DEBT-EQUITY SWAPS: STRUCTURE, IMPACTS AND PERSPECTIVES

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Debt-Equity Swaps: Structure, Impacts and Perspectives

This paper analyzes debt-equity swaps as a debt-conversion instrument, which was used primarily during the privatization programs in Latin America during the late eighties and the early nineties. This paper makes an effort to highlight the pros and cons of using debt-equity swaps as an instrument to convert debt.

What are Swaps? A debt swap can be defined as extinction of debt in return for something else. A formal definition of debt swap can be given as - “A debt swap involves the voluntary exchanges, by a creditor with its debtor, of debt for cash, another asset or a new obligation with different repayment terms. The economic rationale for debt swaps is based on the willingness of a creditor to accept less than face value for debt and of the debtor to make payment at a higher value (than market value), but usually less than 100% of face value of the original debt. The terms debt swap, conversion, and exchange are often used interchangeably” (Moye 2001).

The 1980s saw the dramatic decline of Latin America from a rapidly growing region to a region filled with unstable and debt ridden economies. The foreign debt in that region rose from 150 billion US dollars in 1979 to over 400 billion US dollars in 1980. The governments in the region went from normal credit risks to slackers, with most of the medium-term and long-term debts from the region in arrears (Grosse 1992). This debt crisis led to the introduction of the debt swap mechanism for conversion of non-performing debt owed by the countries in this region. To break the impasse between
Latin American governments and foreign banks, the latter sought to convert the problem loans into alternative instruments that could be sold to other investors – these instruments have now come to be known as **debt-equity swaps**.

**What are Debt-Equity Swaps?** Chile became the first country to establish an institutionalized debt-equity swap program in 1985. In a typical debt-equity swap, commercial debt owed by a sovereign debtor to a private creditor is purchased by an investor in the secondary debt market and is then converted into an equity investment in the debtor country. Trading in sovereign debt increased substantially in 1986-87 after the Latin American countries introduced debt-equity swap programs as part of their London Club debt restructuring packages. Many commercial bank creditors also began to set aside reserves against their developing country debt exposure, enabling them to sell their non-performing loans at a discount from face value. The secondary market, now more commonly called the emerging markets debt market, continued to grow in the 1990s, peaking in 1997 with US$6 trillion in trading volume, before declining to US$2.2 trillion in 1999 in the aftermath of the Asian financial crisis.

Debt-equity swaps can be formally defined as – “In a debt-equity swap, external debt of a developing country is converted into local currency funding for equity investment in that developing country. Typically, the investor (a bank or a private company) buys the debt at a discount from face value on the secondary market or from a bilateral export credit agency. The debtor government then redeems the debt at a negotiated value in local currency or local currency instruments (e.g., bonds) which are
then used to invest in equity. In the context of privatization programs, debtor governments offer to exchange debt for public assets” (Moye, 2001).

**Circumstances for instituting debt-equity swaps:** Debt-equity swap programs were instituted to reduce debt to some extent, but mainly to promote investment. The commercial creditors once they get the wind that a debtor country is unable to service its debt in the immediate future, fresh flow of capital into the country reduces and thereby the investment climate deteriorates significantly. In such instances, the firms, which are doing exceptionally well, would also not be able to attract capital for any of its projects. Institution of debt-for-equity programs in times of such distress would stimulate investment opportunities in the debtor country. Most of the debtor countries venturing into debt-equity swaps use auction systems in order to capture the maximum discount of debt based on competing bids from investors. The motivation for the investors to invest money through a debt-equity swap in countries undergoing debt problems is the investment potential in the country with the expectation that dividends and capital could be repatriated in the future. Debtor governments have typically regulated such transfers like for example – only after 4 years for dividends and 10-12 years for capital. Some debtor countries also insist that not all investment be made through the swap but also through infusion of “new money”.

**Key elements in a debt-equity swap:** The parties to this transaction are generally tripartite in nature and consist of – 1. Debtor government 2. Private sector investor (generally represented by an intermediary bank), who has a genuine investment interest
in the debtor country concerned. 3. Creditor in the form of commercial banks, export credit agency or Ministry of Finance. The types of debt that are eligible for this type of transaction are - a) Commercial debt in the form of bank loans, bonds, promissory notes purchased on the secondary debt market. b) Bilateral publicly guaranteed debts in the form of export credits (Paris Club and non-Paris Club) purchased from an export credit agency (ECA). The proceeds from a typical debt-equity swap are in the form of cash or bonds, which are used in private sector investment through equity shares, fixed investment, and working capital. The proceeds from swaps in the form of public sector assets are obtained in the context of a privatization program.

From 1985 to 1996, debt-equity swaps totaled US$38.6 billion.¹ The linkage of debt-equity swaps to privatization programs stimulated increased swap transactions in 1989-90, primarily in Latin America. However, debt-equity swaps declined precipitously since 1994. Nigeria appears to be the only country that continues to operate an active debt-equity swap program, although countries such as Guinea, Mozambique and Senegal continue to engage in debt-equity swap programs on a case-by-case basis.

**Example of a debt-equity swap:** In 1985, the American Express Bank (AMEX) had loans outstanding from the Mexican borrowers to the tune of about $650 million. About 80% of these loans belonged to Mexican government agencies like the Central Bank and the Ministry of Economy. Since the bank had a long-term commitment to operating in Mexico, it decided to buy into a Mexican company or a financial institution.

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Figure 1: A Swap of Sovereign Debt for Equity in a New Capital Project

Source: Grosse, 1992

Foreign commercial bank holding impaired loan (AMEX Bank’s $US100 million loan to Mexico’s government)

Discounted $ loan

Investment banking intermediary that brokers loan sales and arranges government permissions

Retired loans

Finance Ministry and/or Central Bank of Latin American country (Mexico’s Finance Ministry)

Pesos ($US90 million of Pesos)

Foreign direct investor seeking low-cost financing for a Latin American project (AMEX Bank as direct investor)

FDI

Capital project set up in Latin American country by investor (hotel projects in Mexico)

Dollars ($US56 million)

Pesos

Dollars ($US56 million)

Retired loans

FDI

Pesos

Finance Ministry and/or Central Bank of Latin American country (Mexico’s Finance Ministry)

Investment banking intermediary that brokers loan sales and arranges government permissions

Retired loans

Foreign commercial bank holding impaired loan (AMEX Bank’s $US100 million loan to Mexico’s government)
In order to do that, the bank was considering the option of swapping the dollar loans for Pesos, which could then be invested in a Mexican company. After a series of confabulations with the Mexican government, the bank decided to invest in a series of new hotels to be constructed on various sites in Mexico. Loans worth $US 100 million in face value was agreed to be sold at the existing market exchange rate in return for Pesos. The funds were to be disbursed over time to meet the construction and operation expenses. The agreement was that the bank would receive about 90% of the face value of the loans translated into Pesos. The Pesos were disbursed when the bank submitted to the Finance Ministry the invoices associated with the construction of the hotels. With the submission of invoices, the payments were not being paid to the bank but to the suppliers and contractors involved in the construction of the hotels. Therefore, the swap involved the cancellation of the dollar denominated loans, with Pesos disbursed for expenses incurred during the establishment of the hotel business. Refer to figure 1 for the schematic representation of the debt-equity swap. Since the original swap agreement in 1986, the number of hotels permitted was expanded from five to seven. The bank later entered into joint ventures in all seven of the hotels with large Mexican construction firms for the construction of the hotels in each location. It also later signed agreements with Sheraton (for three hotels), Radisson, Hilton, Club Med, and Marriot for managing and operating the facilities at each of the location (Grosse 1992).

**Debt-equity swaps in Morocco**

Morocco is one of the few countries that operated a debt-equity swap program after 1995. Although a debt-equity swap program was first introduced in 1993 for the conversion of rescheduled debt owed to commercial banks, rising secondary market prices for Morocco’s debt limited the attractiveness of the initial program. In 1996, the Government launched an offer to potential investors for a debt-equity swap program to convert FF 600 million face value of debt owed by the Moroccan Government to the French Government. The program was based on a bilateral agreement signed between France and Morocco.
implementing Morocco’s February 1992 Paris Club agreement. A similar program was subsequently established for debt owed to Spain.

The objective of the program was to contribute to Moroccan economic and social development through increased French investment in Morocco. Eligible investments included capital investments in all economic sectors to finance a new project, extend an existing project, or purchase equity shares in Moroccan companies. The Moroccan Government evaluated investment proposals based on their contribution to job creation, local market expenditures and exports.

The program was reserved for foreigners and Moroccans resident overseas (represented by a bank). While the investment proposal to the Moroccan Government required that the investor indicate the redemption price in Moroccan Dirhams, the French Government required the investor to submit an offer indicating a purchase price and including a letter from the Moroccan Government approving the investment. The French Treasury then accepted the highest bids from eligible investors. Although there are no statistics available regarding the debt converted through this program, the Moroccan Government reportedly was pleased with the range of investment proposals generated by the program.

Source: Overview of Debt Conversion (from Debt Relief International), Melissa Moye

Impacts and Perspectives

There are three stakeholders in a typical debt-equity swap – the lender who originated the debt, the debtor country, and the foreign investor who is ready to invest in the borrowing country. This section of the paper is devoted to analyzing the impacts and perspectives of a debt-equity conversion (as outlined in figure 1) primarily from the viewpoint of a debtor-country.

The debt-equity swaps have declined substantially beginning in 1994 and most of the debt-equity programs that existed in the decade prior have been suspended or no longer exist. The precipitous decline in the number of debt-equity transactions exposes the declining popularity of such transactions. In 1996, the last year for which complete statistics on debt conversions are available, only $100 million of debt was converted into
equity. But, one should keep in mind that the high numbers in the late eighties and early nineties were primarily due to massive privatization programs that the Latin American governments were undertaking, and debt-equity swaps were used massively to attract foreign investment. The biggest drawback of debt-equity swaps has been the lack of fiscal resources in the debtor country to provide the payment in local currency. Debt to equity conversion thus is less attractive for countries with large burdens of domestic debt, since it transforms an external debt into a domestic debt. The one possible way to alleviate the fiscal impact (prevent worsening of the fiscal deficit) is to manage the payments over time like issuing a bond. Another major criticism is that none of the debtor countries that have had a debt-to-equity swap program had a defined role for the foreign investors. As a result there existed apprehensions among the local public of foreign control of the local economy.

The primary reason for a debtor country to commit to a debt-equity swap has been the desire for more private-sector capital formation and to add to the total capital investment in the country. The experience in Latin America has shown that in general wherever debt-equity swaps made the cost of financing direct investment projects lower there was found to be increased amount of capital investment. Many of the countries in that region structured the debt-equity program to require capital investment with the equity for creation of additional capital. In cases (mostly in Latin America) where swaps were permitted simply for investment in existing local businesses without new capital infusion, the impact on new capital formation has been minimal (Grosse 1992). Why do governments ever consider debt-equity swaps for FDI? There has been no concrete
explanation why governments who want to stimulate foreign direct investment would use
debt-equity swaps to favor specific investors rather than have a formal attractive foreign
investment policy. It should however be noted that in some cases of foreign direct
investment the cost of borrowing from the local markets were costlier, and the swaps
were used as an alternative arrangement to provide cheaper capital. Debt-equity swaps
are found to be attractive to investors who are already a major business player in the
debtor country and are now looking to diversify their interests there. The swaps provide
in some cases, leverage to negotiate entry into a highly profitable but protected business
sector. Critics of debt-equity swaps however maintain that swap transactions merely
result in replacing cheap foreign-debt with domestic-debt.

A negative impact of debt conversion in some countries has been the injection of
excessive amounts of local currency into the national economy resulting in inflation.
This is one of the major reasons why debt conversion programs in Latin America were
suspended. In order to mitigate any adverse inflationary impact, debtor governments in
some cases placed a ceiling on the amount of local currency paid through debt swaps and
in some, structured transactions with payments to be made in installments. As a matter of
fact, debt-equity swaps, which did not lead to capital formation but just the privatization
(i.e. investor’s ownership of local assets) of public assets, have lead to high inflation. In
general, if the government does not sterilize the creation of new local currency for the
swap transaction, then the transaction is almost certain to be inflationary in nature. Some
countries have, in order to sterilize, exchanged stock shares in a local company for the
foreign loan as no new local currency is created (here in this case the obligations were
part of the company and not the government). Robert Grosse in his paper – ‘The Debt/Equity Swap in Latin America – In whose interest? - States that the principle of inflationary bias cannot be refuted completely even in the most productive transaction, but the actual impact will almost always be small. Debt-equity transactions in general are complex and often time-consuming, as government officials have to devote significant resources to negotiating, documenting and monitoring transaction. In some cases, debtor governments have commissioned foreign financial advisers to assist them in implementing debt swap transactions. In order to cover some of their costs, many governments have charged a transaction commission.

In the long list of negatives attributed to the debt-equity swaps is the discrimination against local investor vs. foreign investors by the debtor country. Nationals of the debtor countries with the exception of Chile were precluded from taking part in debt-equity swaps. This is to avoid criticism that the government is rewarding people those who took their money out of the country during the debt crisis and who would make lot of gains from converting their capital back into local currency through the swap program. However, the government should find ways and mechanisms so that the gains made by them are recouped. Preventing local investors from participating in the debt-equity programs would reduce the volume of investment produced by those programs. A swap program open to all investors would lead to broad investor confidence in the country, which remains the major problem in all debt-ridden low-income countries. Debt-equity swaps have been perceived in some countries, like Brazil, where local investors are precluded from participating in the swap program, as a challenge to national
sovereignty because swaps often result in the transfer of local assets to foreign ownership or control especially in case of privatization of public enterprises (Moye 2001). The twin goals of reducing the balance of payment burden of foreign debt and generating new capital formation may be served by the swaps if local investors can be stimulated to help re-ignite growth in the economy through this mechanism. It is important that the debtor country makes sure that the proceeds of the debt conversion in local currency are not transferred out of the country by investors for illegal gains. In technical terms, it is known as ‘round-tripping’, and one way to prevent it is to restrict participation by nationals in debt swap programs. Round-tripping is a problem especially in countries with foreign exchange restrictions. In figure 1, if for example instead of AMEX bank, a local investor had taken part in the swap transaction and as part of the investment wanted to bring in imported machinery to the firm (the investor was investing in), then the proceeds of the swap would have to be converted into hard currency for the import. This would cause depletion of the government’s already scarce foreign exchange reserves. As a result, the debtor government would be worse-off with the swap transaction and the proceeds of the swap ends up being spend abroad causing no immediate stimulation in the local economy. In such circumstances, the debtor governments should make sure as part of the swap agreement that the proceeds are spend (as part of the investment) locally instead of being repatriated abroad.

Debt-equity swaps can be structured to favor investment in priority sectors like the export sector that will lead to future increases in the country’s exports bringing in valuable foreign exchange. Debtor governments generally try to estimate the degree of
additionality offered by debt-equity swaps by determining the likelihood of the foreign investment entering the country in the absence of the swap. In the absence of additionality, the debtor government may be subsidizing investment that would have occurred anyway. The literature on debt swaps seems to suggest that overall debt-equity swaps were a major incentive for foreign investment and boost to privatization programs. It is important that the debtor government should attempt to measure the degree of additionality of investments through debt-equity swaps (for reasons to be explained later). Another downside that has been reflected in the debt-equity swaps has been that in most countries the debt is converted into the local currency at the official rate, which is far below the market rate in other words less local currency per unit of hard currency. This could also result in the derailment of the debt-equity program, as was seen in Venezuela in 1988. In Venezuela, the government began a swap program that permitted foreign investors to redeem government foreign debt at essentially full-face value at the official exchange rate of 14.50 bolivares. However, with the existence of legalized “grey-market”, the same investors could buy local currency from a Venezuelan commercial bank at the free-market rate of about 30 bolivares per dollar and end up with approximately the same result without the major costs of time and negotiation required to carry out the swap. As a result, not many swap transactions were executed during that period (Grosse 1992).

Another point that has been raised with respect to debt-equity swaps is that they may not enable a country to reduce its total foreign debt burden, even though some debt is retired in the swap. This may occur in cases where the swap causes the price of the
remaining debt in the secondary market to rise, because investors expect that the probability of repayment has risen. The secondary price of the debt could rise sufficiently so as to match or be more than the original debt value before the swap (Bulow and Rogoff, 1988). Therefore, the government must evaluate such swap transactions and these drawbacks must be compared to the potential benefits of incremental FDI that may be generated in the projects and of new investment that may be generated because of increased confidence in the government.

**Balance of Payments:** By reducing debt service payments in foreign currency, swaps can have a positive impact on a country’s balance of payments. The use of swaps to encourage exports may also improve the trade balance. In the case of debt-equity swaps, the positive impact may be reduced somewhat by future demand for foreign exchange for the repatriation of dividends, profits and capital. For countries with national currencies linked to hard currencies like US dollars, there may be less benefit to replacing external debt with local currency. The Mexican debt-equity swap described earlier which eliminated foreign debt contract of $US100 million and replaced it with a local currency obligation of about $US90 million in value would put the government with the obligation to provide dollars in the future when the foreign investor, American Express bank, chooses to remit portions of the profit (if the investment is profitable). But at the same time, since American Express will try to attract additional international tourists to fill the hotels in Mexico, foreign exchange will be generated by the projects. Therefore, the net impact of the swap on the balance of payments is unclear. Paul Krugman argues that debt-equity swaps in cases where no contribution to capital
formation was made would result in future dividends and capital repatriation simply replacing interest and principal payments. Overall, the balance of payments impact of debt-equity swaps compared to that of other alternatives for reducing the foreign debt burden are yet to be ascertained.

**Macroeconomic analytics:** The macroeconomic effects of permitting swaps depend on the extent to which investments made through the scheme are additional or not – i.e., was the swap mechanism decisive in the investors’ determination to make the investment or not? For the illustration, the investment is assumed to cost $100, and to be financed with 100% equity. This assumption in fact is not realistic but is made to simplify the analysis. In fact, most investments are financed in part through debt, and depending on conditions some of that debt is borrowed in local currency in the host country. This is done much more with “normal” FDI than with swaps. Therefore, normal FDI tends to have more of a crowding out effect in the host economy than this example suggests, and the net impact of swap programs is less crowding out (or inflationary) than in the example. If thirty percent of the assets purchased with this $100 are procured abroad and imported, and the other 70% are procured locally. Then the foreign investor only needs to convert $70 to local currency to make the investment. The government has to come up with the local currency equivalent of $70, which in general it can do by printing money, issuing bonds, reducing expenditure or increasing taxes.

**Foreign investment through normal channels:** If this investment is made without the swaps, the capital stock of the country increases by $100, with a corresponding equity
claim by the foreign investor. The foreign debt of the country does not change. Foreign exchange reserves rise by $70 – the amount the investor paid the government for the local currency he or she needed – and the government’s domestic debt rises by the local currency equivalent of the same amount. The transaction also results in the current account deficit increasing by $30 or current account surplus decreasing by $30 as the case may be. The net impact on foreign exchange reserves is difficult to ascertain but will surely depend on the level of repatriation of profits (or capital) done by the investor.

**FDI through swaps:** If the same investment is made through a swap, the capital stock of the country rises by the same $100, as do foreign equity claims. But in this case the country’s foreign exchange reserves do not rise; rather its foreign debt goes down. If the country redeems the debt swapped at, say, 80% of its face value, to get the $70 worth of local currency from the government, the investor has to give the government foreign debt with a face value of 70/.8 or $87.5. Total foreign claims on the country rise by $100 of equity but fall by $87.5 of debt; therefore the net change is an increase of $12.50. In terms of current account, the deficit increases by $12.50 or the surplus decreases by $12.50 as the case may be. Finally, the government’s domestic debt again rises by $70 worth of local currency. This transaction also improves the overall foreign exchange reserve position of the country because of the reduction in the future debt interest payments. The effect of the swap program can be analyzed under two different possibilities that exist i.e. the investment either would have happened anyway, or it would not. If the investment was additional then the swap program was responsible for the full impact that was just traced out in the analysis of what happened when the investment was
made through a swap program. By extending the analysis a little further, we can note that the existence of the swap program made no difference to the government’s foreign exchange reserves. But $87.50 of foreign debt was retired at a “cost” of an additional $70 of domestic debt. This ratio, the discount at which the transaction causes the government to reduce foreign debt at a cost in local currency, is 70/87.50 or exactly 80% – the value at which the government redeemed the foreign debt in the swap transaction. If the investment was not additional – if it would have happened even if the swap program did not exist - then the impact of the swap program is different. The swap program does not cause any change in the capital stock of the country, or in the equity claims of foreigners. The existence of the swap program does, however, lead to a reduction in the country’s foreign debt, of the same $87.5. In this case, however, the offset or “cost” to the government of this foreign debt reduction is not domestic debt – because the government would have had to issue the same $70 worth of domestic debt whether the swap program existed or not. Rather, the existence of the swap program has cost the government the $70 of unrestricted foreign exchange that the investor would have exchanged for local currency if he had not converted debt instead. So in the non-additional case, the swap program has in effect cost the government unrestricted foreign exchange to pre-pay foreign debt – but again, at a (discounted) price equal to that at which it redeemed the debt in the swap transaction (here in the example 80 cents for the dollar). The overall impact on the foreign exchange reserves (through the swap program) depends on the initial loss of foreign exchange for every $100 of investment vs. the net foreign exchange gains due to the reduction in the future debt interest payments and the reduced principal repayment for every $100 of the face-value of the loans.
To sum up, any investment made through the swap program implies that the government prepays foreign debt, at a discount identical to that which it charges the foreign investor in the swap transaction. If the investment was additional, the effect on the government is to use local currency to pay for the debt reduction, at the same discount. The cost is thus in increased inflationary force, higher domestic interest rates, greater fiscal effort, and/or reduced consumption. If the investment was not additional, then the prepayment of the foreign debt was in effect done with foreign exchange- and the swap program does not added any cost in terms of inflationary effect. In allowing a transaction through a swap always results in reducing foreign debt; it can cost the government either foreign exchange or the need to come up with domestic currency, but not both. A swap program leads to inflationary impact only to the extent that investments made through it would not have happened if there were no swap programs.

**Summary of Cost and Benefits of Debt/Equity swaps to the debtor countries**

*(source: Grosse, 1992)*

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<th>Costs</th>
<th>Benefits</th>
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<td>Replaces capital investment that would have occurred anyway</td>
<td>Increases capital investment</td>
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<tr>
<td>Creates inflationary pressure from redeeming the debt</td>
<td>Reduces pressure to generate foreign exchanges for debt servicing</td>
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<tr>
<td>Results in more foreign control of the</td>
<td>Improves the government’s image as</td>
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CONCLUSION

A well-designed swap program can lead to a small but significant reduction in foreign-debt. But having a debt-reduction program in place may in itself help towards the restoration of creditworthiness. Having a debt-conversion program would help the country seen in a better light by the international financial community because it reveals that the country is making serious efforts to service its debt insofar as is feasible. The more important benefit of a swap program can be in helping trigger both foreign and domestic investment. This effect will be greater to the extent that other aspects of a country’s investment climate are reasonably positive, although swaps can also be valuable in providing a source of long term financing for domestic companies when the domestic financial market is not functioning well. The tendency of swaps to attract export investment more than domestic market-oriented investment is an added bonus.

However, debt-equity swaps cannot be seen as a solution to the debt problem or as a solution for multinational firms seeking to finance their investment projects in the
debtor country. But, the swaps do provide one clear, viable mechanism for reducing the size and crisis nature of the debt burden. Debt-equity swaps will continue to be outliers as financial instruments, because of their relative illiquidity and the difficulties in valuation. For firms such as American Express mentioned earlier in this paper, debt-equity swaps offer a mechanism for reducing the weakness of the banking subsidiary’s loan portfolio without necessarily eliminating the firm’s ability to operate in debtor countries. The bank in the example mentioned earlier was able to replace a non-performing loan portfolio of $US100 million with ownership in seven hotels in Mexico. Those projects were all structured such that the American Express Bank could sell its ownership position to Mexican partners at the end of the required holding period; thus effectively repatriating the capital initially committed. For direct investors, debt-equity swaps make sense when the net present value of a direct investment project in the debtor country can be raised by undertaking the swap. In simplest terms, this implies that the swap needs to reduce financing costs for the project, since the swap is used to obtain local currency for the project. A rational evaluation of the desirability of swap programs must, therefore be made including the consideration of the income effects and other impacts on the economy.
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