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To: Members of the Executive Board

From: The Secretary

Subject: Implementing the Debt Strategy: Financing Issues - Conversion
of External Debt to Equity and Liquidation of Loan Claims at a
Discount

The attached supplement to the paper on "Implementing the Debt Strategy: Financing Issues" (EBS/86/41, 2/24/86) presents information on equity conversion and discounted loan claims. It is being made available as background for the Executive Board discussion of the debt situation scheduled for Monday, March 24, 1986.

Ms. Atkinson (ext. 7359) is available to answer technical or factual questions relating to this paper.

Att: (1)

INTERNATIONAL MONETARY FUND

Implementing the Debt Strategy: Financing Issues--
Supplementary Material: Conversion of External Debt to
Equity and Liquidation of Loan Claims at a Discount

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(In consultation with Area Departments)

Approved by C. David Finch

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I. Introduction

This paper, based on a staff review of countries that have recently restructured their debt, describes experience in facilitating the conversion of external loan claims to equity and the sale of such claims at a discount. It has been prepared in response to questions about such mechanisms raised in the recent Board discussion of Chile (EBM/86/39, 2/28/86). Section II provides a brief overview, while Section III describes in more detail the operation of arrangements in individual countries.

II. Overview

In recent years, there have been a number of cases of arrangements for conversion of debt to equity, although their scale so far has been limited. It has been less common for authorities in debtor countries to set up a facility to encourage the sale of loan claims at a discount, although some countries have also considered this.

With regard to equity conversions, countries have adopted various arrangements to allow the exchange of loan claims for equity, or, more generally, their conversion into domestic currency to meet local currency obligations and make local investments. The legal framework for such arrangements has differed somewhat across countries. In some cases, debt restructuring agreements have specifically provided for the conversion of debt to equity (Chile and Mexico), or for the exchange of external debt claims for local currency (Turkey). In other cases (Argentina and Brazil), the authorities have introduced similar arrangements outside formal debt restructuring agreements.

The flexibility and scope of debt to equity exchange schemes has also varied. In some arrangements, external loan claims on a debtor are exchanged for an equity claim on the same debtor. The Chile scheme, by contrast, also allows for the conversion of a loan to one debtor--for example, a public sector enterprise or the Central Bank--into equity in a different entity--for example a private company. In such cases, the conversion of debt to equity is intermediated through the Chilean financial system, rather than effected directly between debtor and creditor.

In addition to the cases discussed in Section III, it is understood that arrangements may have been made by individual creditors, on a private basis, for swaps of loan claims into equity. One example of such arrangements would be the purchase by a multinational corporation of a loan claim owned by a bank, followed by the conversion of this claim into direct equity in the debtor (which could be a foreign subsidiary of the multinational corporation).

A further option would involve the use of a trust fund, which could pool the external loan claims of various creditors for investment in a debtor country. Thus far, the staff has not identified any such schemes

to convert debt to equity. The International Finance Corporation has been studying whether such arrangements would be feasible or attractive to creditors.

III. Country Experience

1. Argentina

While the debt restructuring agreement between Argentina and commercial banks does not contain a mechanism for the conversion of loan claims to equity, the authorities introduced in September 1984 a scheme that allowed the conversion to direct foreign investment of loans with an exchange guarantee. In the period to August 1985, when the scheme was discontinued, it is estimated that about US\$470 million was converted. In addition, the authorities allowed, on an ad hoc basis and for limited amounts (totaling about US\$50 million), the conversion into direct investment of claims arising from swap operations. However, the equity claims arising from the operation of these two schemes were probably not acquired in substantial amounts by foreign creditor banks.

2. Brazil

While provisions for the conversion of loans to equity have not been a formal part of rescheduling agreements between Brazil and commercial banks, this type of transaction has been permitted under the Foreign Investment Law (Law No. 4131), in effect since the mid-1960s. Fiscal incentives to promote such conversions (tax credits amounting to 5-10 percent of the amount of capital) were introduced in December 1982, and eliminated in June 1984. Conversion of debt into equity rose from US\$136 million in 1982 to US\$425 million in 1983, and US\$731 million in 1984, before declining to US\$530 million in 1985.

Brazil has not set up a specific mechanism to facilitate the repurchase of foreign external claims at a discount. However, the Central Bank of Brazil has on occasion advanced the repurchase of certain long-term external bonds, taking advantage of the discount at which these bonds were being traded.

3. Chile

In Chile, arrangements to convert debt to equity and to facilitate the sale of loan claims at a discount are linked. ^{1/} The conversion of selected categories of external debt into equity is permitted under Central Bank regulations whether the holder of the loan is the original creditor or whether the loan claim has been purchased by its present

^{1/} These arrangements are described in the staff report on Chile: Review Under Extended Arrangement and Request for Modification and Waiver (EBS/86/20, 1/30/86).

holder, such purchases being mainly at a discount. In addition to the possible use of discounted claims by nonresidents for foreign direct investment, both residents and nonresidents are allowed to repatriate such external loan claims, on a limited scale, for certain other specified and restricted uses.

As regards the exchange of external debt claims for equity, the Chilean law distinguishes between the direct exchange of debt for equity in the debtor company, and other types of equity conversion. The Foreign Investment Law (Decree 600), in effect since 1977, allows external creditors to capitalize (i.e., convert to equity) debt claims held on Chilean companies, subject to Central Bank approval, which is granted on a case-by-case basis. Under this law, dividends and profits may be remitted immediately and capital may be repatriated after three years. It is understood that some banks have recently made conversions of debt to equity under these provisions.

In addition, in the context of the 1985 financing package the Central Bank has introduced a broader mechanism that allows nonresidents to convert certain external debt claims--that may have been bought at a discount--into equity in a separate entity. ^{1/} Under the Central Bank regulations, the holders of selected medium- and long-term public and financial system debt may convert their claims into local currency at full face value, even if such claims have been bought at a discount. Such conversions are subject to the agreement of the debtor, which has to renounce its future claims on foreign exchange for servicing the debt. The peso-denominated loans may then be sold to Chilean financial institutions or to the government-owned development bank or--in some cases--prepaid by the debtor. The local currency proceeds obtained from the sale, prepayment, or continued servicing of the loan may be used for equity investment, subject to approval from the Central Bank. The Central Bank may require as a condition of its approval of the investment that a specified percentage be made in foreign exchange.

The conditions attached to foreign direct investment to be made through this mechanism are much more stringent than those applying to foreign investment under Decree Law 600. In particular, capital repatriation is not permitted for ten years following the investment. Profits and dividends cannot be remitted in the first four years and no more than 25 percent of any profits earned during this four year period may be remitted in a single subsequent year. However, profits and dividends earned after the fourth year may be freely remitted. Conversions into equity approved under this law amounted to US\$30.3 million during the period June to December 1985, and to US\$55.5 million in the first two months of 1986.

Under a separate regulation, the Central Bank allows both residents and nonresidents to repatriate discounted loan claims for certain other

^{1/} Compendium of Rules on International Exchange, Chapter XIX.

specified uses, provided that the foreign exchange used to buy the claims was not obtained in the official market. 1/ The local currency proceeds from the disposal of claims under this regulation must be used to repay domestic debt owed to domestic financial institutions, or to acquire goods and financial assets owned by these institutions.

Since discounted external loan claims may be converted into pesos at the official exchange rate, it is worthwhile for residents to purchase foreign exchange in the parallel market in order to buy such claims for as long as the premium in the parallel market for foreign exchange is less than the discount on the loan claims. In order to restrict the amount of such transactions, the Central Bank sets monthly limits on the authorizations that it grants for the financial system to participate in these operations. As of November 1985, financial institutions were paying a premium of 3.2 percent to the Central Bank for the authorizations, which are allocated through an auction system. During the period June to December 1985, such transactions amounted to US\$115.1 million. In January and February 1986, an amount of US\$41.2 million was transacted or approved.

Consistently with the Central Bank regulations, the bank debt restructuring agreements of 1985 allow for the conversion of debt both for direct investment, and for the repayment of domestic debt to Chilean financial institutions or for the purchase of selected assets from such institutions. Such conversions are subject to the agreement of debtor and creditor, the approval of the Central Bank, and--in the case of equity conversions--to the conditions for profit and dividend remittance and capital repatriation described above. 2/

4. Mexico

The 1985 agreements related to the restructuring of Mexico's public sector debt to commercial banks provide for the possibility of capitalizing (i.e., converting into equity) the debt of certain public sector obligors. Subject to written agreement between creditor and debtor, and approval by the Mexican authorities, external loan claims may be exchanged for certain qualified investments. Such investments cover equity in nonpriority, nonstrategic public sector companies, whose sale is being promoted by the Mexican authorities, and equity in private sector companies. The qualified investments must not benefit from guaranteed dividends payable irrespective of earnings and profits, 3/ and must not have more favorable redemption terms than the loans for which they are being exchanged. In addition, such holdings are not transferable to any public or private sector Mexican entity before January 1, 1998.

1/ Compendium of Rules on International Exchange, Chapter XVIII.

2/ Section 5:11 of the Restructuring Agreements.

3/ Except as expressly contemplated by Article 123, of the "Ley General de Sociedades Mercantiles."

No conversion is known to have taken place within the legal framework of the bank agreements. The staff is aware, however, of a transaction of this nature in Mexico involving private sector debt. This operation took place in the course of restructuring the foreign debt of a private financial group; the amount of the conversion reportedly was the equivalent of US\$300 million, out of a debt of approximately US\$2 billion.

The possibility of the repurchase at a discount of foreign banks' claims has been raised in Mexico. However, concern over the impact of such operations on foreign exchange flows, and ultimately on the spread between the official and secondary exchange rates, has led the authorities to discourage the early redemption of external debt at a discount.

5. The Philippines

There is no explicit provision in the Philippines' bank debt restructuring or new money agreements for the conversion of commercial bank loan claims into equity investments. However, there is an option in the restructuring agreement for the early repayment in pesos of public sector obligations, subject to the approval of the Central Bank. The conditions under which approval will be granted are not stated. Such pesos could then presumably be used to make equity investments in the Philippines, although the scale of such conversions may be limited. There are no indications as yet of the interest that foreign banks may display in exercising the option, nor of the uses to which they may prefer to put the local currency proceeds.

6. Turkey

In Turkey, the 1980 agreement for the restructuring of arrears on nonguaranteed suppliers' credits contained an option for creditors to use their claims for investment and equity participation in specified sectors of the Turkish economy. This is described in greater detail below. In addition, the authorities issued a decree in May 1983 that allowed the conversion of rescheduled Convertible Turkish Lira Deposits (CTLDs) into Turkish lira, provided that they were used as foreign capital for investments by CTLD holders. A communique of October 12, 1984 enables foreign companies to use rescheduled CTLDs in petroleum exploration activities in Turkey. Under these provisions, a principal amount of \$43.4 million of CTLDs had been converted into Turkish lira as of March 1, 1985.

Under the 1980 program for the phased elimination of suppliers' credits arrears, which were estimated at \$1.4 billion (some 70 percent of total trade arrears), creditors were allowed to choose between repayment in foreign currency or in Turkish lira, with the option of using the latter for equity investment. (The scheme was described in detail in IMF Occasional Paper 40). The program had four main features: currency options, which allowed creditors to reschedule their claims in terms of either Turkish lira or five other foreign currencies; differentiated repayment terms, depending on the currency options; differing

rates of interest, depending on the currency option; and a deadline by which creditors had to inform the authorities of their currency option. 1/

If creditors chose repayment in Turkish lira, the local currency thus obtained could be used, inter alia, for extending export-oriented "façonnage" production credits to importers in Turkey; for payment of local taxes; for foreign payments to Turkish transporters; and for investment and equity participation in specified sectors. Such investment could not be transferred abroad for at least five years. Conversion of claims for investment of up to \$1 million would take place at a discount of 15 percent from the exchange rate prevailing at the time of settlement, and for claims exceeding \$1 million, at a discount of 10 percent. All other claims would be settled at a 33.3 percent discount on the exchange rate prevailing on January 25, 1980, the initial proclamation date of the program. Payments for claims of less than \$10,000 would take place immediately; claims exceeding \$10,000 were to be settled in two years, in twelve equal bimonthly payments. Under the foreign currency option, 60 percent of each claim was to be settled in eight semiannual installments over four years, after a grace period of four years; the remaining 40 percent was to be repaid subsequently in four equal semiannual installments.

The response of creditors to the program was regarded as very favorable, in large part owing to the flexible elements of the program, in particular, the currency options and the currency-specific repayment terms and interest rates. Furthermore, as the program advanced, data verification procedures in the Central Bank became more systematic, and the program became better managed. In addition, a secondary market had begun to develop where creditors could buy claims at a discount and, exercising the Turkish lira option, use the proceeds for local expenditure. As a result, an estimated 80 percent of eligible arrears were regularized within one year, and by June 1982, all suppliers' arrears had been eliminated.

7. Zambia

The conversion of debt into equity is one of the options currently under consideration by the authorities for the orderly elimination of commercial arrears, which amounted to SDR 539 million at the end of 1985.

1/ Subsequently, scope was allowed through February 21, 1984 for creditors who originally elected to be paid in foreign exchange to switch to settlement in Turkish lira. Claims of the creditors who had opted for repayment in foreign currency amounted to approximately US\$350 million as of February 21, 1984.