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Federal Reserve Board's Liberalization of Restrictions on LDC Debt-Equity Swaps, The Recent Development

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THE FEDERAL RESERVE BOARD'S "LIBERALIZATION" OF RESTRICTIONS ON LDC DEBT-EQUITY SWAPS

INTRODUCTION

Historically, the U.S. banking system has been based on the notion that banks should only engage in financial activities and should limit their involvement in commercial investment to the smallest extent possible. Yet, the ability of banks to maintain this separation has been challenged by the onset of the Latin American debt crisis. In the past two or three years, banks and private investors have developed a method by which a Less Developed Country's (LDC) debt might be retired. The debt retirement is accomplished through transactions known as debt-equity conversions, or, more commonly, "debt-equity swaps." In one example of such swaps, investors purchase LDC debt, which in most cases has been recently restructured, from U.S. banks at a discount, redeem the debt from LDC central banks in exchange for local currency, and then reinvest in the local economy. This method of debt retirement is attractive to U.S. banks because they are relieved of the burden of maintaining questionable debt on their books. It is not, however, fully responsive to their needs because they are often forced to sell the debt at a sizable discount and incur a sizable loss. Nevertheless, this result is clearly preferable to the potential losses which would result from complete default.

Recently, banks have sought to avoid selling their debt at a discount by engaging in swaps directly with the LDC authorities themselves and

1. See 12 C.F.R. § 211.5(a) (1988).


3. In the secondary market for selected Euro-credit sovereign debt in the fall of 1986, prices realized on the secondary market ranged from as little as 22% of face value for Peruvian debt to as much as 75% of face value for debt originating in Brazil. Id. at 85. In Chile and Mexico swappers can get anywhere between 60 to 70% of face value. Ollard, The Debt Swappers, Euromoney, Aug. 1986, at 69, 71.

4. Initially, banks only participated in swap transactions as intermediaries. For example, in May 1986, Nissan Motor Company sought to expand its subsidiary in Mexico through an investment of $60 million. Berg, U.S. Banks Swap Latin Debts, N.Y. Times, Sept. 11, 1986, at D5, col. 2. Rather

163
converting their book debt into the equity of local companies, often at less than a 10 percent discount from the face value of the original loan.\footnote{5}

The obstacles facing banks in structuring these transactions have come not only from the regulations imposed by LDC central banks, but from the U.S. Federal Reserve Board as well. Under the Federal Reserve Board's (FRB) Regulation K\footnote{6}, banks are prohibited from holding equity securities of nonfinancial companies abroad, except in limited situations.\footnote{7}

Recently, however, the FRB has liberalized Regulation K and eased the restrictions on such holdings, giving banks more authority to engage in direct debt-equity swaps.\footnote{8} This Recent Development sets out the general provisions of Regulation K both as initially amended and as currently drafted. It comments on its major provisions, and concludes that while the efforts of the FRB are noteworthy and in the right direction, they are inadequate to provide U.S. banks with the flexibility they require to manage their debt exposure difficulties. Because the regulations are too rigid and are fundamentally incompatible with the swap programs designed by the LDCs themselves, Regulation K will need further

\footnote{5}{See Berg, supra, note 4, at D1, col. 3. In Mexico, for example, those who redeem sovereign debt may do so with only a 10% discount from the face value of the original debt. See id. at D5, col. 2. This small discount is particularly attractive in light of the fact that the secondary market for LDC debt has become increasingly unattractive. For example, in March 1987, secondary market prices for Argentine debt allowed banks to sell at a 36-38% discount from the original loan value. By March 1988, Argentine debt was only selling for 26-28% of its face value, i.e., at a 72-74% discount! Dionne, Revenue Ruling on Debt/Equity Swaps Leaves Unanswered Questions—To the Delight of the Tax Bar, Tax Notes, April 11, 1988, at 166, 167. Direct bank swaps thus provide increasingly more attractive debt retirement opportunities.}

\footnote{6}{12 C.F.R. § 211.5 (1988).}

\footnote{7}{See id. See also Bank Holding Company Act of 1956, as amended, 12 U.S.C.A. § 1843 (West Supp. 1987).}

DEBT-EQUITY SWAPS

amendment if it is to truly serve the current needs of U.S. banks.

LDC Swap Programs and Restrictions

While debt-equity swaps may appear an ideal solution to the debt crisis, LDCs have been somewhat reluctant to fully allow private investors to convert their debt into local equity. This is due in large part to concerns about the undesirable investment incentives that swaps may create, and the derivative effects that swaps might have on LDC economies. For example, LDCs sometimes feel that swaps would allow domestic investors to use flight capital to reinvest in the economy on a subsidized basis. Many LDC governments have therefore expressly refused to allow nationals who took their capital abroad years ago to now bring that capital back at a discount, regardless of the potential benefits that a capital infusion would have on their economy. Direct bank swaps would at least

<table>
<thead>
<tr>
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<th>Face Value of Debt Retired</th>
<th>Total External Debt (12/86)</th>
<th>% Retired</th>
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<tr>
<td>Chile</td>
<td>1.38</td>
<td>20.74</td>
<td>6.7</td>
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<tr>
<td>Brazil</td>
<td>1.99</td>
<td>110.68</td>
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<td>Mexico</td>
<td>1.65</td>
<td>101.72</td>
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<td>Argentina</td>
<td>.52</td>
<td>48.91</td>
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<td>Phillipines</td>
<td>.28</td>
<td>28.17</td>
<td>0.99</td>
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<tr>
<td>Total</td>
<td>5.82</td>
<td>310.22</td>
<td>1.9</td>
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Sources:


Swap figures: L. ALEXANDER, DEBT CONVERSIONS: ECONOMIC ISSUES FOR HEAVILY INDEBTED DEVELOPING COUNTRIES (Federal Reserve Board International Finance Discussion Paper No. 315, 1987) (Table 2).

10. See generally Evans, Sophistication Marks the Mexican Program, EUROMONEY, Jan. 1988 (Special Supp.) at 44 [hereinafter, Evans, Sophistication].

11. The term "flight capital" refers to the removal of money from the local economy by domestic investors, which is then reinvested in foreign assets. Morgan Guar. Trust, LDC Capital Flight, WORLD FIN. MKT. 13 (Mar. 1986).

12. Glynn, The New Latin Beat in Investment Banking, INSTITUTIONAL INVESTOR, 90, 97 (Oct. 1987). Between 1976 and 1985, estimated capital flight from the largest debtor nations totalled $97 billion. Capital flight from individual nations has ranged from $53 billion in Mexico to $9 billion in the Phillipines. It is worth noting that Chile, which has utilized swaps more than any other debtor nation, has actually experienced a capital inflow of $1 billion over this period. Morgan Guar. Trust, supra note 11, at 13.

13. Glynn, supra note 12, at 97. Chile's Chapter 18 program, for example, permits nationals to retire domestic debt by buying sovereign paper at a discount abroad. Mexico seems to be moving to
remove the concerns of those who are averse to the use of flight capital. Such swaps would encourage inflows of foreign capital which would not have occurred otherwise.

LDCs are also concerned about the inflationary effect that swaps might have on the economy, since new local currency would have to be generated in order to redeem the debt and allow for the purchase of converted equity. Clearly, central banks would prefer for local investments to be funded through an infusion of new foreign exchange rather than swaps which require creation of new local currency. Some central banks have resolved this dilemma by redeeming foreign debt through the issuance of new local debt. Others, such as Argentina, require that investments be funded with a minimal level of alternative financing and new money. Nonetheless, concerns over monetary policy have prompted some LDC governments even to consider abandoning their swap programs altogether.

An important concern of U.S. banks is the potentially antagonistic reaction of LDC domestic investors and businesses to the ability of foreign investors to invest using discounted debt swaps to which domestic investors do not have access.

Such widely recognized problems place great local pressures on central banks to limit the designation of convertible debt and reduce the overall level of foreign capital inflows. Debt-equity swaps may also present political problems in that they result in foreign control of domestic enterprises, many of which may ultimately represent the country’s most lucrative investment opportunities.

LDC central banks consequently have been cautious in allowing LDC debt to be classified as “convertible.” Thus far, less than three percent of Latin American debt has been designated as “convertible.” Consequently, adopt similar procedures, albeit with a tax bite that may limit their appeal for flight capitalists, or sacadolares (dollar takers). But other Latin governments are still wary. “Chile doesn’t give a damn where the money comes from,” says a leading Latin investment banker, “but Argentina keeps preaching, ‘We won’t condone a crime.’” One commercial banker says: “All these countries are going to have to turn a blind eye if they want flight capital to return. They have to stop worrying about who ripped the country off ten years ago.”

15. Glynn, supra note 12, at 97.
16. Evans, Sophistication, supra note 10, at 44. In November, 1987, concerns in the Mexican government about the monetary and inflationary impact of swaps prompted the government to temporarily suspend its program while the Ministry of Finance evaluated the negative effects of the swap program on the budget deficit. The Government decided to reinstate the program and designate approximately $1.8 billion of debt as eligible for conversion. Id.
17. See, Glynn, supra note 12, at 102. “There is ‘plenty of institutionalized antagonism toward foreign capital—it’s a reality we have to live with,’ admits Pedro Leitaolda Cunha, president of Bank of Montreal’s Brazilian investment bank.” Id.

166
DEBT-EQUITY SWAPS

banks and corporations alike are faced with a severely limited number of opportunities to engage in debt-equity swaps.\textsuperscript{18} A natural consequence of this limited availability will be heightened competition in seeking approval of swap deals from LDC central banks.\textsuperscript{19}

The FRB's General Foreign Investment Restrictions on Banks

In addition to the obstacles to direct debt-equity swaps imposed by the LDC's themselves, the FRB further restricts the capacity of U.S. banks to engage in these swaps. Generally, the FRB requires that banks confine themselves to activities which are essentially of a banking or financial nature.\textsuperscript{20} Consequently, banks are greatly restricted in their ability to make equity investments in nonfinancial enterprises, whether domestic or foreign.

Presently, banks may make equity or "nonportfolio" investments through bank subsidiaries or joint ventures only if the investee company engages in business activities allowed by Regulation K.\textsuperscript{21} Among those activities considered acceptable are banking and financial services, insurance, management consulting, and other ventures which are considered "closely related to banking."\textsuperscript{22} Thus, banks are effectively prohibited from making nonportfolio investments in nonfinancial enterprises.

The underlying policy behind the FRB's restrictions is a concern that once banks make equity investments in nonfinancial enterprises, they will have significant incentives to commit resources, both financial and managerial, to ensure the success of those companies.\textsuperscript{23} The FRB is also con-

\begin{itemize}
  \item \textsuperscript{18} Id., at 93. For example, Mexico, one of the largest debtor nations, is only designating $1.8 billion of its approximate $91 billion debt as convertible. Evans, \textit{Sophistication}, supra note 10, at 44.
  \item \textsuperscript{19} Even in cases where LDC central banks have fallen short of expressly prohibiting swaps in certain economic sectors, they have nonetheless provided significant incentives for investors who swap in certain sectors. Under the Mexican swap program, "The government gives a better discount if banks invest in priority industries. Of the $1.5 billion of debt capitalized up to May 1987, more than half was split between two sectors, according to figures provided by Bolsa Inverlat. More than $350 million went into the car industry, and $251 million into the tourist industry." Evans, \textit{Sophistication}, supra note 10, at 50.
  \item \textsuperscript{20} 12 C.F.R. § 211.5(a) (1988).
  \item \textsuperscript{21} 12 C.F.R. § 211.5(b)(1) (1988).
  \item \textsuperscript{22} See 12 C.F.R. § 211.5(d) (1988).
  \item \textsuperscript{23} See infra note 43 and accompanying text. The Federal Reserve Board's (FRB's) concerns are not completely unfounded.
\end{itemize}

[F]or many banks, LDC debt trading calls for a change of thinking and planning which is very alien to them. 'In this area bankers are now portfolio managers. It's a very radical departure from traditional bank asset management,' said Thomas Coyne, a director in the
cerned that banks may undertake investments which are unduly risky or in which they lack expertise, thereby threatening the interests of U.S. depositors and creditors.  

1987 Amendments to Regulation K

Under the original version of Regulation K, U.S. banks were generally prohibited from owning equity interests in nonfinancial enterprises unless the investment was categorized as a "portfolio investment," meaning that it constituted less than 20 percent of the voting power of the investee company. 25 On August 12, 1987, the FRB issued proposed amendments to Regulation K, intending to liberalize the restrictive nature of the regulation. 26 Under this version of Regulation K, banks would be allowed to own up to 100 percent of the outstanding capital stock of a foreign company only if: (1) The company was acquired from an eligible foreign government; (2) The country in which the company was located had restructured its sovereign debt since 1980; (3) The ownership interests of the bank were to be divested no later than five years from the date of acquisition, unless the FRB granted an extension for good cause, although in no case more than five additional years; and (4) The investment was held through a bank holding company. 27 If a transaction involved more than $15 million or exceeded 5 percent of the total capital and surplus of the investor-bank, the bank had to obtain consent from the FRB during a 45-day notice period. 28 Finally, it was recommended that banks avoid any Latin American division of Chase Manhattan's investment bank in New York.

Evans, How the Banks Have Seen the Light, EUROMONEY, Jan. 1988 (Special Supp.), at 4, 6.

The risks associated with these investments may be exacerbated by the acquisition of the investment in a debt-for-equity swap environment where the investor may not devote the same care and attention to the acquisition because the investment is being made with funds already committed to heavily indebted countries.

Id.

31. 12 C.F.R. § 211.5(c)(1)-(2) (1988).
DEBT-EQUITY SWAPS

interlocks of their directors or management with that of the investee company, except to the extent that it was administratively necessary. 83

The reaction of the banking community was uniformly critical. 85 As discussed below, it was felt that, while Regulation K certainly had to be liberalized, the “liberalization” proposed by the FRB was more apparent than real. On February 24, 1988, the FRB issued its final version of Regulation K after having reviewed the comments from 23 banks, bank holding companies, trade groups, and members of Congress. 84 In its final version, the FRB made four major changes to Regulation K: (1) banks are now permitted to swap for equity in private companies, although only under limited circumstances 86; (2) banks are permitted to extend limited loans to investee companies 86; (3) banks are permitted to maintain their ownership of equity until after the repatriation of profits and capital is allowed by the LDC government, although in no event longer than 15 years 87; and (4) the general consent limit has been raised to as high as 1 percent of the investor’s equity capital or $15 million. 88 Each of these requirements will be analyzed individually since they each present banks with separate legal roadblocks.

Restrictions on Classes of Eligible Debt

Perhaps the most significant limitation in the final form of Regulation K is that U.S. banks may swap sovereign debt for 100 percent equity interests only in companies that are currently owned by the government and are to be privatized, while they are permitted to swap only for a

32. Regulation K, 52 Fed. Reg. at 30,913-14. Using similar justifications, the FRB “believes that the banking organization and its nonbank affiliate should not have similar names. Even if there is a legal and functional separation between the bank and its affiliate, there is a danger that the market will perceive the banking organization and the affiliate as one.” Id. at 30,913. To ensure that the bank is also acting prudently and according to traditional banking practices, the FRB also requires that the bank “carefully evaluate the soundness of an investment before it is made. In this connection, an investor would be expected to demonstrate that it has conducted a thorough due diligence review of a proposed investment.” Id. at 30,914.

33. See generally Responses to Request for Comment, Docket R-0610, Federal Reserve Board (1987). “It’s a silly impediment and so obviously illogical in the light of today’s circumstances,” said Richard Huber, a senior Citicorp banker in New York. William Rhodes, the leader of Citicorp’s debt negotiating team, agreed. ‘Regulation K definitely needs changing’.” Evans, New Debts for Old-And the Swapper is King, EUROMONEY, Sept. 1987, at 72, 89 [hereinafter Evans, New Debts].


35. Id. at 5359-61, 5363 (to be codified at 12 C.F.R. § 211.5(1)(2)(ii)).

36. Id. at 5359-60, 5363 (to be codified at 12 C.F.R. § 211.5 (1)(2)(ii)(B)).

37. d. at 5359-60, 5363 (to be codified at 12 C.F.R. § 211.5 (1)(2) (ii) (B)).

38. Id. at 5361-62, 5363 (to be codified at 12 C.F.R. § 211.5 (1)(5)).
maximum of 40 percent of the equity of private companies. Regulation K unquestionably discourages U.S. banks from converting their book debt into private equity. One likely justification for this policy is that it encourages LDCs to begin denationalizing their industrial bases. Notwithstanding this development objective, this restriction raises serious doubts about the ability of banks to engage in direct swaps at all.

Although the preferential treatment that privatizing companies receive under Regulation K may encourage denationalization, strong resistance to privatization remains in some LDCs. It is important to reiterate that little debt is available for conversion in the first place. Of the available debt, virtually none of it is convertible into the equity of privatizing enterprises. Only Chile, Mexico, and, to a much lesser extent, Argentina, have engaged in privatization programs designed to swap debt for equity in public enterprises. Venezuela, in fact, prohibits swaps with state-owned enterprises and Costa Rica only permits 40 percent ownership in government enterprises. Given the limited number of government-owned enterprises available for debt-equity swaps, it is clear that Regulation K’s restriction on permissible investment in private companies will all but foreclose the possibility of banks engaging in lucrative swaps, unless they are satisfied with a small portfolio interest in the investee company.

Regulation K must take further account of the structures and restrictions in swap programs established by the LDCs if it is to effectively encourage U.S. banks to remove questionable LDC debts from their books. Even to the extent that government-owned enterprises are in the process of being privatized and available for debt-equity conversion, they would, at least initially, represent substandard investment opportunities. State-owned enterprises typically suffer from financial difficulties, such as cost inefficiencies, labor problems, high levels of indebtedness, and a lack of competitiveness. These companies may be overstaffed and require sub-

39. Regulation K, 53 Fed. Reg. at 5363 (to be codified at 12 C.F.R. § 211.5(f)(2)).
40. For example, although unrelated to its swap program, Argentina’s ruling party, the Radical Civic Union, has made numerous proposals to begin privatizing Argentina’s key industries. These proposals, however, have not resulted in any action being taken, due to the extensive political opposition confronting them. See e.g., Coone, Argentina: Waiting for a Green Light, EUROMONEY, Jan. 1988 (Special Supp.), at 81, 83.
42. “The state of many of the nationalised companies in Latin America is not very good. They are heavily subsidized and protected. All the Fed’s decision does is to allow us to buy garbage . . . .” Evans, Bankers Proceed Cautiously with Debt/Equity Strategy, EUROMONEY, Jan. 1988 (Special Supp.), at 5, 8.
43. Chemical New York Corporation, supra, note 41.
DEBT-EQUITY SWAPS

Substantial layoffs before they could be operated profitably. Beyond the specific problems facing any given enterprise, it is clear that significant restructuring would be required on the part of the investor bank to ensure the safety of its investment. This would necessitate investing significant management and financial resources, a commitment which runs counter to the very purposes of Regulation K. In its comment accompanying the 1987 amendments to Regulation K, the FRB stated that the limitations on swaps for equity in private companies were designed to avoid the possibility that "the affiliation itself could cause the banking organization to extend credit to the nonbank affiliate on other than market terms, even if the affiliate is not creditworthy." Yet, by effectively restricting banks to investing in newly privatized industries, Regulation K promotes the acquisition of substandard and risky investments in which the banks might not otherwise invest.

A final caveat is that state-owned enterprises generally engage in politically-sensitive production, such as telecommunications, and if the companies were to be made sufficiently profitable after their conversion, there is the everpresent risk of renationalization and the possibility that the LDC may freeze dividends in the future. Buying political risk insurance against such eventualities would add considerably to the costs of the swap.

The FRB has allowed U.S. banks to engage in private swaps, albeit under highly limited circumstances. First, banks may swap for no more than 40 percent of the shares, whether voting or nonvoting, of private companies. Second, U.S. banks may own more than 25 percent of the stock "only if another shareholder or control group of shareholders unaffiliated with the bank holding company holds a larger block of voting shares of the company." Third, supplementary loans and credits to the company must be limited to 50 percent of the total credit sought by the investee company, meaning that the company will have to acquire at least 50 percent of its loans from other sources. Finally, the bank's representation on the board of directors is to be proportional to its equity holdings. In its February, 1988 comments, the FRB explains that these new provisions will meet the needs of both the banks and the FRB itself.

45. Evans, New Debts, supra note 33, at 97.
46. Regulation K, 53 Fed. Reg. at 5363 (to be codified at 12 C.F.R. § 211.5(f)(2)(ii)).
47. Id.
48. Id.
49. Id.
50. Id. at 5360. "This approach responds to the interest some U.S. banking organizations have expressed in making more than just portfolio investments in private sector nonfinancial companies, while also helping to assure that banking organizations do not assume all of the risks associated with
Banks would be able to diversify their swap portfolio while at the same time be prevented from taking daily responsibility for management of the private enterprise.

Limiting U.S. banks to public swaps would, however, render them less competitive vis-a-vis private investors and foreign banks which are free to convert their debt holdings into more attractive investment opportunities in the private sector. Since private opportunities will probably generate a greater return, these nonregulated investors will be able to more quickly recoup the outstanding interest and principal previously due, through higher dividend shares. To date, banks searching for lucrative swap opportunities have focused mostly on export-oriented investments. In Chile, for example, the prime opportunities have been in forestry, fresh fruit, and agro-industry, all of which U.S. banks would be able to participate in, albeit in a limited capacity. It is critical that the U.S. banks be able to fully participate in these opportunities. The greater the return, the sooner the bank can divest itself of its holdings, the stated primary objective of the FRB in promulgating Regulation K.

Bank Holding Company Limitation

Under Regulation K, banks under the Federal Reserve system are prohibited from holding converted equity (unless it is classified as "portfolio") except through a bank holding company. This restriction was not altered by the 1988 final regulation. The FRB has justified this restriction by noting that "this form of ownership attempts to erect an effective barrier between the bank and the commercial and industrial activities of the companies to be acquired." While it is important to shield banks from the potential insecurity of investments in LDC commercial enterprises, and to limit direct involvement of banks in nonfinancial activities, there

operating and controlling commercial and industrial companies." Id.

51. The use of debt-equity conversions by private corporate investors, through the use of debt purchased on the secondary debt market is not subject to the private enterprise ownership limits which Regulation K imposes on banks. Id. at 5359.

52. Mark, Chile: Foreigners Find Favour and Incentives, Euromoney, Jan. 1988 (Special Supp.), at 64, 68.

53. The FRB states in its comment accompanying Regulation K that; "[b]ecause the amendment is intended to provide flexibility in managing portfolio of loans to heavily indebted countries and is not intended to permit permanent investments in nonbank concerns, the equity interests acquired under this proposal must be divested after a temporary period when it becomes feasible." Regulation K, 52 Fed. Reg. at 30,913.

54. See supra text accompanying note 25.

55. See supra note 30 and accompanying text.

DEBT-EQUITY SWAPS

are significant problems with this approach which may overshadow any protection that this requirement might provide.

Many of the problems of bank holding company (BHC) ownership stem from potentially adverse tax consequences in the United States. First, since the debt is originally held by the bank itself or by a subsidiary, the bank would need to transfer the debt to the BHC prior to the swap in order to comply with Regulation K. This transfer would generally be accomplished by selling the debt to the holding company, since, in most cases, the debt would be too large to be distributed as a dividend. When the sale occurs, the bank will most likely realize a loss for tax purposes because, owing to the debt's questionable status, its fair market value will have dropped. The BHC, however, will record all profits from the acquired shares. Assuming that the BHC and the bank would be treated separately, this could create confusion in the recognition of actual profits and losses for domestic tax purposes, and also make it difficult for the banks to utilize their foreign tax credits. One solution to this prob-

57. Such adverse consequences flow not only from the sale of the debt to the bank holding company (BHC), but also from the tax benefits which will now accrue to the BHC rather than to the bank itself. Under Revenue Ruling 97-124, the actual debt holder, i.e., the BHC, will be allowed to recognize an immediate loss resulting from the swap of the debt for foreign exchange. Rev. Rul. 97-124, 1987-2 C.B. 205. This loss will be recognized to the extent that the debt holder's adjusted basis in the debt exceeds the fair market value of the foreign currency received. Id. at 206. The realization of a loss for U.S. tax purposes will almost be assured in a LDC swap transaction, because "[the revenue ruling's] conclusion that the Central Bank's restrictions on the use of the [foreign exchange] will generally reduce [its] FMV (fair market value) should be helpful in arriving at a low valuation." Connors, Recent IRS Ruling Focuses on LDC Debt Transactions, 14 INT'L TAX J. 285, 287. Cf. I.R.C. § 964(b) (1986) and Treas. Reg. 1.964-2(b) (1986) (Blocked assets election provisions, which also allow lower valuations in swaps where the LDC prohibits capital repatriation.). Again, it is important to reiterate that the bank will not be able to directly benefit from the loss deductions. For a general discussion of the tax effects of different swap transactions, see Dionne, supra note 5.

58. A significant question about these losses is raised under the 1986 Internal Revenue Code, as amended in 1986, because in the FRB comment on Regulation K, it states that "any loans to the nonbank company acquired pursuant to this amendment should be considered 'investments' in that company and subject to the same investment procedures as apply to investments made in the form of equity." Id. If these investments are viewed as capital investments, then any such losses or gains would fall within the scope of § 1221 and § 582 of the Internal Revenue Code, which is particularly of concern to the bank in a loss situation. 26 U.S.C.A. §§ 582, 1221 (Supp. 1988).

59. See Mellon Bank, Response to Request for Comment, Docket R-0610, Sept. 30, 1987 (available through the FOIA office of the Federal Reserve Board) [hereinafter Mellon Bank]. Under Section 902(a) of the Internal Revenue Code, only the U.S. equity holder itself (the BHC) can take advantage of the foreign tax credit, to the extent that the it is even available. See J. MERTENS, LAW OF FEDERAL INCOME TAXATION § 45-4.03. This undoubtedly creates tax credit accounting difficulties. Furthermore, to the extent that the BHC is not able to fully utilize the foreign tax credit, there are only limited carryforward and carryback provisions. See id. at § 45-4.19.

Revenue Ruling 87-124 also creates additional tax credit difficulties by failing to take account of
lem would be to exempt these transactions from § 23A of the Federal Reserve Act, thereby permitting a wholesale transfer of the debt without requiring the treatment of the transaction as either a sale or a dividend.\(^6\)

There are other tax problems worth considering as well. For example, under the Tax Reform Act of 1986, interest expense paid in connection with foreign income is treated more adversely for bank holding companies than for banks.\(^6\) Again, this reduces return to banks, requiring them to maintain their equity investment for a longer period of time.

The Bank Holding Company requirement also creates inconsistencies within the provisions of various LDC swap programs. Frequently, debtor countries require that the only investment vehicle be the bank itself or an existing subsidiary. Central banks seek to avoid the creation of intermediaries when effectuating the conversion, so that the holder of the original debt directly participates in the swap.\(^6\) Therefore, in such countries, U.S. banks again will be precluded from taking advantage of conversion opportunities as a result of the Regulation K restrictions.

**Equity Divestiture**

Certainly one of the most controversial requirements of Regulation K, from the perspective of the U.S. banking industry, is that equity holdings obtained through debt-equity swaps may only be held for a specified period. As mentioned, the 1987 regulations allowed for a maximum holding period of 5 years, with the possibility of extensions of up to 5 additional years upon a showing of good cause by the bank.\(^6\) Under the final version of Regulation K, banks may hold equity until 2 years following the date on which capital repatriation is permitted by the LDC government, although in no case later than 15 years.\(^6\) This restriction is meant to be similar to the limits imposed on equity acquired "to prevent loss upon a debt previously contracted" but subsequently defaulted.\(^6\) However, the

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Regulation K restrictions. Dionne, *supra* note 5, at 173. For example, in the event that the BHC is limited to less than 50% ownership (i.e., if the foreign company is private and/or is engaged in an impermissible activity), the foreign company will then be considered a noncontrolled foreign corporation under I.R.C. § 904(d)(2)(c), thereby making it more difficult for the BHC to qualify for the foreign tax credit. "In view of the limitations of Regulation K and the fact that many countries impose limitations on foreign ownership, tax credit accounting implications may impede debt/equity swaps." *Id.*

60. See *id. See also* 12 U.S.C.A. § 371c(c) (Supp. 1987).
62. See *Chemical New York Corporation, supra* note 41.
64. Regulation K; 53 Fed. Reg. at 5363 (to be codified at 12 C.F.R. § 211.5(f)(4)(i)).
DEBT-EQUITY SWAPS

analogy to these limits is misplaced since the debts being converted in this case are not technically in default, but are merely being repaid over extended periods. In fact, the conversions are designed to avoid a default, while the provisions of 12 C.F.R. § 211.5(d) are designed to recover losses once they have already occurred.66

U.S. bank responses to the 1987 regulations were extremely negative. The fundamental criticism of the initial divestiture restriction was its inconsistency with the requirements imposed by the LDC central banks. For example, in Argentina capital gains may not be repatriated until 10 years after the initial investment, while in Mexico and Brazil capital repatriation is not permitted for 12 years.67 In each of these situations, U.S. banks would have been unable to repatriate capital gains regardless of any allowable extensions by the FRB. Certainly this would not promote any of the FRB’s safety objectives. It is important to recognize that these extended LDC repatriation requirements are designed by the debtor nations to encourage long-term capital investments. In fact, it is under these conditions that LDCs are more willing to redeem debt obligations that otherwise would be repaid under extended restructuring programs.68

On its face, the FRB has taken great steps to correlate Regulation K with the restrictions imposed by the LDC central banks. Yet, even assuming that U.S. banks could begin to repatriate profits and capital under the newly liberalized system, the divestiture limits ignore the very purpose of debt-equity swaps and the needs of U.S. banks. The effect of the regulation is to force repatriation of capital at the earliest possible moment, regardless of whether repatriation at that time enables the bank to recoup its losses from the original loan. It is quite unlikely that banks will be able to convert newly privatized enterprises into sufficiently profitable investments and obtain adequate dividend income within even the extended divestiture period allowed under the 1988 amendments. While investments in more profitable private companies are now allowed, Regulation K still limits equity participation in those enterprises so that loan recoupment will naturally take longer. It is essential that banks, to the extent they are permitted to convert their debt into equity interests, are able to maintain those interests until they can command a price adequate to recoup their lost principal and interest.

Even assuming that sufficient profit and capital were available for repatriation, there is no guarantee that LDC central banks would possess

66. 12 C.F.R. § 211.5(d) (1988).
67. Chemical New York Corporation, supra note 41.

1988]
sufficient foreign exchange to enable U.S. banks to turn their investments back into dollars. Such considerations also point to the need for maximum flexibility in managing and holding equity investments.

The FRB suggests, however, that neither repatriation nor divestiture requirements pose any significant constraint since they “do not . . . prevent the sale of such companies to other foreign nonresidents” prior to the time of divestiture.69 This is not, however, a realistic solution since buyers will certainly be aware of the pressures imposed on U.S. banks to rid themselves of their equity interests. This would create a “fire sale” atmosphere, in which the prices commanded would be set in a buyers’ market. The restriction is supported by the FRB as promoting the policy that U.S. bank investments be temporary.70 However, it does not follow from this policy that divestiture limits be such that banks cannot recover sufficient profits through dividends to overcome the potential loss of interest and principal, particularly since that is the very purpose of swaps.

An alternative solution might be to state divestiture restrictions in terms of LDC restrictions, without setting any overall caps. Consultation mechanisms could be devised to assure the FRB that equity investments were being maintained strictly for recouping outstanding loans. In this way, the FRB would be assured that investments made will be temporary, while the banks would remain confident in their potential for recovering losses. A similar proposal has been made in the International Debt Recovery Act [IRDA], proposed by U.S. Senator John Heinz, although to date it appears unlikely that the proposal will be adopted.71

70. See id.
71. The International Debt Recovery Act (IDRA) would amend section 4(c)(13) of the Bank Holding Company Act (12 U.S.C. § 1843(c)(13)) to give bank holding companies the authority to hold equity interests in non-bank enterprises if the shares are acquired in connection with a conversion or exchange of debt securities or loans provided that:

(i) prior to effecting the acquisition of shares, the bank holding company has received prior approval of the Board for transactions in excess of $50 million or 2 percent of capital, whichever is smaller, or, for all other transactions, has provided at least 30 days' written notice to the Board and the Board has not, within such period, notified the bank holding company that such a conversion would constitute an unsafe or unsound banking practice,
(ii) the shares are not held for more than 10 years or, if later, 5 years after the investment may be legally repatriated in its entirety subject to the Board's authority to extend such period for good cause.

S. 1117, 100TH CONG., 1ST SESS. § 4(a) (1987) [hereinafter IDRA].
DEBT-EQUITY SWAPS

General Consent Limitations

The 1987 amendments to Regulation K did not change prior law regarding general consent. Banks were permitted to convert debt for equity without obtaining specific FRB consent unless the total amount invested exceeded either $15 million or 5 percent of the bank’s capital and surplus, whichever was less. The 1988 Regulation, however, has increased the consent limit to $15 million or 1 percent of the equity of the investor. The FRB continues to require 45 days notice of transactions that exceed the general consent limit. During that 45 day period, the FRB either grants or withholds its permission to go through with a particular transaction.

These requirements have obvious implications. First, U.S. banks wishing to convert their debt on a large scale will have to wait for 45 days before they are able to undertake major swap transactions. This will render U.S. banks less competitive in their attempts to negotiate the large debt conversions which would best help to reduce their debt exposure. Second, the $15 million ceiling is unrealistically low, as debt-equity conversions often reach levels as high as $100 million or more. For this reason, the IDRA contains a proposal that the general consent requirement be raised from $15 million to $50 million. While it is true that U.S. banks are not completely precluded from participating in such debt conversions, since the FRB could give its approval, the 45-day lag will place U.S. banks at a significant competitive disadvantage vis-a-vis private investors and foreign banks. As mentioned earlier, the eligible debt for swaps is scarce, and swap programs often require competitive bidding within short time frames. Because U.S. banks must wait 45 days before going through with large debt conversion transactions, such transactions may instead go to other investors who are able to enter into them without delay. In order to increase the competitiveness of U.S. banks the IDRA contains a proposal to lower the notice requirement to only 30 days.

The consent restrictions reflect the underlying concerns of the FRB.
about the overall risk exposure of U.S. banks participating in large nonfinancial ventures. However, since the risk accruing to any one bank depends on the size and diversity of its portfolio, a more sensible approach would be to express the consent limitation purely as a percentage of capital stock. Certainly a bank with assets of several billion dollars would not expose itself to significant risks by engaging in a swap transaction of $50 million, although a substantially smaller bank might. The 1988 amendments take a step in the right direction by using the 1 percent of equity consent limit. However, they still retain the $15 million as trigger to the FRB consent restrictions. Such ceilings are inflexible, and will unduly hamper the efforts of large U.S. banks with significant LDC debt exposure to generate a safer portfolio.

Another potential solution to the consent limit might be to condition the need for consent to the extent of ownership in the investee company. Investments accounting for less than 25 percent of the voting power should require no consent since they should be viewed as portfolio investments. Currently, the “portfolio” line is drawn at 20 percent ownership. That limit should be raised because U.S. banks will still be relying on local management to run the investee company. The need to obtain consent for ownership of up to 50 percent depends on the amount invested as a percentage of the equity of the investor bank. Only in the event of a controlling interest in the investee company should the bank be absolutely required to obtain consent from the FRB. The justification for this approach is that the exposure of the investor bank is directly correlated to its stake in the company’s performance and to the amount of management and financial resources that it will have to commit to ensure its investment is recovered.

Director and Management Interlock

The FRB, in its comment, warns:

[C]are should be exercised to ensure the separateness of the banking organization and the nonbank affiliate. To that end, it is expected that banking organizations will maintain few interlocks of officers and directors between the [bank] and the nonbank affilia-

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80. See supra note 74 and accompanying text.
82. See supra note 25 and accompanying text.
DEBT-EQUITY SWAPS

ate, and then only to the extent that it is administratively necessary.83

The interest in maintaining separateness is understandable, particularly for management interlocks. However, it is not self-evident that this prohibition should extend to director interlocks as well, since the FRB is willing to allow as much as 100 percent ownership of eligible enterprises.84 It is unrealistic to expect a bank to acquire a controlling interest and then not seek to maintain board representation to ensure that its concerns are being addressed. Privatizing enterprises often exhibit noncompetitive reflexes and require substantial restructuring.85 In these cases, it is almost imperative that a bank take at least a moderately active role in shaping the policies of the investee affiliate, at least until the investee begins operating in an appropriate manner without direct bank supervision.

In response to criticisms from the banking community, the 1988 amendments allow for board representation proportional to equity ownership in the more profitable, nonfinancial, private sector companies.86 This change is certainly consistent with the FRB's general concern that the banks only engage in safe investments. A moderate amount of bank representation on the board of directors will ensure that investees not act in ways which are detrimental to the investment interests of the bank.

CONCLUSION

Much of the focus on debt-equity conversions has been on the programs developed by the debtor countries and their specific requirements. However, with the emerging realization by U.S. banks that the best opportunities for debt conversion may lie in direct swaps, the constraints of Regulation K and the Federal Reserve Act become an equally, if not more, important area of focus.

The 1987 and 1988 amendments to Regulation K reflect a realization that, while they may not completely cure the LDC debt crisis, debt-equity conversions may relieve a portion of the debt service burden of the larger debtor countries. Unfortunately, the "liberalization" hoped for in these amendments is more apparent than real. While the amendments certainly remove some of the roadblocks which were preventing banks from engaging in these transactions, they still present the banks with an inflexible regulatory scheme that is fundamentally inconsistent with the require-

85. See supra notes 42-43 and accompanying text.
86. Regulation K, 53 Fed. Reg. at 5360, 5363 (to be codified at 12 C.F.R. § 211.5(f)(2)(ii)(C)).
ments prescribed by the debtor nations' central banks. Given the small portion of debt now available for conversion by the LDCs, it is imperative that U.S. laws not provide any additional obstacles. U.S. banks should be given great leeway in devising transactions to reduce the amount of questionable debt that they now carry.

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