IMF WORKING PAPER

February 24, 1988

WP/88/15
Correction 1

Subject: Debt/Equity Swaps

CORRIGENDUM

The attached page 12 of WP/88/15 (2/12/88) is reissued to correct the wording of the first paragraph of Section II, subsection 4.

Att: (1)

A different type of scheme was muted by the U.S. investment firm of Drexel Burnham Lambert in the late summer of 1987 and involved packaging Latin American loans purchased on the secondary market and selling them to investors as high-risk yet potentially high-yield investments--along lines similar to the domestic "junk" bonds this firm had been active in promoting for several years. The attraction of such schemes to investors would be that if they could buy debt at 50 cents on the dollar, the interest rate they would receive--assuming the debtor country were current on its debt obligations--would be doubled, as would the amount of their investment should the debt paper ever be redeemed at par. However, the chances of such schemes succeeding would appear doubtful as debtor countries would probably object to their loans being transferred to private investors who have no interest in providing additional investment to the country; moreover, investors would probably not be greatly attracted by claims on which the terms could change and which might never be repaid.

Another approach to debt conversion that has become the focus of increasing attention involves the swapping of debt paper for equity which is then sold to a syndicate of buyers, with the returns on the investment determined by the profits realized by the equity involved. Investments in the hotel and tourist industries has been particularly attractive in this context. The success of any of these schemes for mutual funds depends above all on the willingness of the creditor banks to sell significant amounts of debt paper at a substantial discount, an action that most major banks still seem reluctant to take.

In the summer of 1987, Brazil, as part of a menu of alternatives for the resolution of its debt problem, proposed that some $30 billion of its bank debt should be converted into tradable securities. This proposal was not accepted by the banks involved, which were concerned by the magnitude of the losses they would have to bear.

Finally, it is possible that some of the poorest countries might follow the example of Bolivia. This country has set up a program under which it will use concessional foreign aid resources to buy back its debt obligations at a heavily discounted price.

Opinions are divided with regard to the length of time the debt/equity swap market will be active. Martin Schubert, chairman of one of the most active finance corporations in this field, concluded at a recent conference on debt/equity swaps:

"At best, the debt equity conversion may have a useful life of two to three more years. During that time, what major investment opportunities have not already been taken up, will have been grabbed by shrewd venturesome entrepreneurs, both locally and externally. Valuable government properties which have been set out for privatization will have been privatized. As in the case of the forestry industry in Chile, important undervalued properties will have been taken up or their market values driven up by anticipation, or by government discount practices, to where they no longer have the same attraction. One should not expect that governments will massively give over their resources in exchange for debt which they more and more are coming to the conclusion that they cannot, and will never be able to repay." 1/

These remarks were probably designed to encourage listeners from the multinational corporations to reach more rapid decisions about their investment plans, but they nevertheless contain several valid points. One further point that could be made is that debt/equity swaps will no doubt be discontinued in countries which regain liberal access to the capital markets, since presumably at that time the discounts on those countries' existing debts in the secondary market would have disappeared.

4. Views of intergovernmental institutions and creditor governments

The conversion of debt into equity has been encouraged by the major international financial institutions. At its meeting in April 1987, the IMF Interim Committee expressed concern over delays in arranging "concerted financial packages" and "welcomed the exploration of a wider range of procedures and financing techniques by commercial bank creditors as appropriate, such as debt/equity swaps...." The World Bank has also shown considerable interest in the development of different types of debt conversion schemes and, as explained in the previous section, the IFC has taken active steps to encourage the exchange of loan claims to purchase investments in debtor countries. The Multilateral Investment Guarantee Agency (MIGA) is expected to begin operation during 1988. This agency, which will work closely with

1/ Schubert (1987).