for cash." *Id.*

267. See Fierman, *supra* note 230, at 27.

268. See George M. Salem & Steven A. Gaviols, *Accounting for Debt/Equity Swaps: Summary and Conclusions from our Investor Seminar, Prudential Bache Securities*, BANKING INDUSTRY UPDATE, Dec. 16, 1987, at 5. The nine most heavily traded nations are Argentina, Brazil, Chile, Ecuador, Mexico, Peru, Philippines, Venezuela, and Yugoslavia. *Id.* Tbl. 1.

269. See *id.* (prices at November 19, 1987). The two largest proportional falls were Peru at 67.7% and Argentina at 37.3% and the two smallest Mexico at 10.6% and Chile at 17.4%. *Id.*

the provisions.²⁷⁰ As Schubert said, "after taking reserves, everyone wants to sell for cash, fearing further price drops . . . since sellers outnumber buyers, prices are dropping and the market has become illiquid."²⁷¹ In a subsequent econometric study,²⁷² Mark Stone confirmed statistically that increases in bank reserves tend to depress secondary market prices²⁷³ and identified two further reasons for these declines in prices: (i) investor perceptions that the debtors' bargaining positions had been weakened, and (ii) the consequences of the expected decrease in new money loans.²⁷⁴

The sinking secondary market prices led to a second round of provisioning in late 1987 and early 1988, this time by the U.S. regional banks. In the main, the regionals had not followed Citicorp's lead in May because their provisions were generally well in excess of the twenty-five percent benchmark set by Citicorp's US\$3 billion reserve. The leader in this second round was the Bank of Boston, which in late 1987 increased its reserves by US\$200 million, one-fifth of its total LDC loans.²⁷⁵ Many U.S. regional banks followed.²⁷⁶

At this time, some of the larger banks with relatively manageable LDC exposures followed the regionals into a second round of provisioning. Hence, First Interstate Bancorp added US\$180 million to loan loss reserves to bring its total reserves for LDC loans to fifty-three percent of its portfolio; Continental Illi-

270. See Bernard J. Wolfson, *Debt Swap Mart Prices Slide on Weak Demand*, J. COM., Aug. 26, 1987, at 7A; Rose, *supra* note 261, at 1; Robert D. Sloan, *The Third World Debt Crisis: Where We Have Been and Where We Are Going*, WASH. Q., 103, 110 (1988).

271. See Tobin, *supra* note 253, at 2 (quoting Martin Schubert).

272. See Mark Stone, *Are Sovereign Debt Secondary Market Returns Sensitive to Macroeconomic Fundamentals? Evidence From the Contemporary and Interwar Markets*, 10 J. INT'L MONEY & FIN. 100 (1991).

273. *Id.* at 113, 118.

274. *Id.* at 113.

275. See Kate Ballen, et al., *A Boston Banker's Bold Stroke*, FORTUNE, Jan. 18, 1988, at 8; Stephen Fidler, *Busy Year for LDC Debt Trading*, FIN. TIMES, Jan. 11, 1989, at 33; Peter Truell & Alan Murray, *Debt Breakthrough: Loan Plan May Help Mexico, Some Banks; But It's No Panacea*, WALL. ST. J., Dec. 30, 1987, at 1.

276. Mellon Bank, Banc One, and Riggs National Bank followed almost immediately. See Ballen *supra*, note 275, at 8. In addition, in January 1988, American Express Bank, increased its reserves to a very healthy sixty percent of loans to rescheduling countries. The reasons given for the extra reserves were the decreasing prices in the secondary market and the acceleration of the bank's policy of getting out of international lending. See *American Express Bank Ltd Adds US\$350 Million to LDC Loan Reserves*, BUS. WIRE, Jan. 12, 1988.

nois added US\$200 million to its reserves to bring them to fifty percent of its portfolio and Security Pacific added US\$350 million dollars to its reserves to bring them to fifty-four percent of its exposure.²⁷⁷

4. Aztec Bonds - 1988

The next significant event was the announcement in the final days of 1987 of a plan for the securitization of up to US\$20 billion of Mexico's loans by converting them into bonds, known as Aztec or Morgan-Mexico bonds, upon which the payment of principal was secured.²⁷⁸ This had little impact on the secondary market as the loans eligible for conversion were those held by banks as original creditors not those acquired in the market. Nonetheless, this proposal is significant as the precursor to the Brady bonds of subsequent years which would transform the market.²⁷⁹

The proposal was structured by Morgan Guaranty²⁸⁰ as an attempt to recover a portion of the secondary market discount for Mexico's benefit.²⁸¹ Under the proposal Mexico invited the banks to a sealed bid auction at which banks could bid to exchange their current Mexican loans for the new secured bonds.²⁸² The bonds had a term of twenty years and paid inter-

277. See *First Interstate Adds LDC Loan Loss Reserve*, REUTERS, JAN. 13, 1988; *Latin American Nations Petition Banks For New Round of Restructurings*, 707 INT'L FIN. REV., JAN 16, 1987, at 172.

278. See Truell & Murray, *supra* note 275, at 1; *First Step to Debt Realism*, FIN. TIMES, Dec. 31, 1987, at 10 (providing excellent contemporaneous accounts of this proposal). See Michael Chamberlin et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415, 450-57 (1988) (providing excellent retrospective view).

279. There are many similarities between Aztec bonds and Brady bonds. Brady bonds incorporated many of the lessons learned from the Aztec scheme. For the interest the Aztec scheme generated among other debtors, see Paraso, *RP Could Try Mexican Tack in Solving Own Debt Problem*, PHILIPPINE BUS. WEEKLY, Jan. 6, 1988.

280. In the media it was reported that Mexico had requested Morgan to put together such a scheme, which technically, no doubt, at some stage it did. See Robert A. Bennett, *Morgan Bank Outlines Its Mexican Debt Plan*, N.Y. TIMES, Dec. 31, 1987, at D3 col 1. However, Morgan, in its own internal correspondence, notes that "the transaction resulted from a proposal first put forward by JP Morgan and Co to the Mexican government in July 1987." Inter-Department Memorandum from Morgan Guaranty Ltd. to Hong Kong Corporate Office, re Mexican Debt Exchange, Jan. 5, 1988 (on file with the *Fordham International Law Journal*).

281. See Robert Plehn, *Securitization of Third World Debt*, 23 INT'L LAW. 161, 170 (1989).

282. See John P. Forde & Jed Horowitz, *Bankers Give Mixed Reviews to Mexico's Plan to Exchange Loans for Collateralized Bonds*, AM. BANKER, Dec. 30, 1987, at 1.

est at 1 5/8th % over Libor,²⁸³ as opposed to the 7/8th % margin generally payable on Mexican bank loans. Principal would be repaid upon maturity and its repayment secured by the purchase by Mexico of zero-coupon bonds²⁸⁴ specially issued by the U.S. Treasury.²⁸⁵ Mexico was prepared to issue up to US\$10 billion of these Aztec bonds. The amount of loans that would be converted into such bonds would depend upon the magnitude of the discounts bid by the banks. Mexico would select bids on the basis of price — the higher a discount a bank was willing to accept the more likely the securitization of its tendered loans. Mexico hoped to receive bids in the range of the current secondary market price of fifty to fifty-four percent,²⁸⁶ and thus securitize up to US\$20 billion of loans.

Why would a bank accept a bond for fifty cents on the dollar when it could have the same amount of cash from the secondary market?²⁸⁷ The principal guarantee could hardly have been the reason when the twenty years of interest payments were Mexican risk. Perhaps Mexico and Morgan anticipated that these bonds would be as attractive as cash as they were “exit bonds”, (i.e. there were to be no subsequent new money calls based upon the loans converted into these bonds or the bonds themselves),²⁸⁸ an advantage a sale for cash could not offer. Nonetheless, the promise not to make new money calls based on these bonds

283. Libor stands for the London Interbank Offered Rate.

284. See Plehn, *supra* note 281, at 164. Zero-coupon bonds, as their name suggests, do not pay interest. Accordingly, they are issued at deep discounts. Mexico could have purchased the US\$10 billion of 20 year zero coupon bonds for about US\$2 billion. *Id.*

285. See *id.* at 163-64. The zero coupon bonds were to be held in escrow for this purpose at the New York Federal Reserve. See Truell & Murray, *supra* note 275.

286. See Plehn, *supra* note 281, at 164, 171.

287. One reason is that any bank with a large portfolio of Mexican loans would have depressed the price in this thin market by trying to sell all of the loans at once and certainly if a number of large banks were to try to liquidate their portfolios, prices in the market would have plummeted.

288. There was no legal obligation upon banks to meet new money calls from LDC debtors. However, recalcitrant banks would typically be the subject of intense pressure from other banks and bank regulators to participate in the new money loan. In a letter which accompanied the formal invitation to submit bids sent to all Mexico's bank creditors, Mexico's Minister of Finance and Public Credit, stated that, “neither the Bonds nor any indebtedness tendered and accepted in exchange therefor will be included in the base amount for determining any future requests that Mexico may make to its commercial bank creditors generally.” Plehn, *supra* note 281, at 165. For more on “exit bonds” in this context, see Clark, *Deals Available to a Bank With LDC Debt*, in *THIRD WORLD DEBT* *supra* note 50, at 111-12.

could be broken by a future Mexican government in sufficiently dire economic straits.²⁸⁹

Perhaps unsurprisingly, this securitization proposal was not as warmly received as Mexico and Morgan Guaranty might have wished.²⁹⁰ The plan attracted 320 bids from 139 banks covering US\$6.7 billion of loans. Mexico accepted bids from 95 of those banks covering US\$3.67 billion of loans.²⁹¹ The average price Mexico paid for this debt was 69.77%,²⁹² which meant that US\$2.56 billion of new, secured bonds had to be issued to replace it.²⁹³

Even though the interest rate on the new bonds was higher than on the loans they replaced, the reduced principal means that Mexico would have saved about US\$500 million in net interest payments over the life of the bonds.²⁹⁴ Its total debt was reduced by US\$1.1 billion.²⁹⁵

There were a number of reasons for the relatively disappointing result of this auction. First, an accounting risk associated with tendering for these bonds probably dissuaded more potential tenderers than any other factor. Pursuant to Staff Accounting Bulletin 75²⁹⁶ ("SAB 75"), the mere act of tendering loans at a nominated discount required that they be valued at their fair market value, *even if the tendered loans were not accepted by*

289. See Plehn, *supra* note 281, at 165-66, 169.

290. See Mexico — *The auction postmortem continues*, 715 INT'L FIN. REV., Mar. 12, 1987, at 798. Indeed, many of the bids were made by banks as a "favor" to preserve their bona fides with the Mexican government. See Pettis Interview, *supra* note 22.

291. See Peter Truell, *Mexico's Plan to Reduce Debt Is Short of Goal*, WALL. ST. J., Mar. 4, 1988.

292. See *id.* Mexico accepted tenders up to a price of 74.99%. *Id.*

293. See *id.*; Plehn, *supra* note 281, at 164. See generally Chamberlin, et al., *supra* note 278, at 454 (on results of this offer).

294. See Truell, *supra* note 291 (citing Morgan Guaranty spokesman). Mexico stood to save US\$1.54 billion in gross interest payments over the 20 year life of the bonds. *Id.*; see also Mexico — *The Auction Postmortem Continues*, 715 INT'L FIN. REV., Mar. 12, 1987, 798. However, this statistic fails to tell the full story. The interest foregone on the reserves used to purchase the zero coupon bonds must be factored into the equation, which leads to net savings on interest of US\$500 million. See Rimmer de Vries, Chief Economist, Morgan Guaranty Trust Company, *Economic and Trade Adjustment in the United States and Other Industrial Countries and The LDC Debt Issue: Problems and Prospects*, Statement to The Asahi-Zeit Symposium, Tokyo, Japan, March 29-30, 1988 at 21 (on file with the *Fordham International Law Journal*).

295. See *id.*; Mexico — *The Auction Postmortem Continues*, *supra* note 294, at 798.

296. See Staff Accounting Bulletin No 75, SEC, 17 CFR Part 211, Jan. 4, 1988, reproduced in Hay & Paul, REGULATION AND TAXATION OF COMMERCIAL BANKS DURING THE INTERNATIONAL DEBT CRISIS 131 (1991).

*Mexico for conversion into bonds.*²⁹⁷ Furthermore, there was a risk that the revised valuation would have to be applied to the balance of loans to Mexico in the creditor's portfolio.²⁹⁸ This inflexibility of U.S. regulators attracted strong criticism from Mexico.²⁹⁹ Second, the bonds were in registered, rather than the traditionally more attractive bearer, form.³⁰⁰ Third, the principal guarantee was of small comfort on a twenty year bond which would trade on the likelihood of timely interest repayments being made by Mexico.³⁰¹ Fourth, for that reason most banks expected that these bonds would trade at less than their full face value,³⁰² and in hindsight they were right.³⁰³ Accordingly, the banks had to bid above the current secondary market price to allow for the subsequent discount of these bonds on the secondary market.

While at the time the Aztec bond scheme was disappointing, in hindsight, it was significant for two reasons. First, lessons from the Aztec experience were applied to the subsequent Brady

297. See Ricki Rhodaimer Tigert, *Recent Regulatory Perspectives on Debt-for-Equity Swaps and Securitization of Third World Debt*, 1988 U. ILL. L. REV. 481, 487-89 (1988); Ricks & Truell, *SEC Tells Banks How to Handle Mexico Debt Swap*, WALL. ST. J., Jan. 5, 1988; Peter Truell & Jeff Bailey, *Some Big Banks Plan to Shun Mexican Plan*, WALL. ST. J., Jan. 8, 1988. The authors stated "[t]he SEC said the very act of offering the debt for exchange means the banks should either write off the difference between the carrying value of loan amounts tendered and the auction amount bid, or increase reserves allocated to the debt to reflect the difference." *Id.*

298. See Plehn, *supra* note 281, at 167; Chamberlin et al., *supra* note 278, at 455-56.

299. See *Mexico — A second bond auction already considered*, 714 INT'L FIN. REV., Mar. 5, 1988, 709. The basis of this ruling was that the best evidence of market value was the discount the bank's management was prepared to accept in the auction process. *Id.*; see also HAY & PAUL, *supra* note 296, at 113-14 (reproducing excellent consideration of FAS 75 in Office of Superintendent of Financial Institutions, Canada).

300. See Chamberlin et al., *supra* note 278, at 455. This was partly because the principal of the new bonds was secured by a pledge of U.S. Treasury securities. *Id.* The consequential ready indentifiability of registered bondholders may also have left some banks nervous as to future new money calls. See Plehn, *supra* note 281, at 169-70, 184-85.

301. This weakness was identified immediately. In the words of an investment banker quoted on the day following the announcement, "[p]rincipal isn't as important as interest when you're talking about 20 years. If the interest rate risk is going to be the same, what's the point?" Forde & Horowitz, *supra* note 282, at 1; see also Plehn, *supra* note 281, at 167-68.

302. See Plehn, *supra* note 281, at 168-69, 184; Chamberlin et al., *supra* note 278, at 455; Schubert, *supra* note 152, at 17.

303. See Lori Ioannou, *Banking on a Better Future*, EUROMONEY, Sept. 1989, at 251, 252. History bore out this expectation of the banks. In mid-August, 1989, Aztec bonds were trading at between seventy-two and seventy-four percent of their face value. *Id.*

bond proposals. In particular, the Aztec bonds highlighted the need for at least a partial guarantee of interest payments³⁰⁴ and for greater flexibility on the part of U.S. bank regulators and accounting bodies. The risk that bidding a certain discount for the conversion of one's loans would be interpreted by one's auditors as an admission as to the loan's true value, thus necessitating writedowns, was removed by changes to accounting regulations to pave the way for Brady bonds.³⁰⁵ Second, because the U.S. Treasury assisted the Aztec scheme by making a special purpose issue of zero-coupon bonds,³⁰⁶ this was the first public admission by the U.S. government that LDC debtors were entitled to some degree of debt forgiveness.³⁰⁷ This departure from the former "repayment in full" philosophy was a pivotal step in the journey towards the Brady Plan.

B. *Impetus for the Market*

The principal factor driving the market throughout this period was the demand for the debt for use in debt conversion schemes and debt buy-backs.³⁰⁸ A subsidiary source of demand were the round tripping transactions, commonly known as *bicicletas*, under the Mexican and Chilean debt-equity programmes. The supply of debt was principally from regional U.S., Continental European, and Canadian banks; many of which pursued aggressive programs aimed at liquidating their holding of LDC debt.³⁰⁹ Some of the factors considered previously (particularly

304. In hindsight, the Aztec scheme was a vital dry-run for Mexico's first massive Brady bond scheme.

305. See *The American Institute of Certified Public Accountants Practice Bulletin*, Oct. 1987. The American Institute of Certified Public Accountants published a new view in October 1987 with respect to the valuation of loans to a country a part of which have been sold at a discount. This interpretation opened the way for unrestricted sales of loans in the secondary market and conversions of loans into equity as it removed the risk that the balance of one's portfolio of loans would have to be written down in value to the price received for the sold or converted loans. *Id.*; ECLAC/CTC, *supra* note 50, at 139.

306. See Chamberlin et al., *supra* note 278, at 451.

307. See Truell & Murray, *supra* note 275. In the words of Truell & Murray, "for the first time, the U.S. is throwing its weight behind a plan that sanctions losses by banks on loans to a big debtor country." *Id.*; see also Clyde H. Farnsworth, *IMF Weighs Idea of Debt Forgiveness — It is the First Time Washington has Backed a Plan to Reduce Total Debt*, INT'L HERALD TRIBUNE, Feb. 11, 1988, at 7 col 2; Plehn, *supra* note 281, at 173.

308. The demand was by both debtor governments and private debtor corporations.

309. See Schubert, Address, *The LDC Debt Debacle - An Update. Historical Perspectives*,

portfolio adjustment³¹⁰ and, to a lesser extent, differing regulatory treatment in different nations), continued to exert some influence but the overarching influence on the market was the need to use the debt in debt conversion and debt buy-back schemes. These two uses for the debt and the role of biciletas will now be considered.

1. Debt Conversion Schemes

The principal forms of debt conversion occur in debt-equity schemes, privatizations for debt, and in debt-for-nature, debt-for-development, and debt-for-education schemes. Each will be considered.

a. Debt-Equity Schemes

In this period, a number of nations implemented or expanded debt-equity schemes. The Chilean program, begun in May 1985, was in full flight in 1987 and 1988.³¹¹ Argentina liberalized its scheme in October 1987 to make it more attractive to investors.³¹² Brazil instituted a new program in February 1988,³¹³ in which over US\$1.27 billion of external debt was converted into US\$1.02 billion of equity in its first seven months of operation.³¹⁴ Mexico's program was suspended briefly in March

The Brady Plan; How Serious Is the Leveraging of America?, delivered to the National Honor Society in Finance Annual Dinner at Fairleigh Dickinson University, May 5, 1989, at 6 (on file with the *Fordham International Law Journal*). "Most super-regional banks have disposed of at least 50 pct of their LDC loans during the past year." *Id.*

310. See Urwin, *An Overview of LDC Portfolio Management*, in *THIRD WORLD DEBT*, *supra* note 50, at 63, 69.

311. In excess of US\$2 billion of Chilean external debt was converted through its formal program in 1987 and over US\$2.6 billion was so converted in 1988. In addition, some US\$450 million was converted informally in 1987 and over US\$1 billion in 1988. See Mary L. Williamson, *Chile's Debt Conversion Program: Its Promises and Limitations*, 27 *STAN. J. INT'L. L.* 437, 490 (1991) (providing bar for figures in table 3).

312. See Asiedu-Akrofi, *supra* note 90, at 537, 549-50. Argentina variously promoted and suspended its scheme throughout this period. However, once the price on its debts had fallen to the twenty percent range in 1988 and 1989, conversions became very attractive to the nation because of the large amounts of debt erased in them. For instance, in March 1989, US\$348 million of debt was discounted to US\$79.7 million of local currency for investment into 22 projects. See *Argentina Agrees Latest Debt-Equity Conversions*, *INT'L TRADE FIN.*, Apr. 6, 1989.

313. This was pursuant to Central Bank Regulation 1416 issued on November 17, 1987.

314. See Peter Truell, *Debt Swaps by Brazilians Draw Interest, But Terms Discourage Some Participants*, *WALL. ST. J.*, Apr. 26, 1988. Under this programme, Brazil held monthly auctions at which prospective investors bid the discount rates they were willing to ac-

1987, but was soon resumed and operated until October 1987.³¹⁵ It was then suspended indefinitely amid concerns about its inflationary impact and effect on the allocation of new investments.³¹⁶ The Philippines implemented its scheme in August 1986³¹⁷ and expanded it in July 1987 to include a broader range of government debt to make it more attractive to investors.³¹⁸ In addition, in this period, debt-equity schemes were implemented or expanded in the following countries: Costa Rica, the Dominican Republic, Ecuador, Jamaica, Nigeria, Poland, the Philippines, Uruguay, and Venezuela.³¹⁹

Often in this period, the permission and procedure for

cept. Half the amount converted at each auction had to be invested in projects in the depressed regions of north-east Brazil. Up to US\$150 million could be accepted for conversion at each auction, with a further US\$50 million per month available for conversion outside the auction system. At the first auction in March, US\$186.5 million of loans were swapped for local currency for these investments. The loans were discounted by 10.5% for investments in the north-east and by 27% for investments elsewhere in the country. Accordingly, this programme allowed Brazil to direct foreign investment where it was most needed and to recapture a substantial amount of the secondary market discount for loans. *Id.* The average discount on the first seven monthly conversions was 19.7%; and discounts had reached 16.5% in the north-east and 38% in the free area by October. See *The Brazil Auction Series*, 2 SWAPS: THE NEWSLETTER OF NEW FINANCIAL INSTRUMENTS 3 (1988); *LDC Debt — Brazilian Bonanza* 719 INT'L FIN. REV., Apr. 9, 1988, 1136; *Brazilian Debt Auction: Mood Unsettled* 748 INT'L FIN. REV., Oct 29, 1988, 3524; *Record Discounts at Rio Auction*, 753 INT'L FIN. REV., Dec. 3, 1988, 3916; See also Asiedu-Akrofi, *supra* note 90, at 546.

315. See Asiedu-Akrofi, *supra* note 90, at 556. Mexico suspended its program as a bargaining tool to use against banks not wishing to advance fresh funds in the then current rescheduling. Mexico threatened to declare such bank's loans ineligible for conversion into equity or to deny those banks a role as either an agent or broker for other investors in conversions. After the new money agreement was executed, Mexico resumed its programme. *Id.*; see also *Debt-Equity Swap in Mexico* 717 INT'L FIN. REV., Mar. 26, 1987, 969 (providing example of debt-equity swap transacted under Mexican scheme and describing how Whirlpool Corp of U.S. swapped US\$108 million face value of Mexican debt for 49% stake in Mexican plastics and goods manufacturer).

316. See Asiedu-Akrofi, *supra* note 90, at 560; See also Peter Truell, *Brazil Could Cut Foreign Bank Debt By US\$19 Billion by 1994, Study Says*, WALL. ST. J. Aug. 23, 1988.

317. The scheme was implemented pursuant to Executive Order 32 issued on July 24, 1986 and Central Bank Circular 1111 issued on August 4, 1986.

318. See Asiedu-Akrofi, *supra* note 90, at 564. Specifically the scheme was expanded to permit the conversion of Philippine Investment Notes (non-interest-bearing, foreign currency obligations of the Philippines government) which offered various advantages to the prospective investor. *Id.* For a consideration of the Filipino scheme and the domestic political tensions to which it gave rise, see *Uncertain Future for Philippine Debt-Equity Programme* 723 INT'L FIN. REV., May 7, 1988, 1439.

319. See Chamberlin et al., *supra* note 278, at 417 n.17; Schubert, *supra* note 152, at 12; see also Peter Truell & Charles F. McCoy, *Third World Creditors Give Debt-Equity Swaps a Try*, WALL. ST. J., June 11, 1987, at 6, col. 1.

debt-equity conversions was included in the rescheduling agreements, usually at the insistence of the banks.³²⁰ Such provisions would define the scheme and put in place all necessary consents and waivers.³²¹ At times, the restructuring agreements would permit the purchase by the debtor of a portion of its loans on the secondary market, i.e. the necessary consents and waivers were provided in advance for a defined amount of debt buy-backs.³²²

The popularity of debt-equity schemes was further enhanced in this period by the liberalization of U.S. banking regulations. Before August 1987, U.S. banks were limited to holding up to twenty percent of the equity in nonfinancial companies. Regulation K was amended by the Federal Reserve Board in August 1987 to permit up to 100 percent ownership in non-financial companies in the thirty-three most heavily indebted LDCs provided the companies were state-owned and the acquisition was from the government.³²³ This change was specifically to promote debt-equity privatizations.³²⁴ The acquiring banks were

320. See *Refresher Course — Swap Shop*, BARRONS, Sept. 4, 1989. Mexico suspended its debt-equity program in late 1987 and only “grudgingly” agreed to include advance permission for the conversion of about US\$3 billion of loans into equity as part of its 1989 restructuring package with the banks. *Id.*

321. See Chamberlin et al., *supra* note 278, at 421-24; Carsten Ebenroth & Rudiger Woggon, *The Development of the Equal Treatment Principle in the International Debt Crisis*, 12 MICH. J. INT’L L. 690, 710-13 (1991). An example of such a provision may be found in section 5.11 of the Mexico Restructure and New Restructure Agreements of 1985-1987, reproduced in Chamberlin et al., *supra*, note 278, at 477-80; reproduced in Ebenroth & Woggon, *supra*, at 731-34.

322. This was the case in June 1988 for Brazil’s restructuring agreement which rescheduled US\$62 billion of debt and provided US\$5.2 billion of new funds. See Peter Truell & Roger Cohen, *Brazil and Panel of Bank Lenders Agree on Debt*, WALL ST. J., June 22, 1987.

323. See De Faria et al., PW/EUROMONEY DEBT-EQUITY SWAP GUIDE (1988); Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, 1988 U. ILL. L. REV. 401, 410 (1988); Lee C. Buchheit, *Banking Regulation: Federal Reserve Liberalises Foreign Investment Rules for US Banks*, 3 JIBL N-111 to N-113 (1988).

324. With their potential for reducing both the debt burden on a country and the perceived inefficiencies of state-owned enterprises. See also Spencer, *Regulation K Allows 100 Percent Ownership*, INT’L FIN. L. REV., Oct., 1987 13, 13-14 (citing Federal Reserve Board’s commentary on amendment); OCC Unpublished Interpretative Letter of Feb. 27, 1989 from the Comptroller of the Currency to the President, Miami National Bank, NA, (Ref. 12 U.S.C. 29a, 12 U.S.C. 24(7)) (giving example of conversion which took advantage of this liberalized regulatory environment). The Comptroller approved a transaction in which the named bank proposed to exchange its Argentine debt for Honduran debt and then swap the Honduran debt for local currency with which to acquire 100% of the common stock in a Honduran steel foundry. *Id.*

expected to sell their stakes in such companies within five years although extensions of up to a further five years were available for good cause.³²⁵ Regulation K was further liberalized in February 1988 to permit banks to invest through debt-equity swaps in up to forty percent of any private sector company in a heavily indebted country³²⁶ (i.e. investment was permitted in any company, not only those being privatized).³²⁷

These liberalizations of the U.S. bank regulatory regime were of particular benefit to Bankers Trust and Citicorp,³²⁸ each of which committed substantial amounts of debt from their portfolios into debt-equity schemes. In Chile, Citicorp converted debt to invest in a range of resource businesses such as agriculture, mining, fishing, and forestry often in a joint venture with a subsidiary of the Royal Dutch Shell group.³²⁹ It has been estimated that US\$3 billion of debt was converted into equity through formal programs in 1987.³³⁰ Schubert noted in Octo-

325. *Id.*

326. 53 Fed. Reg. 5358 (1988).

327. See Buchheit, *supra* note 323, at 410-11. See generally Rubenstein, *The Federal Reserve Board's "Liberalization" of the Restrictions on LDC Debt-Equity Swaps*, 20 LAW & POLICY IN INT'L BUS. 163 (1988) (discussing revisions to Regulation K); Tigert, *supra* note 297, at 487-89; Chamberlin et al., *supra* note 278, at 469-74 (providing detailed analysis of Regulation K revisions).

328. See Peter Truell, *Brazil Could Cut Foreign Bank Debt By US\$19 Billion by 1994*, *Study Says*, WALL. ST. J., Aug. 23, 1988.

329. See Peter Truell, *Chile Pushes Debt - Conversion Program*, WALL. ST. J., Dec. 9, 1987. For instance, Citicorp converted some US\$70 million of its loans into 20 percent of the equity in a Chilean wood-products company, pulp mill and eucalypt forest. See Ryser et al., *Deals That are Making a Dent in Third World Debt*, BUS. WK., Oct. 3, 1988, p.111. In Brazil Manufacturers Hanover converted US\$115 million of Brazilian loans from its own portfolio into US\$100 million worth of cruzados. These funds were used to acquire a ten percent equity stake in Companhia Suzano de Papel e Celulose, a Brazilian forest products concern. *Id.*; see also *Better Brazilian Exit Bond Terms Sought*, 720 INT'L FIN. REV., Apr. 16, 1988, at 1204 (describing Brazil's privatization programme). Midland Bank did debt for asparagus and debt for tee-shirts swaps in Peru. See Pettis Interview, *supra* note 22. A number of New Zealand corporations were also significant players in this industry. Carter Holt Holdings and Fletcher Challenge used debt acquired in the secondary market to invest in Chilean forest products companies. Carter Holt Holdings Ltd used US\$160 million of debt and US\$50 million cash to buy a substantial stake in Copec, a Chilean forest products company. See Peter Truell, *Chile Pushes Debt - Conversion Program*, WALL. ST. J., Dec. 9, 1987.

330. See De Faria et al., *supra* note 323, at ch 2. Between June 1985 and May 1987, US\$714 million of Chilean debt was converted through Chapter XVIII investments and US\$484 million through Chapter XIX investments. See Asiedu-Akrofi, *supra* note 90, at 545. The majority of debt-equity exchanges in this period were made by multi-national industrial corporations as a way of subsidising additional investment in their local subsidiaries. The first debt-equity conversion in Mexico was typical in this regard — it was

ber 1987 that "debt equity conversion transactions drive the market and there is a good likelihood that more than sixty percent of loan exchange transactions are for ultimate debt equity conversion."³³¹ This fact remained true for debt-equity programs in 1988, particularly Brazil's.³³²

Debt-equity swaps had been rapidly embraced by most banks and commentators, and, after a short period of time, the U.S. government.³³³ As a potential market-based response to the debt crisis, conversions into equity held out a hope against the spectre of mandatory debt forgiveness. To the extent the debtor country can recapture the discount by its debt being converted into equity at less than full face value, these schemes involve an element of debt forgiveness. This element is usually in the range of ten to fifteen cents on the dollar; although, in Brazil's case, it did at times climb as high as thirty-eight cents on the dollar.

b. Privatizations for Debt

A number of Latin American countries, including Brazil³³⁴ and Mexico, announced or implemented privatization schemes in this period, especially during 1988. A typical scheme would provide for local state-owned companies to be sold in exchange for cash and/or government debt. These schemes generated substantial demand for debt which, with the expectation of future demand as the schemes expanded, supported the market during 1988 and early 1989.³³⁵ One of the largest transactions

an injection of further capital by Nissan Motor Company of Japan into Nissan Mexicana, its Mexican affiliated company. See Chamberlin et al., *supra* note 278, at 431-32.

331. See Schubert, *A Critical Appraisal of the Changing Secondary Market for Discounted Third World Debt*, Address delivered at the Debt-Equity / Swap Market Conference sponsored by the Institute for International Research, New York, New York, Oct. 19-20, 1987.

332. See *Mexican Mine Sale and Brazilian Auction Fuel Rates*, 754 INT'L FIN. REV., Dec. 10, 1988, 4003.

333. Debt-equity swaps have also had their vociferous critics. Professor Rudiger Dornbusch, Remarks at *Panel Discussion on Latin American Adjustment: The Record and Next Steps* in PANEL DISCUSSION ON LATIN AMERICAN ADJUSTMENT: THE RECORD AND NEXT STEPS 312, 324 (J Williamson ed., 1990). "Washington has been obscene in advocating debt-equity swaps and in insisting that they be part of the debt strategy. The U.S. Treasury has made this dogma, and the IMF and the World Bank, against their staff's professional advice and judgment, have simply caved in." *Id.*

334. Brazil announced its privatisation programme in April 1988 listing 64 state-owned companies that were potential candidates. See *Better Brazilian Exit Bond Terms Sought*, 720 INT'L FIN. REV., Apr. 16, 1988, 1204.

335. See *Mexican Mine Sale and Brazilian Auction Fuel Rates*, 754 INT'L FIN. REV., Dec. 10, 1988, 4003.

was the privatization of Mexicana de Cobre, a huge copper mine, that was sold for US\$1.36 billion in debt and equity.³³⁶

c. Debt-for-Nature and Other Types of Swaps

Three types of debt exchanges, in addition to those for equity, were developed. These exchanges merit consideration because of their innovative nature and because the secondary market facilitated them to varying degrees. The three types of exchange are debt-for-nature swaps, debt-for-development swaps, and debt-for-education swaps.

There are two broad forms of debt-for-nature swaps.³³⁷ In the first form, a nation's debts are purchased and offered to it for cancellation in exchange principally for its ongoing protection of a designated part of its land. An example is the first debt-for-nature swap in July 1987 in which Conservation International (a U.S. conservation group) purchased about US\$650,000 face value of Bolivian debt for US\$100,000. Under an agreement previously reached with the Bolivian government, the external debt was cancelled in exchange for two commitments: (i) the protection by legislation of some 1.2 million acres of biosphere reserve and regional park and some 2.8 million acres of adjoining forest reserve as a buffer zone, and (ii) the establishment of an operational fund in local currency to the equivalent of US\$250,000 for the ongoing management and protection of the biosphere reserve.³³⁸

336. *See id.*

337. *See* Lovejoy III, *Aid Debtor Nations' Ecology*, N.Y. TIMES, Oct. 4, 1984, at A31. Debt-for-nature swaps were first proposed in 1984 by the then Vice-President of the World Wildlife Fund, Dr Thomas Lovejoy. *Id.*; *see generally* Priya Alagiri, *Give Us Sovereignty or Give Us Debt: Debtor Countries' Perspective on Debt-For-Nature Swaps*, 41 AM. U. L. REV. 485 (1992); David Barrans, *Promoting International Environmental Protections Through Foreign Debt Exchange Transactions*, 24 CORNELL INT'L. L.J. 65 (1991); Daniel H. Cole, *Debt-Equity Conversions, Debt-for-Nature Swaps, and the Continuing World Debt Crisis*, COLUM. J. TRANSNT'L. L. 57 (1992); Tamara J. Hrynik, *Debt-for-Nature Swaps: Effective But Not Enforceable*, 22 CASE W. RES. J. INT'L. L. 141 (1990); Julian C. Juergensmeyer & James C. Nicholas, *Debt For Nature Swaps: A Modest But Meaningful Response to Two International Crises*, 15 FLA. J. INT'L. L. 193 (1990); Wee, *Debt-for-Nature Swaps, A Reassessment of Their Significance in International Environmental Law*, 6 J. ENV. L. 57 (1994).

338. *See* Chamberlin, et al., *supra* note 278, at 441-43; Hrynik, *supra* at 142-45; Wee, *supra* at 61; *Bolivia: Son of Debt-Equity, Part 1*, 2 SWAPS - THE NEWSLETTER OF NEW FINANCIAL INSTRUMENTS 4 (1988). Another example is the somewhat controversial cash-for-nature swap in which Australia agreed to donate US\$2 million to the Solomon Islands upon condition that logging of an important lagoon habitat be halted. *See* Astbury, *Malaysia angry at Solomons Deal*, AUSTRALIAN FIN. REV., Aug. 29, 1994, at 14 col. 1.

In the second form of debt-for-nature swap, the debt is exchanged for local currency which is then used by local conservation groups (often in association with international conservation groups) for various environmental projects in the debtor country. An example of this form of transaction is, coincidentally, the second debt-for-nature swap, which was between the World Wildlife Fund and Ecuador in December 1987.³³⁹ The World Wildlife Fund acquired Ecuadorian debt with a face value of US\$1 million. Under prior agreement this was then exchanged with the Ecuadorian government for local currency bonds to the value of US\$1 million at the official exchange rate. The interest on these bonds was then applied by Fundacion Natura (Ecuador's leading private conservation organization) to a range of its activities concerned with protecting and managing natural areas. Upon maturity, the principal of the bonds will be used to establish an endowment fund for Fundacion Natura.³⁴⁰

The second form of exchange has a number of advantages over the first. The perceived loss of sovereignty is far less when there are a range of projects selected with local input rather than when the entire transaction is for the preservation of one area of country designated by the foreign conservation group. Sovereignty is a highly sensitive issue in many LDCs³⁴¹ where the IMF's structural adjustment programs have seriously eroded much of their economic sovereignty. The second advantage is that the designation of an area as protected is a developed world notion that may not be entirely appropriate when applied in the context of a LDC in which people still have to forage for food and fuel in the designated areas³⁴² or, for that matter, in Poland, a nation with catastrophic pollution problems, in which the setting aside of a wetlands reserve was seen as highly inappropriate and pollution cleanup was seen locally to be a far higher priority than preservation of birdlife habitats.³⁴³

339. See Chamberlin, et al., *supra* note 278, at 443-45. This swap was completed in March 1988. *Id.*

340. See *id.*

341. See Alagiri, *supra* note 383, at 496-503; Barrans, *supra* note 383, at 79-80; Wee, *supra* note 383, at 63-65.

342. The first debt-for-nature swap, in Bolivia, attracted criticism on these grounds. See Alagiri, *supra* note 383, at 499; and Wee, *supra* note 383, at 64 n. 71; See generally Barrans, *supra* note 383, at 81-82.

343. See Cole, *Cleaning Up Krakow: Poland's Ecological Crisis and the Political Economy of International Environmental Assistance*, 2 COLO. J. INT'L ENV'T'L L. & POL'Y. 205, at 217-

Debt-for-nature exchanges have also been implemented in Costa Rica, the Dominican Republic, the Philippines,³⁴⁴ Madagascar, Mexico, Poland, and Zambia.³⁴⁵ Between 1987 and 1990 debt-for-nature swaps resulted in about US\$100 million of face value of debt being exchanged for environmental protection.³⁴⁶ Their impact should not be measured upon the debt crisis as the stock of land available and suitable for conservation was never going to permit this mechanism to resolve that problem.³⁴⁷ Their success should be seen in offsetting to a limited extent the environmental damage, particularly deforestation,³⁴⁸ occasioned by the need to earn foreign exchange to service the debts of the crisis, rather than in terms of the ever so slight reduction in the debt burden of some countries.³⁴⁹ In the words of the Minister of Natural Resources, Energy and Mines of Costa Rica, Mr Alvaro Umana, "debt-for-nature swaps, even though they affect less than 1 percent of the total debt, are absolutely essential . . . There would [otherwise] have been no money to purchase land bridges between parks, to start tree nurseries for farmers, or even to fight forest fires."³⁵⁰ Furthermore debt-for-nature swaps

20 (1991); Cole, *supra* note 383, at 76. Scientists predict up to twenty-five percent of all Poles will contract some form of pollution-related cancer. *Id.*

344. The Philippines exchange involved the WWF and was in the second form. The application of the funds was governed by the relevant Philippine government department, a local environmental foundation and the WWF. See Chamberlin, et al., *supra* note 278, at 444-45, n. 114.

345. See Minujin, *Debt-for-Nature Swaps - A Financial Mechanism to Reduce Debt and Preserve the Environment*, ENV'T'L. POL. & L. 146, 147 (1991). Furthermore, debt-for-nature swaps have been expanded dramatically in scope by the donation of debt by some OECD governments; such as the U.S. government donating up to US\$100 million of debt and the German government donating US\$60 million of debt to Poland to finance environmental programmes. See Cole, *supra* note 383, at 80-81. These developments are beyond the scope of this work as they do not involve the secondary market. *Id.*

346. See *id.* at 77.

347. See *id.*

348. Latin America is home to fifty percent of the world's remaining forests. See Gibson & Curtis, *A Debt-for-Nature Blueprint*, 28 COLUM. J. TRANSN'T'L. L. 331, at 332.

349. See Wee, *supra* note 383, at 57-59; *The Debt-for-Nature Option*, in 2 SWAPS - THE NEWSLETTER OF NEW FINANCIAL INSTITUTIONS 1 (1988).

350. See Wee, *supra* note 383, at 63; See also Alvaro Umana, *Costa Rica Swaps Debt for Trees*, WALL. ST. J., March 6, 1987, at 31. As an interesting aside, one Costa Rican swap permitted the purchase of extra forest for a national park. Salomon Brothers arranged the swap and obtained some of the debt for free. In gratitude, Dr. Jansen, of Cornell University, named three newly discovered wasp species after John Gutfreund, the Chairman of Salomon Brothers, and Mark Franklin and Stephen Dizard, who headed the trading desk. The bankers may have preferred something more cuddly

have spawned two useful variants: debt-for-development swaps and debt-for-education swaps.

d. Debt-for-Development Swaps

The first true debt-for-development transaction involved the donation of US\$1 million of Nigerian loans by American Express Bank Ltd. to the International Foundation for Education and Self Help. The loans were then exchanged for local currency in Nigeria to be used in a program to fight hunger, disease, unemployment, and illiteracy in that country.³⁵¹

In a later transaction in December 1988, Midland Bank donated its entire portfolio of some US\$800,000 face value of Sudanese debt to the United Nations Children's Fund ("UNICEF"). UNICEF had arranged for the Sudanese government to continue servicing the debt in local currency (as opposed to the foreign currency in which it was denominated) and these interest payments were invested in water, sanitation, reforestation, and health education programs administered by UNICEF in the Sudan.³⁵²

CARE, a large development and relief organization headquartered in the United States, was quick to hop on the debt-for-development bandwagon by developing a "Developing Country Loan Contribution Program." Under the program banks could donate loans to CARE. CARE would arrange with the local Central Bank for these loans to be paid out in local currency which CARE would employ in its programs in that country.³⁵³

Such loan contribution programs and donations of debt by U.S. banks to charities took advantage of Revenue Ruling 87-124 (November 12, 1987)³⁵⁴ from the U.S. Internal Revenue Ser-

than a wasp, but it is nonetheless rare for a banker to give his name to an new species. See Pettis Interview I *supra* note 22.

351. See Griffith-Jones & Wainman, *Donations of LDC Debt by Banks to Charities*, in *THIRD WORLD DEBT*, *supra* note 50, at 99-100.

352. See *id* at 100-101.

353. See *The Developing Country Loan Contribution Program* (1/19/88) and *The Developing Country Loan Contribution Program - Honduras* (1/22/88), flyers produced by CARE (on file with the *Fordham International Law Journal*).

354. See Hay & Paul, *supra* note 296, at 146 (reproducing text of Revenue Ruling 87-124); See also the letter to Senator John Chafee reproduced in HAY & PAUL, *supra* note 296, at 149, Annex 7 regarding Debt For Nature Swaps.

vice.³⁵⁵ This ruling was designed to clarify the taxation consequences of, and otherwise promote, debt-equity swaps. The ruling meant a bank donating debt could take a loss equal to the difference between the book value of the debt and its fair market value and then deduct the fair market value of the debt as a charitable contribution, so that the entire book value of the debt was a tax deduction to the bank.³⁵⁶

The volume of debt-for-development swaps soon surpassed the debt-for-nature swaps out of which they grew. It has been estimated that from 1987 to 1994 between US\$750 million and US\$1 billion face value of foreign debt was cancelled in debt-for-development swaps³⁵⁷ with UNICEF alone converting nearly US\$193 million of debt for development.³⁵⁸ In the same period, a total of about US\$177 million of foreign debt was converted in debt-for-nature swaps.³⁵⁹

In summary, debt-for-development swaps are a highly effective means for aid agencies to increase the buying power of their foreign currency in local currency. If handled properly they pose none of the infringement of sovereignty problems associated with some styles of debt-for-nature swaps and "enhance the ability of aid organizations to operate programs that make peo-

355. See Leslie A. Sowle, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. UNI. L. REV. 1079 (1989); Barrans, *supra* note 383, at 89.

356. See CARE, *The Developing Country Loan Contribution Program - Honduras* (1/22/88) (copy on file with the *Fordham International Law Journal*). The U.S. Agency for International Development also promoted debt-for-development initiatives by permitting its grants to private aid organizations to be used to acquire debt on the secondary market for conversion into local currency. See Meuchner, *US Funding LDC Debt Purchases on Secondary Market*, XIII Bank Letter, March 20, 1989, 1. As these grants used taxpayers money this was a somewhat controversial step as it could be seen as a taxpayer bailout of banks. Nonetheless the opportunity for aid agencies to multiply the buying power of their aid funds by converting them through debt exchanges was too potent a benefit to let slip. See generally Eve Burton, *Debt for Development: A New Opportunity for Nonprofits, Commercial Banks, and Developing States*, 31 HARV. INT'L. L. J. 233 (1990); Barrans, *supra* note 383, at 86-88.

357. See Kaiser & Lambert, *DEBT SWAPS FOR SUSTAINABLE DEVELOPMENT - A PRACTICAL GUIDE FOR NGOS* 14 (1996). Much of the debt converted in debt-for-development swaps was official bilateral debt (i.e. loans made by developed nations to the LDCs) and was donated for the purpose by the developed nations. For instance, in 1994 Canada forgave seventy-five percent of the US\$ 22.7 million of Peru's official bilateral debt and converted the balance for development purposes. Similar arrangements were entered into between Finland and Peru (1995), Germany and Peru (1994), Switzerland and Bulgaria (1995), and the United States and the Philippines (1995). *Id.* at 8.

358. See *id.* at 16.

359. See *id.* at 12-13.

ple their first concern."³⁶⁰ As a side benefit, these swaps permit the country receiving aid to convert small amounts of its foreign debt into local obligations.

e. Debt-for-Education Swaps

Debt-for-education swaps are another application of the basic principle developed above: the acquisition of debt and its tender to the debtor nation for discharge can, by virtue of the debt's secondary market discount, magnify the purchasing power of one's hard currency for local currency.³⁶¹ In the first debt-for-education swap, Harvard University multiplied its purchasing power almost three times.³⁶²

On July 10, 1990, Harvard University and Ecuador entered into a debt-for-education agreement. Pursuant to the agreement, Harvard acquired US\$5 million of Ecuadorian debt in the secondary market and exchanged these loans with the Central Bank of Ecuador for fifty percent³⁶³ of their face value in local currency bonds. As Harvard acquired the loans at a price of 15.5% of face value their total investment was US\$775,000.³⁶⁴ The bonds were transferred to a local Ecuadorian educational foundation, formed for the purpose. This foundation sold the bonds in Ecuador and used the proceeds to purchase U.S. dollars in the local market. The proceeds amounted to some US\$2 million, or almost three times Harvard's initial contribution. These funds, now owned by the local foundation, were invested in the United States. The investments are designed to realize about US\$150,000 per annum of which about eighty-five percent will be used to fund scholarships for Ecuadorian students to attend Harvard and the balance will fund local costs for research and study in Ecuador by Harvard faculty and students.³⁶⁵

360. See Burton, *supra* note 402, at 243.

361. See Minujin, *supra* note 393, at 147-48. The discount in the secondary market is of the essence of all of these debt exchanges as noted, with respect to debt-for-nature swaps. *Id.*

362. See Jennifer F. Zaiser, *Swapping Debt for Education: Harvard and Ecuador Provide a Model for Relief*, 12 B.C. THIRD WORLD L. J. 157 (1992).

363. The Ecuadorian government drove a hard bargain here, recapturing 50 percent of the loans value for free. The reason to insist upon such favorable terms was probably that the government wished to minimize the inflationary impact of the local currency bonds which had to be issued to "repurchase" the debt.

364. See Zaiser, *supra* note 408, at 180-81.

365. See *id.* at 182-83.

2. Debt Buy-Backs

As their name implies, debt buy-backs involve the acquisition of the debt by the debtor either directly from the creditors or through the secondary market. They are not a new idea. Between 1935 and 1939, Chile repurchased about one-third of its bonds at an average price of fifteen percent of face value.³⁶⁶ Debt buy-backs did not receive from the banks the warm welcome that had greeted debt-equity swaps. Banks resisted buy-backs strongly as those who chose not to sell their debt perceived the buy-backs resulted in the transfer of reserves to the selling banks. This would have been true if the buybacks were at prices that overvalued the debt, i.e. that the "real" value of the debt was less than the price the debtor paid to repurchase it. Yet it was principally the major, money center banks that objected to buy-backs on these grounds; and these banks had long argued that the secondary market undervalued the debt. Incredibly, such flawed reasoning long served as a major impediment to the growth of buy-backs.³⁶⁷ Buy-backs met further opposition because the debt forgiveness was so obvious. The game of images and mirrors of the rescheduling years could accommodate covert debt forgiveness, but blanched at the prospect of overt forgiveness.

As a result, buy-backs were only tolerated initially for "basket-case" countries,³⁶⁸ and, anomalously, for Chile. Bolivia established a buy-back scheme in July 1987³⁶⁹ for which the foreign exchange was donated by anonymous sources thought to be The Netherlands, Spain, and some wealthier Latin American countries.³⁷⁰ Bolivia offered to repurchase its debt directly from all of its 131 creditors in a coordinated scheme at a price of eleven cents on the dollar.³⁷¹ At the time, Bolivian debt traded at six to eleven cents in the secondary market,³⁷² interest payments having ceased in mid-1985. For an outlay of US\$34 million, the

366. See Anayiotos & De Pinies, *supra* note 156.

367. See Pettis Interview II, *supra* note 106.

368. See Peter Truell, *Latin American Debt Prompts Action*, WALL ST. J., Sept. 22, 1988.

369. See Peter Truell, *Dutch Bank Sees More Countries Repurchasing Debt*, REUTERS, Nov. 19, 1987.

370. See Peter Truell, *Bolivia Buys Back Nearly Half of Its Debt at a Fraction of the Face Value*, WALL ST. J., Mar. 18, 1988.

371. See *Dutch Bank Sees More Countries Repurchasing Debt*, REUTERS, Nov. 19, 1987. Bolivia had sought and received a four month waiver of the sharing provisions in its loan agreements to enable this offer to be made. *Id.*

372. See Derek Asiedu-Akrofi, *Sustaining Lender Commitment to Sovereign Debtors*, 30

country repurchased some US\$308 million of debt, which represented about forty-six percent of its US\$670 million foreign commercial bank debt.³⁷³

The first buy-back scheme in Latin America was implemented by Chile in May 1985. Its debt conversion program had two limbs commonly referred to as Chapter XVIII and Chapter XIX after the legal provisions which implemented them. Chapter XVIII was a debt purchase program for Chilean companies or persons wishing to purchase foreign debt and convert it into local currency.³⁷⁴ Yet this program met with surprisingly little resistance from the international banking community.³⁷⁵ Even Chile itself was able to buy back its own debt regularly in 1988.³⁷⁶ The cause of this surprising degree of acceptance is not known; it may have been because Chile's economic growth³⁷⁷ and stability and the orderly efficient administration of these debt conversion programs made Chile the international banks' favorite LDC debtor. It may even have been because the transactions were commonly called Chapter XVIII conversions rather than debt buy-backs.³⁷⁸ All that can be said is that Chile's debt-equity conversion programs have been consistently hailed as the most suc-

COLUM. J. TRANSN'T'L. L. 1, 25 (1992); *Bolivia's Loan Repurchase Programme Heads For Success*, 715 INT'L FIN. REV., Mar. 12, 1987, at 796.

373. See Truell, *supra* note 328.

374. The consideration of Chile's debt conversion programs has been slightly simplified for their full complexity does not advance our consideration of the secondary market. For instance, certain debt-equity swaps could be conducted under Chapter XVIII and conversions were also possible under Decree Law 600, which represented a third limb of the conversion program. In addition, some thirty-two percent of conversions between 1985 and 1990 occurred outside the formal programme, typically by way of direct agreements between debtor companies and their creditors. For a full consideration of Chile's debt conversion program, see generally Mary Williamson, *supra* note 311; see also Williamson, *supra* note 311, at 449 (providing more information on informal conversions).

375. Hernan Sommerville, Chile's chief debt negotiator, *Free Fall in Secondary Market*, 750 INT'L FIN. REV., Nov. 12, 1988, at 3864-5. "We have signed at least two amendments (one that allowed the buyback) and we have been able to get endorsement of 100percent of banks in record time." *Id.*

376. For instance, Chile repurchased some US\$229 million face value of its debt for US\$168.4 million accepting all bids lower than 57.5% in a debt buy-back auction in October 1988 (the average price was 56.3%, considered remarkably low at the time). *Id.*

377. See Peter Truell, *Chile Buy-Back of Foreign Debt at Discount Set*, WALL ST. J., Sept. 22, 1988. Economic growth averaged about five percent p.a. throughout this period, and in 1988 Chile's trade surplus approached US\$500 million. *Id.*

378. Never underestimate the power of appearances in international finance — the 1980s was in many respects one long game of images and mirrors.

cessful of any debtor nation³⁷⁹ and the appropriate precedent for other debtors to follow³⁸⁰ and one of its central components was a debt purchase scheme.

Under chapter XVIII, the Chilean government held regular fortnightly auctions at which local companies would tender the amount of discount they were prepared to accept in exchange for the right to purchase and convert external debt.³⁸¹ A typical discount was usually about fifteen percent of the face amount of the debt.³⁸² If its tender was accepted, the Chilean entity would then buy the external debt of Chile in the secondary market with dollars. These dollars would either be acquired at a slight premium within Chile,³⁸³ or, perhaps more commonly, were dollars all ready held abroad.³⁸⁴ The external debt would then be converted at the official exchange rate, less the tendered discount, into peso-denominated bonds (which could be sold in the local market).³⁸⁵ Hence, a Chilean person or company which purchased the debt at sixty-five percent on the secondary market, and tendered a discount of fifteen percent, would have received eighty-five cents worth of pesos for sixty-five cents of U.S. currency and would have increased the value of its foreign currency some thirty percent (less associated transaction costs). These transactions were debt purchases rather than debt buy-backs as the debt purchaser was not necessarily the debtor. The common criticism that debt-equity programs subsidised foreign

379. See Truell, *supra* note 328.

380. See *id.*; Williamson, *supra* note 311, at 441-42. What is intriguing is while many other countries implemented debt-equity schemes along the lines of Chapter XIX, few implemented debt buy-back schemes similar to Chapter XVIII. This may be because few other economies shared Chile's distinctive capacity to absorb new long-term debt. *Id.* at 443.

381. The government would accept the bids of those companies willing to accept the largest discounts.

382. See Foulke, Remarks at a conference sponsored by The Heritage Foundation, Center for International Economic Growth in *DEBT/EQUITY CONVERSION*, Jan. 21, 1987, at 37.

383. The typical premium was about five percent.

384. See Asiedu-Akrofi, *supra* note 90, at 543 n 14. Chapter XVIII can be viewed as a scheme to facilitate and make attractive the repatriation of flight capital as participants under a Chapter XVIII conversion do not need to reveal the origins of the foreign debt being converted whereas under Chapter XIX detailed information was required on the source of the funds and the nature of the investment. *Id.*; Williamson, *supra* note 311, at 450.

385. See Asiedu-Akrofi, *supra* note 90, at 542-43.

investors at the expense of locals was rarely heard in Chile because these transactions were open to Chileans.

Chapter XIX was a conventional debt-equity scheme distinguished by its consistency — it was the only scheme not periodically suspended or cancelled — and the timely efficiency of its operation.³⁸⁶ Interestingly, while Chile was repeatedly applauded for its debt-equity scheme by the international banks, more debt was converted under Chapter XVIII than Chapter XIX.³⁸⁷

In early 1988, Chile was able to amend its debt agreements to incorporate permission from the international lenders to use up to US\$500 million of its reserves to repurchase its own debt directly in a true buy-back,³⁸⁸ rather than having a Chilean company do so under Chapter XVIII. In October of that year, Chile proceeded with a large government buy-back in which banks were invited to tender for the repurchase of their Chilean Central Bank debt,³⁸⁹ the result being that Chile retired US\$299 million of central bank debt for US\$168.4 million of cash from its foreign exchange reserves.³⁹⁰

Perhaps the most significant use of buy-backs in this period was in the repurchase of private sector debt by Mexican corporations. Between 1983 and 1988, Mexican corporations almost halved their level of indebtedness from US\$22.3 billion to US\$14.5 billion.³⁹¹ Buy-backs were the principal tool of this debt reduction. For example, in a mixed debt buy-back and equity swap Grupo Alfa, one of Mexico's largest corporations, agreed with its foreign creditors in 1988 to exchange US\$25 million in cash, US\$200 million in Mexican government paper, and forty-five percent of the group's stock for US\$920 million of the

386. See Foulke, *supra* note 350, at 38 (discussing efficiency of Chile's scheme). Up to December 1987, about US\$1.5 billion of debt had been converted through Chapter XVIII and about US\$660 million through Chapter XIX. See Truell, *supra* note 328.

387. See Foulke, *supra* note 350, at 38. Up to December 1987, about US\$1.5 billion of debt had been converted through Chapter XVIII and about US\$660 million through Chapter XIX. See Truell, *supra* note 328.

388. See Truell, *supra* note 328.

389. See Peter Truell, *Chile Buy-Back of Foreign Debt at Discount Set*, WALL ST. J., Sept. 22, 1988.

390. See Peter Truell, *Chile Is Using Its Reserves to Buy Back US\$299 Million of Bank Debt at Discount*, WALL ST. J., Nov. 10, 1988. Chile received 129 offers to sell the country US\$822 million of its debt and accepted all offers up to a price of 57.5 cents on the dollar. It paid an average price of 56.3%. *Id.*

391. See Truell, *supra* note 328.

group's debt.³⁹² The Mexican government debt would have been acquired for cash through the secondary market.³⁹³

Argentine and Brazilian companies also repurchased their debt by negotiating private buy-backs with their creditors in this period.³⁹⁴ In Brazil, local banks and industrial companies were particularly active buying back about US\$150 million of their debt a month through much of 1988 in informal transactions.³⁹⁵ In the words of Kenneth Telljohann of Salomon Brothers, "The informal conversions have accounted for a lot of the demand and have helped Brazil debt to rally thirteen percent in market value since the beginning of the year [i.e. from thirty-seven cents on the dollar at the end of 1987 to above fifty cents on the dollar in April 1988]."³⁹⁶

An example of a pure debt buy-back in this period is to be found in the repurchase of US\$75 million of floating rate notes by Grupo Tolteca in late 1987.³⁹⁷ Morgan Guaranty Trust Company of New York acted as Coordinator of the buy-back.³⁹⁸ Grupo Tolteca offered to repurchase the notes at a discount of 38.5 percent. Morgan negotiated with each note holder to purchase their notes either for cash, sovereign debt or a combination thereof to the value of 61.5% of the face value of the notes³⁹⁹ (so as to facilitate the participation of noteholders not prepared to sell for cash). As Mexican sovereign debt was trad-

392. See Asiedu-Akrofi, *supra* note 90, at 557.

393. See Pettis Interview I, *supra* note 22. Player Crosby, formerly of Salomon's, formed a partnership with Finamex, of Mexico, at this time and allegedly made a fortune. Their U.S. partnership bought from banks at bargain basement prices a lot of Grupo Alpha shares which the banks had received in the swap and did not otherwise know what to do with. *Id.*

394. See Martin W. Schubert, Speech Delivered at a Seminar entitled, *Latin American Investors' Issues: 1988-89 - Salient Trends and How to Profit from Them*, New York, NY, Sept. 16 1988, at 21 (on file with the *Fordham International Law Journal*) reprinted in OVERVIEW OF FINANCIAL AND BUSINESS TRENDS FOR 1989 — HOW TO PROFIT FROM THE USE OF DEBT AS A MEANS OF EXCHANGE IN A CHANGING LATIN AMERICA. .

395. See *Better Brazilian Exit Bond Terms Sought*, 720 INT'L FIN. REV., Apr. 16, 1988, at 1204. Banks did these conversions under Resolution 63 and industrial companies under Resolution 4131. *Id.*

396. *Id.*

397. The Tolteca Group was composed of Empresas Tolteca de Mexico SA de CV and its subsidiaries.

398. Reimbursement Agreement between Grupo Tolteca and its subsidiaries and Morgan Guaranty Trust Company of New York dated as of Oct. 9, 1987 [hereinafter Reimbursement Agreement] (on file with the *Fordham International Law Journal*) (defining Morgan as coordinator).

399. *Id.*

ing at forty-eight to fifty-two cents on the dollar,⁴⁰⁰ a noteholder could have received up to twenty-five percent more face value of sovereign debt by engaging in the exchange. An interesting question is that as Tolteca had the funds to pay for 61.5% of its indebtedness in cash,⁴⁰¹ why were the banks willing to accept that payment in discharge of their loans? A borrower which has the funds to repay nearly two-thirds of principal today would appear a good credit risk for the repayment of the entire principal and interest over the coming four years.⁴⁰² However, such straightforward reasoning fails to accommodate the realpolitik of the debt crisis. The foreign currency for servicing loans was controlled and rationed by the Central Bank. While Tolteca could clearly have repaid its loans over the following four years it may not have been permitted to do so by its local authorities. The debt repurchase, on the other hand, probably involved Tolteca funds that were held offshore and thus beyond the Central Bank's purview.⁴⁰³

Waivers of certain provisions by some stated proportion of creditors were necessary for virtually all debt buy-backs.⁴⁰⁴ This was necessary because loan agreements invariably contained provisions along the following lines: (a) payments received by any creditor through exercise of any right of counterclaim, setoff, banker's lien or otherwise which exceed that received by any other creditors should be shared with the other creditors so that all creditors benefit equally (commonly called a "sharing clause");⁴⁰⁵ (b) any prepayments by the debtor should be on cer-

400. See *Market Prices for Developing Country Debt*, 703 INT'L FIN. REV., Dec 12 1987, 3876.

401. See Reimbursement Agreement, *supra* note 366.

402. Note Agency Agreement dated as of March 20, 1986 among Empress Tolteca de Mexico SA de CV, the Guarantors, the Noteholders and the Morgan Guaranty Trust Company of New York, as Note Agent, for US\$75,000,000, Floating Rate Notes Due 1988-1991 [hereinafter Note Agency Agreement].

403. See Pettis Interview II, *supra* note 106.

404. See Reimbursement Agreement, *supra* note 366. For instance, in the Tolteca transaction, under the terms of the original note issuance agreement, the consent of 51% of noteholders was required to waive the clauses of the note issuance agreement which could have otherwise prohibited this repurchase transaction. One of Morgan's roles as Coordinator was to solicit consents and waivers from the required number of creditors. *Id.*; Letter Agreement between Grupo Tolteca and Morgan of October 12, 1987, as amended by Letter Agreement of October 21, 1987 (on file with the *Fordham International Law Journal*).

405. See Lee C. Buchheit, *How to Negotiate the Sharing Clause*, INT'L FIN. L. REV., July 1993, 36; see also MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT'L L. 305, 348-

tain dates and in multiples of a certain amount (the "prepayments clause");⁴⁰⁶ and (c) the creditors should be repaid ratably with other comparable creditors under other debt agreements (the "mandatory prepayment" clause).⁴⁰⁷ The purchase of the debt at a discount from the participating creditors to the exclusion of those who chose not to participate might be construed as a payment received by those creditors and a prepayment by the debtor. Accordingly, waivers of these provisions by the required proportion of creditors⁴⁰⁸ was a necessary precondition to most debt buy-backs.⁴⁰⁹

In addition to the formal debt-exchange auctions and buy-backs, foreign investors in need of local currency in this period began to initiate private buy-backs, most often in Brazil. The foreign investor would seek a private sector debtors' agreement to

349 (1995) (considering sharing clauses); Ebenroth & Woggon, *supra* note 321, at 695-97.

406. See generally Asiedu-Akrofi, *supra* note 340, at 26-27 (discussing clauses (a) & (b)). The language referred to in clauses (a) & (b) comes from sections 3.07 and 3.05 respectively of the Note Agency Agreement. See Note Agency Agreement, *supra* note 370.

407. See Lee C. Buchheit, *The Capitalization of Sovereign Debt: An Introduction*, U. ILL. L. REV. 401, 407-08 (1988); Lee C. Buchheit & Ralph Reisner, *The Effect of the Sovereign Debt Restructuring Process on Inter-Creditor Relationships*, U. ILL. L. REV. 493, 511-13 (1988); Clark, *supra* note 288, at 110-11; Ebenroth & Woggon, *supra* note 321, at 695-99. Mandatory prepayment clauses typically confer remedies upon the bank creditors under the loan agreement if the debtor services comparable indebtedness in a manner preferential to its servicing of this indebtedness. See Clark, *supra* note 288, at 111-12. Mandatory prepayment clauses were included, for instance, in the rescheduling agreements for the debt of Argentina, Chile and Mexico. See Chamberlin, et al., *supra* note 278, at 420 n. 23. For an example of a sharing clause see the clause from the Mexico New Restructure Agreement of 1985 reproduced as Appendix I to Ebenroth & Woggon, *supra* note 321, at 722. For an example of a mandatory prepayment clause, see the clause from the Mexico New Restructure Agreement of 1985 reproduced as Appendix II to Ebenroth & Woggon, *supra* at 726.

408. Many of the restructuring agreements between 1982 and 1985 required the consent of all creditors to waive such a provision. See Buchheit, *Making Amends for Amendments*, INT'L FIN. L. REV., Feb. 1991, 11 (providing explanation of difficulties caused by such amendments). Buchheit described such amendment clauses as "Frankensteinian monsters." *Id.*

409. In addition, a buy-back usually required the waiver of a host of other clauses which might be technically infringed by it, including (i) the funding losses provision which protects the banks against any loss occasioned by a repayment by the debtor on a date which breaks into the bank's matched funding of the loan, (ii) certain provisions regarding the maintenance of foreign currency accounts with the debtor nation's central bank, and (iii) certain of the events of default. See terms of the Waiver, Consent and Agreement of Each Bank prepared by the Coordinator for use in the Tolteca repurchase (on file with the *Fordham International Law Journal*).

repay the debt in local currency and then acquire, at a substantial discount, the external debt of that debtor.⁴¹⁰ The investor thus obtained local currency without the limitations on the use of the proceeds imposed in the formal debt-exchange auctions, and usually at a more advantageous price. It has been estimated that up to US\$500 million of external Brazilian debt was discharged in this manner between September 1987 and June 1988.⁴¹¹

3. Bicicletas

“Bicicleta” is the Chilean name for a round-tripping transaction. Over time, the term came to be used to describe all round tripping transactions. These served as the final impetus to the market in this period. In essence, a bicicleta is a way to convert external debt into local currency in such a way that the foreign exchange value of the local currency exceeds the value of the converted external debt.

The classic round tripping transaction occurs when a local company under-invoices exports or over-invoices imports so that it surrenders less foreign currency or receives more foreign currency from the Central Bank than it needs and, in so doing, engineers capital flight. Alternatively, a local company that would otherwise retain foreign currency earnings in the local economy may remit them abroad to use in a round-tripping transaction. Debt buy-backs and debt-equity conversion schemes provide a preferential exchange rate for investors. In round tripping transactions funds are taken abroad and returned to the country of origin via a buy-back or equity conversion to take advantage of the preferential exchange rate for purposes for which it was never intended.

The potential for round tripping has been analyzed in the literature on debt-equity swaps.⁴¹² The market, however, kept its role in facilitating these transactions quite secret. This writer has

410. See Chamberlin, et al., *supra* note 278, at 459; See also *Brazilian Debt Arbitrage May be Too Good to Last*, EUROMONEY, Apr. 1988, at 40.

411. See Chamberlin, et al., *supra* note 278, at 459 n. 166.

412. See Lee C. Buchheit, *Debt Equity Conversion Programmes from the Debtor Country's Perspective*, in A GUIDE TO DEBT EQUITY SWAPS 33, 37 (S. Rubin ed., 1987); Shilling & Toft, DEBT EQUITY CONVERSION ANALYSIS - A CASE STUDY OF THE PHILIPPINE PROGRAM ¶ 3.19-3.20 (World Bank Discussion Paper No 76, 1990); DEBS, et al., FINANCE FOR DEVELOPING COUNTRIES - ALTERNATIVE SOURCES OF FINANCE 35 (1987).

been able to find no literature on this aspect of the market. There were three reasons for the secrecy:

- (i) most *bicicletas* involved exploiting the inability of the local central banks to control the loopholes in their complex debt-equity and currency control regulations — the transactions would typically be within the letter but not the spirit of the regulations, and thus were likely to invoke the displeasure of the central bank if they came to light;
- (ii) at times *bicicletas* involved transactions of dubious legality in terms of exchange control regulations; and
- (iii) the trading desks earning handsome returns from the *bicicletas* knew that the profitability would be squeezed from these transactions if too many traders learned of, and participated in, them.

Mexico and Chile were host to the majority of *bicicleta* transactions and an example of a typical transaction in each country will be given.

In Mexico, *bicicletas* centered on the Ficorca Agreement. This agreement governed the foreign obligations of Mexican private sector corporations. Under it, the Mexican debtor could convert its original foreign currency loan obligation to a foreign bank into a peso-denominated obligation to Banco Central de Mexico. The Central Bank then assumed the indebtedness and foreign currency exposure and paid the foreign bank on terms similar to those of the Mexican restructuring agreements.⁴¹³

The Ficorca Agreement provided for the prepayment of their peso obligations by the Mexican corporate debtor. Indeed, one of the approved uses of converted debt, in the debt-equity conversion program of 1987, was the prepayment of Ficorca debt. A number of Mexican companies took up the offer. Pre-paid Ficorca obligations earned the peso rate of interest in an account at the Central Bank. The potential for a *bicicleta* came to light when Michael Pettis, of Manufacturers Hanover, realized that under Ficorca the original lender could at any time cancel the loan and take over the pesos at the Central Bank. The provenance of this provision is unclear but the Mexican drafters of Ficorca surely expected few foreign banks to avail themselves of this right to convert a foreign currency debt into pesos. Fred

413. See Asiedu-Akrofi, *supra* note 90, at 557.

Manger at Lazards made the same discovery within days of Pettis and so began a highly lucrative venture for these traders.

For the traders, step one was to identify the prepaid Ficorca debts, and then check the value of the pesos in the relevant account at the central bank. Step two was to locate the holder of the original loan and offer them a swap of that loan for Mexican government indebtedness plus a cash fee.⁴¹⁴ This was usually very attractive because, from the lenders' perspective, the only difference between private sector and government debt was that the market for the latter was more liquid. The trader would then take the original loan for the prepaid Ficorca debt to the Central Bank, exchange it for the pesos in the relevant Ficorca account and profit to the extent of the secondary market discount less the cash fee and transaction costs.⁴¹⁵

These schemes were fabulously lucrative, at least initially. As an example, consider a loan of US\$1,000 to a Mexican corporation that had been prepaid at the prevailing controlled rate of 2,400 pesos to the dollar (loans were converted from dollars at the official exchange rate (the "controlled rate") that was between fifteen and thirty percent below the free-market rate). The corporate thus had 2.4 million pesos to its credit at the Central Bank. If we assume an annual interest rate of eighty percent for these pesos, which is not unrealistic, after two months, there were 2.72 million pesos in the account. If the free market peso rate was 3,125 to the dollar, the pesos in the account were now worth US\$870. The US\$1,000 face value of the original loan could be purchased in the secondary market for about US\$480 — its price of about forty-three cents on the dollar, plus a five cent on the dollar fee to the holder of the loan to induce their participation. Once Manufacturers Hanover and Lazard had made their discovery that the original loans could be exchanged for the prepaid pesos, it was a relatively simple matter to realize US\$870 for an outlay of US\$480. To make these figures realistic, increase the amounts by a factor of about 1,000; and the potential profits become obvious. The two trading houses spent the

414. The trader would have been equally prepared to buy the private sector debt but because most lenders had inadequate provisions against these debts, few were willing to sell for cash, hence the swap.

415. The trader would typically also pray there was not a devaluation in the two week processing period the Central Bank required between receiving the original loan and paying out the pesos.

summer of 1988 buying up all the prepaid Ficorca loans in the market, of which there were about US\$150 million. In the process they drove up the premium they had to pay to acquire the loans to as much as thirty cents on the dollar, so the bicicletas were not as profitable at summer's end as they had been at the beginning. Nonetheless, it was one of the more highly profitable exercises in the market's history.

The second example of a typical bicicleta is from Chile. It also was quite legal. In Chile the Central Bank was aware of these transactions and felt that they served Chilean interests. In the usual way in the 1983 restructuring, the Chilean government decided to assume the foreign currency exposure and stand between its private sector borrowers and the foreign banks. Chilean corporates would repay their debts in Chilean pesos to the Central Bank which, in turn, assumed the obligation to repay the foreign loans pursuant to the terms of the restructuring.

Some Chilean corporates were in a position to prepay their loans and convinced the Central Bank to permit the prepayment in full of these peso debts. However, the Central Bank did not consequently repay the foreign loan. As the foreign creditors were not receiving the funds their original debtor had now repaid, they sought access to the prepaid pesos, to "relend" them to their Chilean customers as part of their ordinary banking business. The Central Bank agreed (which incidentally gave birth to a small secondary market in "relending" rights).⁴¹⁶ Once the peso loan was disbursed, the foreign creditor had no claim on the Central Bank and the restructuring agreement no longer applied to that debt. The new Chilean borrower of the peso loan was free to do whatever it liked with the pesos. This bicicleta was born when traders realized that these pesos could be used to buy dollars at the parallel exchange rate.

The first two trading houses to come to this realization were Manufacturers Hanover, again, and Chase Manhattan. Citibank and Security Pacific discovered it shortly thereafter and, by the final stages, a large number of traders were playing this bicicleta and thus reducing its profitability. Its form was much like the Mexican one. A trader would acquire prepaid private sector

416. Banks would trade, in this secondary market, the right to relend pesos on deposit with the Central Bank of Chile (or at times with Central Banks elsewhere, particularly Argentina).

debt from a creditor in the secondary market, typically by swapping it for Chilean government debt. This would cost about US\$630 for US\$1,000 face value of Chilean debt.⁴¹⁷ The pesos would then be relent to a friendly borrower in Chile, which could be any entity interested in earning a fee for its troubles (in one case it was a small private school). If an exchange rate of 250 pesos to the dollar is used, the US\$1,000 of debt results in 250,000 pesos at the Central Bank available to be relent. The new borrower passes these pesos on to the trader, their debt is extinguished, and the trader converts the pesos into dollars. The Chilean entity will be paid a fee, perhaps three percent, which leaves the trader with 242,500 pesos. Their conversion into dollars would be in the parallel market at rates higher than in the official market: 270 pesos to the dollar being typical. At this rate, the trader ends up with US\$898; and a profit of forty-three percent on an initial investment of US\$630.

Finally, there was another type of *bicicleta* used in Chile that involved breaching the debt-equity conversion guidelines. Unlike the above transactions, this one was quite illegal.

None of these innovative types of debt exchanges would have been possible without the secondary market. For most the market was necessary as the source of the debt. Even those transactions in which the loans were donated, however, owe a debt to the market for without the groundbreaking work of debt-equity swaps, for which the market was essential, these more esoteric forms of swaps would probably never have been developed.⁴¹⁸

C. Market Characteristics

The four principal characteristics of the preceding period were identified as the demand for the debt for debt-equity conversions, the hand-crafted nature of transactions, the absence of market structure and external regulation, and confidentiality.

⁴¹⁷ At this time, 60 cents on the dollar was a typical price for Chilean debt and 3 cents on the dollar was typical of the cash fees paid to induce the counterparty to participate in the exchange.

⁴¹⁸ This is true notwithstanding that the idea of debt-for-nature exchanges was first proposed in 1984. See Lovejoy, *supra* note 383, at A31. Debt-equity schemes showed *how* to do it. In the words of Randall Curtis, director of Costa Rica's debt-for-nature program for the Nature Conservancy, "the ideas for debt-for-nature didn't really get off the ground until debt-equity programs had been launched . . . Really these programs can be viewed as son-of-debt-equity." *The Debt-for-Nature Option*, 2 SWAPS - THE NEWSLETTER OF NEW FINANCIAL INSTITUTIONS 1 (1988).

As we have seen, the demand for debt for use in debt-equity conversions remained the major determinative of the market throughout this period. Throughout this period there remained more sellers than buyers.⁴¹⁹ Accordingly, the market tended to be heavily influenced by any sources of demand for the debt. A new influence upon the market in these years was the emerging tendency for traders to take large positions in the debt. At the beginning of this period, US\$20 million (face value of debt) was a large position for a trading house to take.⁴²⁰ During the period, the traders took progressively larger positions so that by March 1989 it was true to say that "it is not unusual for major institutions to create or liquidate trading positions of up to US\$100 million."⁴²¹

1. Hand-crafted Transactions

Throughout this period a progressively higher proportion of sales were for cash. The ratio swap was accepted by very few U.S. auditors as an effective channel through which to avoid having to writedown the swapped assets to market value, therefore, the principal U.S. sellers remained the smaller and mid-sized banks that had sufficient reserves to facilitate cash sales. European banks, served by a more generous and flexible accounting profession,⁴²² continued to engage in some swaps, but increasingly their preference was to liquidate their LDC portfolios, thus cash sales were the preferred form of most transactions.⁴²³ This shift in the fundamental nature of the market from a swap market to a cash market was one of the most significant developments of this period.⁴²⁴

This rise in the prevalence of cash sales simplified the market considerably. By the end of 1988, long chains of transactions

419. See Urwin, *supra* note 309, at 67.

420. See Pettis Interview II, *supra* note 106. The market value of the position, which is the correct way to value it, would have been between 40 percent and 60 percent of face value. *Id.*

421. See Urwin, *supra* note 309, at 66; Pettis Interview II, *supra* note 106 (confirming Urwin's conclusions).

422. See Urwin, *supra* note 309, at 72.

423. In the words of a report in *International Financing Review*, "[r]egional US banks and some foreign banks have been the major participants in cash debt sales with many willing to . . . take substantial write-downs to put the LDC turmoil behind them." See 733 *INT'L FIN. REV.*, July 16, 1988, 2289.

424. See Pettis Interview II, *supra* note 106.

and the valuation of one nation's debts in terms of another's were no longer the norm.⁴²⁵

During this period, the market was further simplified by a degree of standardization in swap and sale documentation. Virtually all debt had been rescheduled and virtually all of a country's rescheduling and new money agreements, by now, included identical loan assignment provisions. This permitted the larger traders to move the drafting of the required loan assignment agreements in-house, resulting in substantial savings of legal costs.

2. Absence of Structure and Rules

In the words of Peter Truell,⁴²⁶

the Third-World debt market isn't an official market at all. Rather it's an informal network of large banks, big multinational corporations and some Wall Street investment banks that trade loans of troubled debtor nations over the telephone and by telex.⁴²⁷

As we have seen in the immediately preceding section, the practices in the market had become somewhat simplified during this period. However, the formal structure of the market remained unchanged.

3. Confidentiality

The periodic quotation of secondary market prices in journals⁴²⁸ and their regular appearance in newspaper articles⁴²⁹ was

425. *See id.*

426. Peter Truell, a staff reporter for *The Wall Street Journal*, was the most persistent and accurate market commentator on the market of the 1980s.

427. *See* Peter Truell, *Third-World Debt Market Sinks, Hurt by Debtor Moves, Rumors*, WALL ST. J., Jan. 23, 1989.

428. The first journal to publish LDC debt prices with any regularity was probably the *International Financing Review*. *See e.g.* 603 INT'L FIN. REV., Jan. 4, 1986, 16; 642 INT'L FIN. REV., Oct. 4, 1986, 2933; 663 INT'L FIN. REV., Mar. 7, 1987, 763; 674 INT'L FIN. REV., May 23, 1987, 1686. Other journals followed suit. For instance, *The American Banker*, published fortnightly bid and offer prices for the loans of 27 countries and a commentary on the market (for example, see issue of November 7, 1988); *Swaps - The Newsletter of New Financial Instruments*, published price ranges each month for the loans of the ten principal debtor nations and a commentary on the market (for example, see vol 2 no 11, November, 1988); and *Barrons* published the values of the major debtors' loans each week in the statistics section under the title, "Latin American Debt." *See e.g. Refresher Course — Swap Shop: the Whys and Ways of the Market in LDC Debt*, BARRONS, Sept. 4, 1989.

429. *See e.g.* Peter Truell & Steve Swartz, *Drexel's Milken Is Trying to Find a Lode in*

now commonplace, as was the reference to such prices by governmental and regulatory bodies. By the beginning of this period, the prices of different nations' debts were no longer confidential. In January 1989, towards the end of the period, the *International Financing Review*, began a regular weekly section entitled LDC Finance or LDC Debt, which quoted market prices. At times, a seller would not wish to be identified, for the reasons identified earlier, and would hide behind its broker. However, such instances were less common in this period — the market was well and truly out of the closet.

Market volume in 1987 is commonly estimated to have been in the range of US\$12 billion to US\$15 billion⁴³⁰ — a dramatic increase of some 300% over 1986. The market continued to accelerate in 1988 and the range of estimates regarding its size continued to broaden. Volume estimates for 1988 range from US\$20 billion to US\$50 billion.⁴³¹

Regardless of its exact size, with additional loan loss reserves permitting a supply of debt at low prices and debt-equity conver-

Latin Debt, WALL. ST. J. SEPT. 14, 1987, at 6; Wolfson, *Debt Swap Mart Prices Slide on Weak Demand*, THE J. OF COMMERCE, Aug. 26, 1987, at 7A col. 2.

430. See Stone, *supra* note 272, at S101 (providing for this US\$12 billion estimate); Wallenstein, *supra* note 74, at 32. The Bank of England estimated the secondary market size in 1987 to be US\$15 billion, without double-counting. See Urwin, *supra* note 310, at 68. NMB also estimated the volume to be US\$15 billion but acknowledged that some of the volume might involve double counting. See Tobin, *Innovations May Dampen Debt Crisis*, UPI MARKET NEWS SERVICE, Feb. 5, 1988 (citing NMB estimate by NMB). Martin Schubert, on the other hand, estimated the volume in 1987 to be only US\$10 billion. See Schubert, *supra* note 152, at 6. Indeed, there was one estimate as low as the US\$5 billion to US\$8 billion range. See Anayiotos & De Pinies, *supra* note 156, at 1665.

431. Schubert, ever scornful of high estimates which he considered fanciful and ridiculous, estimated that in 1988 over US\$20 billion face value of debt was traded in the market. See Martin Schubert, *The Growing International Debt Menace; Its Impact on the U.S. Banking Sector. How Serious is the Leveraging of America?*, speech delivered at the Executive Management Seminar sponsored by the Missouri Bankers Association, Kansas City, Kansas, Dec. 6-8, 1988 (copy on file with the *Fordham International Law Journal*). Remarkably, with the benefit of nine months for reflection, Schubert's estimate for 1988 volume had more than doubled to between US\$40 and US\$45 billion. See Martin Schubert, *The Secondary Market in LDC Debt - 1990 and Beyond*, speech delivered at the third Annual Latin America Financial Forecasts Conference, Miami, Florida Sept. 29-30, 1989, at 5 (on file with the *Fordham International Law Journal*). The Bank of England's estimate was US\$25 billion. See Urwin, *supra* note 310, at 68. Wallenstein's estimate was US\$30 billion. See Wallenstein, *supra* note 74, at 32. Libra Bank, a consortium bank based in London and a significant market participant, estimated market turnover to be as high as US\$40 billion in 1988. See Fidler, *supra* note 275, at 33. The estimate of US\$50 billion, which may well be too high, was made by Stone. See Stone, *supra* note 272, at S101.

sion and debt buy-back schemes providing the demand, the market was now growing at a dizzying rate.

Notwithstanding this growth in volume, the market remained exceptionally thin. At the end of this period less than two percent of total LDC debt was being traded⁴³² and there was a legitimate debate over whether the secondary market comprised a true financial market at all.⁴³³ A dramatic example of the thinness of the market was given by Richard Marin of Bankers Trust while speaking at a conference in 1988.⁴³⁴ Four banks were appointed by a large corporation to sound out the market with respect to acquiring US\$200 million face value of Brazilian debt, the most heavily traded in the market, for use in a debt-equity conversion. On the strength of these factors alone, and before the actual acquisition of any loans, the price went from about forty-two cents on the dollar to fifty-five cents on the dollar.⁴³⁵ In other words, other demand for Brazilian paper was so minimal that the mere rumour of the acquisition of three tenths of one percent of the total Brazilian debt resulted in a thirty percent price increase.⁴³⁶ Research by the Comptroller of the Currency disclosed that in the year 1988 about eight percent of the total stock of LDC debt changed hands,⁴³⁷ compared to an average *daily* turnover of six percent of the total stock of government securities.⁴³⁸ The concentration of the debt in the hands of the major U.S. and U.K. banks⁴³⁹ made a deeper market impossible.

In 1987, the most actively traded debt was of Chile and Mexico because of the demand supplied by their debt-equity schemes.⁴⁴⁰ In 1988, Brazil's debt was the most heavily traded for the same reason.⁴⁴¹

Throughout this period, the general trend in market prices

432. See Anayiotos & De Pinies, *supra* note 156, at 1656.

433. See DEBT EQUITY CONVERSIONS, *supra* note 6, at 19.

434. See *id.*

435. See *id.*

436. See *id.*

437. While, there are many ways of calculating such figures, the point is, nonetheless, well made.

438. Testimony of Mr Herriman of the Office of the Comptroller of the Currency, Federal News Service, June 27, 1989, at 21.

439. The major U.S. and U.K. banks only began to sell loans on relatively small scale in 1989 and 1990 whereas banks from other countries had been far more active in selling off or converting their LDC exposure. See ECLAC/CTC, *supra* note 118, at 138.

440. See Schubert, *supra* note 152, at 12.

441. See Fidler, *supra* note 275, at 33.

was consistently downward. Indeed, prices fell virtually without interruption between February 1986 and March 1989.⁴⁴² The only slight departures from this trend were provided by the stop-start operation of the various debtors' debt-equity schemes.⁴⁴³

Margins for traders contracted as the market grew, but overall margins remained robust. A typical margin on a routine transaction in this period was about one-half of one percent of the transaction amount.⁴⁴⁴

D. *Participants*

The market was described at this time as "a loose configuration of some fifty commercial banks, investment banks, and newly created boutiques that make markets, as principal and/or agent, for swaps and sales of LDC loans."⁴⁴⁵ Whether any of the traders at this stage were true market makers is highly questionable, but the estimate of the number of regular traders is about right.⁴⁴⁶

One of the major debt traders in this period was a small Dutch bank which had been in the market from the beginning and, unlike the boutique brokerages, had the capital to remain a major player. By its own estimate NMB had about twenty percent of the market in 1987 with US\$3.5 billion in trading vol-

442. See *From the Desk of Geoffrey Bell*, INT'L REP., June 8, 1990; Pettis Interview I, *supra* note 22.

443. In the words of Schubert, "In countries where debt equity conversion programs exist, secondary market trading in that country's debt accelerates and prices creep up. Where programs are not operative, or are tightly restricted, demand for that debt dries up and prices retreat." See Schubert, *supra* note 152, at 12-13.

444. See Pettis Interview II, *supra* note 106; but see Fidler, *supra* note 275, at 33.

445. See *Refresher Course — Swap Shop — The Whys and Ways of the Market in LDC Debt*, BARRONS, Sept. 4, 1989. This article was reporting the comments of Ken Hoffman and Lawrence Krohn of Shearson Lehman Hutton.

446. In October 1987, Martin Schubert thought there were probably more than fifty traders, "although about eight institutions probably account for more than 85 percent of the volume." See Martin Schubert, *A Critical Appraisal of the Changing Secondary Market for Discounted Third World Debt*, address delivered at the Debt-Equity / Swap Market Conference sponsored by the Institute for International Research, New York, NY October 19-20, 1987 (on file with the *Fordham International Law Journal*). New players were still entering the New York market during this period. For instance, in July 1988 Midland Montagu, the investment banking subsidiary of the British Midland group, assembled a new asset trading group in New York to trade Midland's own portfolio and others LDCs loans and to complement its London group. See *Midland Montagu Hiring for New LDC Unit*, BANK LETTER, July 18, 1988. Such trading groups were not necessarily large — Midland sought three traders for this operation.

ume.⁴⁴⁷

Another major trader was Libra Bank, a consortium bank formed in London to hold and trade LDC debt. It claimed to have traded US\$1.2 billion face value of debt in 301 transactions in 1986, US\$2.6 billion in 681 transactions in 1987, and US\$5.6 billion in 1,667 transactions in 1988.⁴⁴⁸

This period saw a new type of participant in the market — individual investors.⁴⁴⁹ These investors had to be comfortable with large risks and typically were either from the debtor nation or knew it well.⁴⁵⁰ The minimum face value of investments tended to be about US\$1 million, as transaction costs made smaller purchases uneconomic.⁴⁵¹ However, such purchases were not only for millionaires — US\$1 million face value of Argentine debt could be acquired in May 1988 for about US\$290,000 and, for the brave, the same amount of Peruvian debt was available for about US\$90,000.⁴⁵²

While some traders, such as Merrill Lynch, had a policy of not encouraging individual investors; more were active in promoting the debt to individuals.⁴⁵³ While the risks were signifi-

447. See Tobin, *supra* note 431; Tobin, *NMB's Record Year for LDC Debt Trading* 721 IFR 1287 (Apr. 23, 1988). NMB was subsequently acquired by and merged into the Internationale Nederlanden Groups ("ING"). Traders were notorious for overstating their level of business in this market in which there was no way to verify volumes done. The option of counting the total amounts of debt traded, which in swaps results in the one transaction being counted twice, was a convenient method. This is not to impugn NMB's estimates, but merely to put it into context. There is no doubt NMB was a major player in this market at this time. Within Latin America it had trading desks in Sao Paulo, Montevideo and Buenos Aires. In 1990 it was described as a "disproportionately influential participant in developing country's debt markets, particularly in Latin America, where it is almost certainly the largest single player." See DEBT EQUITY CONVERSIONS, *supra* note 6, at 27.

448. See 764 INT'L FIN. REV. 25 (1989) (advertisement by Libra Bank PLC dated Jan. 30, 1989); See also 1988's Scales Tip in *Libra's Favour* 766 INT'L FIN. REV. 30, Mar. 11, 1989.

449. While the odd individual had bought debt from time to time, their first appearance in significant numbers was in 1987-1988. The transfer of loans was generally restricted to "banks or financial institutions," so individual investors would have to own such an entity to participate in the market. Of course, depending upon the view of the central bank of the particular debtor, a corporation with the sole function of investing in LDC debt could well be considered a financial institution.

450. See George Anders & Peter Truell, *For Investors Who Are Strong of Heart, Third-World Debt Holds Some Allure*, WALL ST. J., May 17, 1988.

451. See *id.*

452. See *id.*

453. *Id.* Examples of these are Bear Stearns, Drexel Burnham Lambert and Nederlandsche Middenstandsbank. *Id.*

cant the rewards that could be realized by receiving a large coupon on the full face value of a loan for which one had paid, perhaps, fifty cents on the dollar were, perhaps, disproportionately larger.⁴⁵⁴

E. *Impact of the Market*

Quite simply the primary impact of the market in this period was that it made debt-equity conversions possible. The economic *raison d'être* of conversions was that the investor and the host country could each share in the secondary market discount on the debt, so each party to the conversion was better off.⁴⁵⁵

As we have seen, the Citicorp reserving decision with which this period commenced was heavily influenced by the pressure that the secondary market prices brought to bear on banks' stock prices and by the dramatic improvement that U.S. regional banks had been able to realize on their balance sheets by off-loading their debt through the market.

The other major impact of the market in this period, was the opportunity it provided to many of the smaller U.S. banks and some European banks to divest themselves of their LDC loan portfolios.⁴⁵⁶ In the words of one senior banker, "the universe of banks involved in the debt crisis has shrunk dramatically."⁴⁵⁷ Many of these smaller U.S. banks, as well as many European banks, were proving increasingly reluctant to lend new money as part of each rescheduling package.⁴⁵⁸ From the perspective of these smaller banks, the leader banks had involved them in the debt crisis by encouraging their participation in the syndicated lending of the late 1970s and then eschewed all re-

454. See Pettis Interview II, *supra* note 106.

455. See Chamberlin, et al., *supra* note 278, at 417-18. Debt-equity conversions could have occurred without the secondary market as banks converted loans from their own portfolios and investors acquired loans on an ad hoc basis for conversion. However, conversions on the scale witnessed in this period could never have occurred without the support of an organized secondary market because sufficient amounts of debt would have not been available at such relatively low prices. See Schubert Remarks, *supra* note 93.

456. In 1988, Blackwell & Nocera wrote, "Most sales of debt paper have come from the continental European banks and smaller US regional banks with relatively small exposure to the heavily indebted countries." See Blackwell & Nocera, *The Impact of Debt to Equity Conversion*, FIN. & DEV., June 1988, 15.

457. See Ryser, et al., *supra* note 329, at 112 (citing Louis G Schirano, senior vice-president at First Interstate Bank Ltd).

458. See ECLAC/CTC, *supra* note 118, at 69.

sponsibility when the crisis broke. As the 1980s progressed, the smaller banks became increasingly disenchanted with the management of the debt crisis by the major banks which, by and large, comprised the steering committees for the restructurings. The smaller banks felt that there was a conflict between the duties of these large banks as members of the steering committee and their interests as the largest creditors of these nations.⁴⁵⁹ The smaller bank also thought that the large banks were being too lenient in the reschedulings and were taking steps that favored themselves over the community of lenders as a whole.⁴⁶⁰ The secondary market permitted many smaller banks to liquidate their exposure to the region. This reduction in the number of creditors and removal of many of those who were the most disenchanted simplified the process of gaining agreement to fresh restructuring packages and to the Brady bond proposals that were to come. The down side was that this trend led to an ever-increasing concentration of LDC debt in the hands of the U.S. money center banks. In the words of a U.N. sponsored study in 1989:

Thus, again, those banks which were the least prudent during the credit boom and least flexible during the debt restructuring process are being brought back to the forefront of the international debt crisis and, ironically, the debt crisis is becoming an essentially United States one, from the point of view of the creditor banks involved.⁴⁶¹

The secondary market made possible this substantial realignment of the creditors of the crisis.⁴⁶² The major money center banks began to use the market in this period. For instance, the twelve largest U.S. banks reduced their LDC expo-

459. See *supra* note 118, at 59-61 (providing consideration of one manifestation of this conflict in ECLAC/CTC).

460. See *id.* at 14-16. One such step taken by the restructuring committees which unduly favoured the leader banks was the grouping together of all loans to the corporations and government of one country together under the sovereign's guarantee. The leader banks had a much higher proportion of loans to private sector corporations than other banks. The loans to these borrowers, to whom the leaders had charged higher fees and interest rates to compensate for the higher risk, were by this step rendered equally creditworthy as the loans to sovereign borrowers made by the challenger and follower banks at lower fees and interest rates. *Id.*

461. See *id.* at 138.

462. This greater concentration of debt also led to the significant increase in volatility the secondary market was to experience.

sure by some US\$6 billion⁴⁶³ in the first three quarters of 1988 by the same means.⁴⁶⁴ However, this reduction in exposure was not sufficient to counteract the overall trend towards a greater concentration of the debt in the hands of the U.S. money center banks. In Canada, the escape route afforded to banks with small exposures was demonstrated by Toronto Dominion Bank which disposed of US\$1.7 billion of its LDC loans in 1988, leaving it with only US\$602 million of LDC debt.⁴⁶⁵ Such a radical reduction in exposure to LDC debtors would have been virtually impossible for Toronto Dominion without the secondary market.

Another interesting effect of the market in this period was its influence upon regulators. Market prices were factored into the calculation of the appropriate level of provisions on LDC debt by the Bank of England,⁴⁶⁶ were the basis of a proposal to Congress suggesting that banks mark their loans to market⁴⁶⁷

463. See Peter Truell, *Big Banks See Bonanza in Fourth Quarter — Brazil's Catch-Up on Interest Payments Is Main Reason*, WALL ST. J., Oct. 26, 1988.

464. The sales of loans into the secondary market played a larger part in these reductions of the LDC portfolios of the largest U.S. banks than did the conversion of these banks' own debt into equity. See Peter Truell, *Cutting Losses: When They Can't Take the Money and Run, Banks Agree to Swap Debt for Local Equity*, WALL ST. J., Sept. 23, 1988; See also *Chase to Continue Debt Sales, Loan Loss Reserves at 1988 Rate*, REUTER Bus. Rep., Jan. 23, 1989 (describing Chase Manhattan's experience which reduced its LDC debt portfolio some ten percent in 1988 from US\$8.6 billion to US\$7.9 billion through loan conversions and sales); Phillip T. Sudo, *Chase Announces Plan to Fortify LDC Reserve*, AM. BANKER, Jan. 24, 1989, at 3.

465. See Fred Langan, *Canadian Banks Clear LDC Debt*, THE CHRISTIAN SCIENCE MONITOR, Nov. 30, 1988, at 22.

466. In the United Kingdom the secondary market prices were factored into an equation, formulated by the regulator, the Bank of England, to determine the extent of provisions which ought to be taken against exposures to different nations. See Letter from the Bank of England, with enclosures, to all U.K. incorporated institutions authorised under the Banking Act, Aug. 5, 1987 (on file with the *Fordham International Law Journal*); HAY & PAUL, *supra* note 296, 33 et seq. The prices were one of fifteen factors in the so-called matrix, ranging from debt/GDP ratios and debt/export ratios to over-dependence on a single crop or commodity. Some of these other factors were weighted more heavily than others. Nonetheless, this is an interesting official application of secondary market prices at a time when the market was still illiquid and prices were driven by many factors other than the economic fundamentals of the relevant borrower. See Stone, *supra* note 277, at 118. In 1990, the matrix was revised to retain secondary market prices as a factor. The revised matrix of 1990 is considered in Hay & Paul, *supra*, note 246, at 33-59.

467. In April 1989, Representative Joseph Kennedy (Democrat from Massachusetts) proposed to the House Banking Subcommittee that after two years on a bank's books loans, including LDC loans, should be marked to market value based on secondary market prices. See *House Panel Defeats Bank Accounting Change*, REUTERS, Apr. 11, 1989. While this proposal was defeated by a vote of 31 to 14, its incorporation of second-

and were used by the General Accounting Office in its investigation of the adequacy of the reserves required by the U.S. bank regulatory agencies.⁴⁶⁸ Indeed, the General Accounting Office consistently advocated the use of “secondary market prices as a primary consideration in setting reserve requirements.”⁴⁶⁹ The banking regulators argued against the use of secondary market prices by citing the failure of the market to differentiate between different debtor’s capacities to repay and the general inaccuracy of the market as a guide to the real value of the loans.⁴⁷⁰ Nonetheless, Congressional subcommittees put considerable pressure on the bank regulators⁴⁷¹ because of the secondary market prices and it is highly unlikely banks would have increased reserves as rapidly as they did without the pressure of secondary market prices. The market had, in effect, undermined the major reason for the ongoing lending of new money — to avoid the revaluation of these loans.⁴⁷²

dary market prices, illustrates the influence of these market discounts on the minds of bank regulators and politicians.

468. Further testament to the influence of the secondary market is found in a report by the General Accounting Office addressing the supervision of overseas lending. The GAO investigated the regulatory requirements of the Federal Reserve, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation and found their requirements to be lacking. This was due partly to the large gap between required reserves and the discounts in the secondary market. See Bureau of National Affairs, *Supervision of Foreign Lending Is Inadequate*, GAO Study Reports, Daily Report for Executives, May 13, 1988. The GAO relied heavily on the secondary market prices of January 1989 in its testimony given before the House Banking Committee recommending higher loan loss reserves for LDC debt. Moody’s Investors Services agreed with the recommendation in its testimony and based its conclusion upon secondary market prices and its own, in-house analysis of the capacity of debtor nations to repay. See GAO, *Moody’s Tell Congress Banks Are Under-Reserved for LDC Debt*, XIII, Bank Letter, Jan. 16, 1989, at 5.

469. See Testimony of Dr Mendelowitz, Federal News Service, June 27, 1989, at 6. The secondary market discount was also the foundation of various solutions proposed to the debt crisis at this time. See James D Robinson III, Chairman of American Express, *Third World Debt: What’s the Solution?; I2D2 Could Start Moving US\$250 Billion Problem Off Dead Center*, THE AM. BANKER, Mar. 11, 1988, 4. In late 1987, Moody’s cited the sharp decline in secondary market prices for LDC debt as one of the factors which prompted their placing most of the major U.S. banks’ credit ratings under review. Another reason given by Moody’s was the “decreasing cohesion with the bank creditor group” which as we will see was, in part, also a result of the secondary market. See *Moody’s Downgrades Latinos, Puts US Banks on Review*, 702 INT’L FIN. REV., Dec. 5, 1987, 3796.

470. See Testimony of Mr Herriman, FEDERAL NEWS SERVICE, June 27, 1989, at 21.

471. See generally *Testimony Before the Congressional Subcommittee*, FEDERAL NEWS SERVICE, June 27, 1989.

472. See MacMillan, *The Next Sovereign Debt Crisis*, 31 STAN. J. INT’L. L. 305, 329 (1995).

In summary, the principal impact of the market in this period was expressed by Fulvio Dobrich,⁴⁷³ who stated "Debt relief is already here. Brazil's latest package, the Mexico [Aztec] bonds, Chile's buyback, debt-debt and debt-product swaps are all forms of debt relief in the sense that they reduce the amount of debt on the books."⁴⁷⁴

While debt forgiveness remained a political hot potato, the secondary market made possible the latter three market initiatives listed by Dobrich. Debt relief could be a part of a formal or informal buy-back, a debt-equity swap, or a debt-product swap (such as the exchange of debt for exports) without attracting much political opposition.⁴⁷⁵ This was the most important impact of the market for the debtor nations in this period.

CONCLUSION

In its first six years, the face value of debt traded in the market increased from about US\$600 million to about US\$35 billion, and the number of trading houses increased from about eight to fifty. The basic transaction in the market changed from a loan swap to a cash sale. The change was facilitated by increasing levels of bank loan loss provisions and increasing realism from the accounting profession as to the value of these loans. This change simplified the market considerably and laid the groundwork for its explosive growth in the next period. The role of traders changed from hand-crafting each transaction, often involving numerous phone calls over a period of weeks in return for proportionally high fees of three or four cents on the dollar, to processing relatively standard trades quite quickly (although still not immediately as in mature securities markets) for fees that, while still generous, had declined to around one-half of one percent of face value. However, in this period one characteristic remained constant. The market remained thin and volatile, fluctuating wildly in response to actual or rumoured increases in demand for the debt.

In its first six years, the market had three principal effects

473. Employee of Manufacturers Hanover Trust.

474. See *The Debt Forgiveness Debate*, 745 INT'L FIN. REV., Oct. 8 1988, 3264 (quoting Dobrich).

475. This was probably due to the fact that because the complexity of the transaction masked the extent of the implicit debt relief.

and consequences. First, it brought pressure to bear on banks to increase their loan loss provisions. The secondary market shined the harsh light of reality onto the value of the banks' LDC debt portfolios. Without the market, the major U.S. and U.K. banks would not have taken loan loss provisions as early or as substantially as they did. The fiction that these loans were worth their full face value would have been continued long past May 1987 and may have made the Brady Plan impossible. If all of the losses occasioned by the securitization of the loans into Brady bonds had been taken onto the bank's books at one time, it is highly unlikely that the Plan would have gotten off the ground. The reality testing forced by the market upon the banks eventually benefited them.

Second, the market facilitated the exit of certain banks from LDC lending. It enabled regional U.S. and Continental European banks to dispose of their LDC debt portfolios in the late 1980s and early 1990s. These banks could do what their larger cousins could not because, generally, their exposures were relatively small, their loan loss provisions relatively large, and their capital relatively healthy. Many of these banks took the opportunity and got out of LDC lending altogether. This led to a breakdown in creditor solidarity as more and more of these banks refused to participate in the extensions of new money that accompanied each restructuring under the Baker Plan. Particularly, many regional U.S. and Continental European banks decided not to advance new money based on loans they had made previously and since sold. This unraveling of the Baker Plan made a new plan necessary and thereby helped bring about a radical new approach, the Brady Plan, which was to benefit all banks.

Third, the market facilitated debt-equity swaps, debt buy-backs and other debt exchanges. The secondary market provided the debt for use in debt-equity swaps, debt-for-nature swaps, debt-for-development swaps, and debt buy-backs, each of which afforded a measure of debt relief to the debtor nations. Without a secondary market, debt-equity swaps would only have been open to the original bank creditors, whereas the major users of this device were multi-national corporations increasing their investment in the host country. Debt-equity swaps were a boon to banks. They provided the opportunity for banks to convert their loans into direct investments in the debtor nations; they provided a demand for the debt so that banks that wanted

to sell their debt at a discount could do so, and they provided a significant income to the trading desks, most of which were in banks, from assembling the portfolios of debt for conversion.

Whether debt-equity swaps were as positive for the debtor nations is a more complicated issue, principally because of their inflationary effect, although they are generally portrayed as positive. Debt-for-nature and debt-for-development swaps contributed to nature conservancy and development programs in the debtor nations, but were on too small a scale to have an appreciable effect on levels of indebtedness. Debt buy-backs, on the other hand, were the principal source of debt relief for debtors. They afforded many times the debt relief of debt-equity programs while attracting a fraction of the attention. Indeed, the very degree of relief contributed to the parties keeping relatively quiet about these transactions. Particularly when secondary market prices for the nation's debt were especially low, the short-term costs of the buy-back would be recouped entirely by the interest savings of the next few years, if, in fact, they were not funded by the savings from a moratorium on the repayment of interest that had driven secondary market prices so low in the first place, as was the case with Brazil. Furthermore, buy-backs were typically funded with foreign exchange reserves, not by printing money or by issuing local currency bonds and, therefore were not inflationary. In sum, from the debtor's perspective, buy-backs were an effective form of debt reduction and the greatest gift the secondary market gave the debtor nations.