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<u>DEBT EQUITY SWAPS</u>

A REVIEW OF AN UNDERUTILIZED PRIVATIZATION MECHANISM

BY

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1.0 INTRODUCTION

1.1 What Is It

By way of introduction, a debt-for-equity swap is a process in which the holder of a loan exchanges the right of payment for an equity interest in an organization in the borrower's country; thus, debt is swapped for equity. Upon this simple base is built the sometimes complex system of debt and equity exchanges that has been receiving so much attention. The process becomes complex because there are always other actors taking part in the activity, as will be described in detail in this review. Among the key groups are:

- Debt holders - Principally banks;
- Advisors and consultants - Banks, specialized firms;
- Debt purchasers - Multinational corporations, investors;
- Host country government - Central bank, investment review board; and
- Organization invested in.

These various groups work, in any transaction, in a sequential scheme, one in which the debt is moved from the original holder, through the host government, and, in local currency form, into the equity capital of the target entity. Among the many variations on the basic theme is the ability of governments and investors to utilize the process to promote the privatization of government organizations. It should be noted at this early stage that the contents of the review, the examples of existing programs, and the commentaries of practitioners were all based on an economic and political environment which ceased to exist during the third week in October 1987. It cannot be stated too strongly that the dramatic worldwide fall in financial and equity markets will have immense and long-lasting -- yet regrettably currently unknowable -- implications for less developed countries (LDCs) in general, and debt-equity swap programs in particular.

1.2 Purpose

The most generally framed purpose for debt-equity swaps is to allow investors to secure a discounted pool of investment funds, and thus increase their participation in the economies of LDCs. Other tangential benefits are numerous. For example, an expanded debt-equity program can be an economic stimulant and pour liquidity into debt ridden sectors of a nation's economy. Swaps can reduce the rate of growth of external debt, assist in repatriation of flight capital, provide an additional incentive for private foreign investors, reduce outflows from debt service payments by converting them to lower outflows from investments (e.g., dividend payments), facilitate the financial restructuring of domestic borrowers (especially in the banking sector), and encourage privatization.

1.3 Organization and Purpose of the Paper

This paper is intended to provide an overview and introduction to the topic of debt-equity swaps, and to show some of the important linkages it has to privatization. After a background section, there is an analysis of the mechanics of the most basic swap and some more complex variations, followed by a study of many of the factors that complicate transactions, and a summary of the arguments that are given both in favor of and against the use of debt - equity swaps. The final sections deal with privatization issues and the future of swaps, something made especially complex by the October 1987 worldwide stock market crash.

1.4 Background

It is appropriate to review the background of debt-equity swap programs, including history, users, locations, and size. At this point in time, debt - equity swaps are a widely discussed and increasingly used financial technique, but one that might well be subject to a radically different environment. Debt - equity swaps are a well-accepted concept in both the private and public sectors. For example, the US Treasury is on record in support of swaps and the finance ministers of the major industrial countries endorsed debt-equity swaps at the 1987 World Bank/IMF meetings and called for ways to increase their scope and make them more feasible.

One of the areas of appeal and usefulness for swaps is that national systems can, without drastic changes, accommodate them. The incentives accorded to foreign investors by debt-equity swap programs will be nullified if the broader domestic policy environment is not conducive to foreign investment flows. For example, a minimum regulatory framework is required, and this means such basic issues as predictability, equal protection, and fairness.

History

The transactions underlying debt-equity swaps can be traced back to the longstanding practice of multinationals advancing funds to overseas subsidiaries (through loans or purchases) and then forgiving the debt by recapitalizing it, or converting it to stock. There were no U.S. tax consequences since it was the purchase of stock with debt; some host countries treated this as a stock dividend and imposed a dividend withholding tax, which was generally creditable in the U.S.

Users and Active Countries

Among the primary actors in the world of debt-equity swaps are the major banks (holders and sellers of the debt, and occasionally investors) and the various types of organizations that purchase the debt and carry out the transactions; among these are multinationals, mutual funds, retirement funds, and Employee Stock Ownership Plans (ESOPs).

The most active countries have included, at one time or another, Chile, Costa Rica, Ecuador, Mexico, the Philippines, Brazil, and Argentina. Colombia, Dominican Republic, Uruguay, Venezuela and Peru have programs under study, and Yugoslavia has just announced legislation to implement a comprehensive program.

Chile is far and away the most active player in debt-equity swaps. Various estimates place the debt converted at $US 1.2 billion, equal to four to five percent of Chile's external debt. The largest single deal in Chile has been the 1986 Bankers Trust conversion of a $US 60 million debt into a 51 percent stake in AFP, Chile's largest pension management fund (which is now wholly privatized).

Size

The estimates of the size of the debt-equity market vary, ranging, for example, from the U.S. Treasury Department estimate that there were $US 2.5 billion in swaps done in 1986, to the Shearson Lehman determination that the secondary market reached $US 5 billion in trading volume in 1986, and could reach $US 10 billion in 1987. This should be compared to an overall sovereign debt of $US 500 billion.

2.0 THE SWAP MECHANISM

2.1 The Basic Swap

The "basic" or "plain vanilla" debt-equity swap is fairly straightforward in concept, although local requirements and nuances mean that one will never see a text-book case. In the simplest form, a government owes a sum of money to a number of private lenders, i.e., sovereign debt exists. In virtually all cases involving developing countries, there is an informal secondary market in these debt instruments, wherein obligations are bought and sold at a deep discount; thus a bank (creditor) can sell the country (debtor) debt to another party (investor), or can "give it back" to the debtor government. When the debt is purchased by an investor, that group deals with the debtor government directly. The government accepts the debt back, and credits the tenderer with an amount of local currency, in some cases 100 percent of the face value of the debt, and in some cases the value less an amount constituting a fee for the government's participation.

With the right to this sum of local currency, the investor -- the third party or the creditor bank -- acquires title to the equity in a local enterprise. This may happen via direct purchase of shares, or by arranging for the forgiveness of the enterprise's debt.

In the process, an intermediary institution often acts as a conversion agent, receiving assignment of the credit on behalf of the investor, passing title to the ultimate investor, and redenominating the foreign currency credit into local currency through the central bank or other host-government entity. If there are applicable restructuring agreements, the investor submits a correction notice under the relevant agreement, thus discharging the credit.

2.2 Variations on a Theme

Building on the basic swap mechanism, a large number of variations are possible.

Mutual Funds

One of the most interesting new ideas for swaps is the use of mutual funds and investment companies created to deal with debt-equity swap opportunities. In early October 1987, Midland Bank and the International Finance Corporation established a $US 75 million investment company whose capital is created by converting debts. Holders of Chilean debt are able to exchange up to $US 60 million in face value of loans; IFC and Midland are each investing $US 7.5 million. Such investment funds are of interest to banks and other debt holders since they save the institution the work of finding suitable investment opportunities. The fund takes a minority holding in companies listed on Chilean stock exchanges and buys equity in privatized state operations. The fund, which is targeted at long term capital appreciation, won't pay dividends for five years and there will be no capital returned to investors for 12 years. Management will be by the Chile Asset Management Company with Midland having a majority holding and it will be advised by Iverchile, a local financial services concern.

Special Uses

As for uses of swaps, at least two themes are being tested in Bolivia. The first, called a debt-for-nature swap, evolved as Conservation International bought $US 650,000 of debt for $US 100,000. Funded by the Frank Weedon Foundation, the deal allows the government to protect and care for tropical forest in return for retirement of debt. Bills are being introduced in the U.S. Congress to have multilateral development institutions formalize the approach.

Another sort of special use for the swap technique has also been developed with Bolivia which will, over four months, offer to buy back debt with cash provided by western donor countries; Bolivia will act to stem cocaine trade in this deal. The banks are coordinated by Bank of America, the biggest creditor, and an IMF trusteeship will receive and distribute the funds; any commercial debt obligations still remaining after the buyout will be restructured.

Employee Stock Ownership Plans

A mechanism of increasing interest for holding the equity of the firm -- and for running the operation -- is via the use of Employee Stock Ownership Plans (ESOPs). In this way one can leverage the ESOP by having the creditor bank contribute the loan to the parastatal through the ESOP trust; the trust exchanges the loan with the government or a third party for the shares, and the bank takes back a note from the trust.

Especially in the case of ESOPs, it is very desirable to improve the creditworthiness of the borrower, so banks often seek host government guarantees (credit enhancement) of the notes; this means that the lending bank has undergone no change in its exposure/risk profile. The ultimate obligor is still the government. However, the banks do not want to enter into such a deal -- and extra effort -- without some fees being paid to the bank. ESOPs are an important vehicle since it is much more feasible politically to sell an organization to an ESOP than to a multinational. If host government aid is impossible banks would find it desirable to have a partial credit enhancement from the U.S. government or a multilateral. An interesting form of U.S. enhancement would be by providing a tax break for the interest earned from an investment in an ESOP.

One good pathway for using ESOPs is for multinationals to use them for setting up subsidiaries. This works best in cases where the subsidiary is designed to be a profit center, or as a mechanism for building a network of suppliers or creating a just-in-time supply system.

If investors are worried enough about the dangers of dealing with ESOPs, many believe that there should be specific language written into U.S. legislation mandating that the World Bank's Multilateral Investment Guaranty Agency (MIGA) provide coverage via guarantees of MIGA notes.

3.0 COMPLICATING FACTORS IN SWAPS

Swap transactions are always subject to a number of factors that are specific to the needs and policies of both the host and the home countries.

3.1 Host Country

Many of the complicating factors concern the type and magnitude of the risk. The nature of the entity bought into defines the risk. For example, a utility presents a greater degree of government risk -- and therefore government protection -- than a small manufacturer.

Fee Generation

In an effort to share in the benefits afforded by the discount on the sovereign debt, many governments exact charges for participating in the transactions. Charges by a government can come in many forms: processing fees, charges for quota rights on conversion availability, a temporary or permanent loss of interest income on exchanged debt instruments, the application of off-market rates of exchange on currency conversion and outright discount imposed by the central bank when providing local currency cash. Also included are the discount imposed by local financial markets when placing exchanged debt instruments to generate liquidity. The last-noted mechanism is the most significant.

Fiscal Controls

To dampen inflation, Mexico and the Philippines have used systems where excess currency proceeds are left on deposit with the government and paid to the enterprise under an agreed schedule; this works especially well with construction-related investments. An alternative approach is to have the debtor government issue a local currency certificate of indebtedness with installment amortizations at the time the conversion transaction is completed -- the investor then has the choice of either capitalizing the enterprise with this instrument or, if the funds are needed immediately, selling the instrument for cash in the local discount market.

Another basic host government-related hindrance concerns the need to make foreign exchange available for meeting obligations, whether debt interest payments or dividends. The country may impose a "lock-up" period in which there are restrictions on the repatriation of dividend income; it could be limited to the outflow of debt payments, for example a limit on repatriatable amounts to the profits made by the enterprise and exclusion of a repayment of the original investment.

Most Latin American nations have at one time restricted repatriation/remittance of profits -- for reasons unrelated to debt-equity programs -- and there is a substantial fear that they could do so again. In fact, some argue that these funds are tainted by their source and might be the targets of expropriation actions.

Process Controls

One of the most basic desires of host governments is to be able to control the volume and flow of swap transactions. One technique is the imposition of quotas on the amount of certain types of transactions approved during a period; rights are sold at auction. This is a process well developed in Chile.

Restructured and Rescheduled Debt

Restructuring agreements are designed to ensure equal treatment among creditors. The capital portion of investments made with the proceeds of the restructured debt may not be repaid to the investor earlier than the scheduled amortization of principal on the restructured debt, and repayment of dividends for those investments may be similarly restricted. These restrictions are intended to prevent the debtor country from using a debt-equity swap to effect a preferred payment to a specific creditor; they are not generally objectionable to the debtor country since they coincide with the government's own desire to manage the outflow of foreign exchange.

Thus, debt rescheduling agreements executed by the host governments contain terms that must be factored into swap transactions. Loan agreements should be amended to cover rescheduled debt to avoid conflict with the "pari pasu" and "sharing" provisions; they should establish clear and reasonable remittance rights for the conversion investment; they should enable the creditor to achieve liquidity in local currency at an acceptable cost; and should provide guidance on procedural matters.

Mandatory prepayment clauses in restructuring agreements require that the debtor repay all creditors ratably if it prepays any debt. Akin to this are the "sharing clauses" found in syndicated loan or restructuring agreements requiring that all creditors must share the benefits of any prepayment to one of them. Some restructuring agreements restrict loan assignments to financial institutions; in the worst case the investor purchases a silent sub-participation in the loan targeted for redemption and the bank remains a nominal creditor until the loan is discharged.

The Underlying Environment

The political/economic context of the host is of great importance; for example, in most of the target countries one of the basic hindrances to effective use of swaps is the lack of desirable projects in which to invest. Also, traditional nationalism, especially in Latin America, is always a problem for investors. At any rate, it is felt that nationalistic feelings won't imperil the process if investments are made on a portfolio basis, and control of important operations doesn't vest in foreigners. In certain areas, such as northern Mexico, the drive for investment and development is so strong that nationalism has ceased to be an issue.

In the area of privatization, U.S. firms generally are wary of acquiring privatized firms due to fear of government/political risk; this is not so much fear of expropriation as of a gradual chipping away of cash flows through mandated wage increases or delayed or proscribed price increases. Also, banks do not like the idea of directly investing in privatized enterprises, which they feel are by definition poorly run, undercapitalized, etc. In other words, they are in need of more aid and attention than banks are prepared to provide.

3.2 Home Country

Likewise, many impediments to debt-equity swaps have their origin in the home country of the actors. U.S. impediments to debt-equity swaps generally relate to banks and are not very troublesome to other firms. Further, the U.S. legal and regulatory environment is not inherently anti-swap.

Bank-related Issues

One of the primary worries of U.S. bankers regarding debt-equity swaps is the fear that they will be required to book a loss, based on the discounted value, when they participate in a swap.

Currently, commercial banks are entitled to carry sovereign loans at the traditional cost (even if the country is engaged in general debt restructuring) unless U.S. bank regulators specifically mandate a writedown of loans to borrowers in that country; the policy is due to lack of ways to determine value of the assets. A growing secondary market gives rise to fears that the more precise valuation will get accountants to decide to go for real value.

At the least, when a bank sells a loan at discount it is required to book a loss on that sale. Less clear are the issues involved when a bank converts its own loan holdings into equity or tenders its debt to a mutual fund in exchange for shares in the fund or limited partnership investments.

Even more critical is the spectre of the "mark to market" process endangering the value of a portfolio beyond a particular transaction. This is based on the fear that debt notes sold or purchased by a bank at a discount can establish a "mark value" below par, forcing the bank to mark to market the balance of the entire foreign debt portfolio, forcing writeoffs.

Some banks won't do debt-equity swaps without equity accounting rules, since this is a trade of a generally performing loan for a non-performing investment. The Federal Reserve Board staff is concerned that use of equity accounting would allow the swap investment to be carried on the books at a value greater than that of the loan and also allow the accrual on the books of the value of dividends that could not be repatriated.

Other constraints exist. Except for the Regulation K privatization rule, U.S. bank holding companies are restricted from making investments in non-financial companies exceeding $US 15 million or 20 percent of the voting stock of the company. In its revision of Regulation K, the Federal Reserve staff felt that the situation was analogous to powers of the banks in acquiring assets in the course of collecting a debt previously contracted (DPC). These are seen as having a temporary nature.

Some changes are in the works. For example, last year the Institute of Certified Public Accountants ruled that banks could avoid taking a loss only if they proved such deals entailed no loss of value, and many feel that holding loans is becoming a less attractive option since the possibility of mandated reserves is becoming stronger. This would place U.S. money center banks in a position more like non-U.S. and smaller U.S. banks. Much debt is bought from Europeans whose balance sheets don't need to reflect the same steep loss from selling discounted debt (due to existing mandated reserve rules) and from U.S. regional banks, which don't have the same exposure in LDC non-performing loans, and are willing to take the loss to be rid of it.

Accounting and Tax Requirements

One of the most critical areas of restraint in debt-equity swap activities relates to accounting practices and standards and tax consequences.

In general, prudent man rules and other conservative restraints compel a slowing of investment in unknown companies. Valuation is a key concept here, and "loss" or "gains" thus flows. The majority of the U.S. accounting profession views swaps as one related transaction, but the minority sees it as a sale with a purchase. The difference is significant vis-a-vis the amount of loss recognized and the booking value of the asset acquired. At this time, accountants and regulators are leaning toward recording the equity part of the swap at fair market value of the debt as is done in a debt for debt swap.

In cases where the foreign exchange structures are not tightly tied down, one may also confront exchange risks as well as investment risk. To deal with these problems in the U.S., FASB-52 requires quarterly translation of the exchange risk and GAAP requires quarterly valuation of the investment.

4.0 RATIONALES FOR AND AGAINST DEBT-EQUITY SWAPS

One universal truth about debt-equity swaps is that they inspire deeply motivated feelings, both in favor of them and opposed to them.

Positive Attributes

Looking first at the positive, the following are supported as pro-swap issues:

First, they can reduce annual debt and debt service burdens. They do this more effectively than would be possible under debt relief -- via a World Bank facility, for example -- since there is a total elimination of debt service on the swapped part. Not only is there a reduction in outflows in absolute terms, but also in terms of the fact that hard currency assets need not be expended. Whatever the future outflows generated by the investors (i.e., dividends) might be, they will be conditional on the business success of the undertaking, and will, to some degree, be under the control of the government's foreign exchange and general investment regulations.

The second major component of the debt-equity equation relates to the fact that such swaps encourage increased equity and investment flows into the host country. Swaps work best at times when there is a significant secondary market discount in sovereign debt, thus allowing investors to leverage their purchases of local currency -- effectively a separate and much more favorable exchange rate. In this way there is an increased publicizing of good business opportunities in a good climate -- witness Chile. Other motivating factors for private firms include the potential to earn locally generated profits from the operation and to beneficially utilize tax and related rules.

The debtor is further benefitted by an improvement in the debt/equity mix of external liabilities, which serves to reduce exposure to variations in worldwide interest rates, an important consideration in the near-term future, as the ramifications of the stock market collapse are felt. Additional benefit along these lines accrues to the lender, as banks are able to lower their exposure while becoming more securely established in the country.

Tangential considerations exist as well; for instance, debt-equity programs are often the companions or precursors of other forms of liberalization of trade and investment, such as privatization. Use of debt-equity provides an important degree of flexibility, for example its usefulness by a multinational corporation which desires control of assets with a minimal country exposure. With participation under debt-equity, the firm would be able to later increase its presence and exposure if the environment becomes even more favorable. Enthusiastic investors are good for the debtor, and in many cases are more desirable than creditors, since the former take a more active role in promoting economic and community growth, and also transfer technology and resources.

Another continuing concern of the host countries which can be positively affected by debt-equity swaps is flight capital, money being held outside of the productive parts of the local economy;

since such flight capital can be seen as the least expensive of all forms of capital available to the governments, debt-equity mechanisms are very desirable in allowing local participants to carry out deals and repatriate local money.

Also among the driving forces behind debt-equity swaps is the growing feeling that sovereign borrowers will not make full repayments for the foreseeable future, and even repackaging cannot help enough, as the security merely takes on the appearance of a perpetual obligation. Thus, as a means for avoiding a no-win situation, debt-equity is attractive. Even though switching from debt to equity means dropping from a first tier to a second tier risk, it is not a serious concern, as existing loans are often classed as Other Transfer Risk Problems or worse.

Finally, swap programs can be used as a bargaining chip; e.g., by selective accommodation on debt-equity swap issues, a country can strike a better deal on rescheduling of larger debt packages.

Negative Attributes

Just as there are many cited advantages to debt-equity, there are also numerous strong arguments advanced against the concept.

Among the most-often-heard themes is the argument that good swap deals (i.e., investments) would have taken place in any event, and the swap-related concessions are little but a give-away. In fact, the argument goes, there is an implicit government subsidy present in swap transactions which provides expensive artificial viability for deals that should not take place. Critics feel that in most cases swaps are used by firms already operating in country and the benefit of the deal is unneeded government largess.

Another critical argument is that swaps add to the money supply by bringing fresh capital into the country, thus boosting inflation; in some locations this is a serious, or fatal, issue for the swap program.

Chile falls into the former category, and has addressed it by selling long-term government bonds to match the swaps and setting monthly limits on the volume of deals; Mexico fell into the latter category when it halted the operation of the swap program in early November 1987 as an inflation-fighting mechanism. In these areas, a basic fear of the host government is losing control of the money supply.

Interestingly, another negative flows from an opposite premise. In addition to inflationary pressures, swapping might substitute for more beneficial foreign investment; often debtor governments must float new domestic debt -- often at rates higher than the international debt -- to "sterilize" the swap payment made to the local company. Thus, there is a strong chance that debt-equity conversion may result in the release of additional local currency into the system. A further fear is that downstream dividend payments by investors will offset immediate savings in interest payments.

Because debt-equity swaps have a close relationship with many types of transborder capital flows, a cited negative is the stimulating effect swaps have for "roundtripping," the process of bringing flight capital back to a country to swap it cheaply into local currency, then converting it back into dollars on the black market. This can be monitored and addressed to a degree. For instance, Chile does not allow repatriation of capital for ten years. Another way of addressing this is to prohibit participation in the system by local citizens; for much of the history of its program, Mexico only let foreign corporations deal in swaps.

Such capital flows are disruptive, according to the Group of Thirty, in that swaps create an effective two-tier exchange rate; "foreign firms that would otherwise retain earnings in the country are instead encouraged to take the funds out and bring them back through swaps, taking advantage of the preferential rate."

Another negative, from the point of view of the lender banks, relates to a diminution in their bargaining power. Some feel that banks that are converting debt for equity are unlikely to continue to provide loans, with the result that the burden of carrying the debtors falls on the shoulders of a smaller group of institutions. However, the facts are that some shakeout of the smaller participants in the lending and syndication process would often be a cost-effective act.

A further detriment noted by the Group of Thirty relates to the moral hazard of a country having a perverse incentive to pursue poor policy or undertake unilateral action on its debt to depress the market price and buy back its own debt.

Finally, swaps can be a problem for the investor who picks up commercial risk. This requires monitoring and oversight, and a new degree of dependence on many factors outside the investor's control. Additionally, bank regulations in the U.S. are intended to prevent financial institutions from being thus exposed (e.g., Glass-Steagall and Regulation K). Recent regulatory amendments are intended to allow participation in privatization-related transactions, but, ironically, banks feel the commercial viability of privatized firms is too low to interest them.

The Final Balance

Overall, the consensus is that debt-equity swaps are a process that works in particular situations because the benefits outweigh the costs. Depending on the local system and the attractiveness of investments, solutions to the problems can be created. There is no fixed approach, however, and variety is the key word in the overall picture.

5.0 SPECIAL PRIVATIZATION ISSUES

Using debt-equity swaps to stimulate privatization programs is a natural and very desirable process. However, the volume and importance of this mechanism for privatization has not kept up with its potential. The reasons for this are several.

For one, the Bankers' Association for Foreign Trade has noted that most members would be more interested in investing in private sector companies than in parastatals; the number of the latter is limited and a private sector company is more likely to be well managed, since parastatals are prone to being run as public service organizations. However, they would still presumably be interested in serving as advisors and intermediaries.

Also, U.S. firms are wary of acquiring privatized firms due to fear of government/political risk; this is not so much fear of expropriation as of a gradual chipping away of cash flows through mandated wage increases or delayed or proscribed price increases.

To stimulate privatization, the Federal Reserve has liberalized Regulation K to permit a U.S. banking organization to acquire as much as 100 percent of the shares of a foreign non-financial company if:

- The entity is in the process of being transferred from government to private ownership;
- The country in which it is located is a heavily indebted developing country;
- The shares are acquired through a debt for equity swap;
- The shares are held by the bank holding company or its subsidiaries; and
- The ownership interest must be divested within five years from the date of acquisition, unless the Board extends the time for good cause but in no event longer than a total of ten years.

There is some concern that the action of the Federal Reserve is to force banks to act in a public sector role, encouraging privatization, which could be troublesome since the consensus among banks is that privatized firms are losers compared to private companies. This fact opens the management of the investor to shareholder suits.

There is a ten year divestiture requirement in the revised Regulation K, but the banks feel this is not long enough. There is a general belief that there will be few interested parties during the period when the host government is restricting dividend repatriations (or at least principal repayment limits). In most countries local citizens are not allowed to be purchasers, so even if the bank could sell just after becoming allowed to repatriate, the prices would be depressed.

6.0 THE FUTURE OF DEBT-EQUITY SWAPS

At this time, the previous assurance of strong future growth for swaps has been cast into doubt because of the immense impact of the global stock market collapse.

In general, though, many initiatives are proceeding. For instance, the World Bank is taking on a new role as a go-between and promoter of swaps, as well as reducing the commercial bank debt burden in LDCs; it will be a facilitator and intermediary, analyzing the terms of proposed deals and easing their misgivings. The concept is being supported by the United States.

The African Development Bank is currently working with S.G. Warburg to design a plan in which the debt of sub-Saharan African countries can be converted into marketable securities; they would carry below-market interest rates and could be swapped for equity investments at the lender's option. Additionally, there will be a sinking fund controlled by a trustee, which would receive a portion of the debt service payments, ensuring that the maturing debt is at least partially repaid. There are, however, some roadblocks; for example, U.S. officials, afraid of the precedent being set, are not providing the necessary support.

Also, there is talk of an IMF or World Bank debt facility funded by, e.g., nations with large current account surpluses, paid-in callable capital from members, borrowing against IMF gold assets, or issuing bonds to banks in return for their debt paper. The costs of this program are very large. For the U.S., in addition to the payment of the callable capital, the sale of the debt by U.S. banks would be tax deductible; also, the full risk on commercial bank debt portfolios would be assumed by the facility, backed by the taxpayer.

However, the stock market crash is creating many unknowns. One of the principal ramifications of the market crash is the fact that there are many excellent domestic firms in all developed countries with extremely underpriced shares (and in some cases that includes the very firms that might otherwise interested in debt-equity swaps). In many of the cases, these domestic opportunities are going to be much more attractive to investors than LDC equities.

Another post-crash problem area relates to the fact that banks and firms will be capital-short and not in the market for debt instruments. In fact, many firms will be using their available capital to buy back their own stock or make other adjustments. With the impending restrictions on the ability of firms to raise capital worldwide, existing investable cash will be carefully husbanded.

In a general sense, lowered interest rates -- designed to encourage economic activity -- could benefit borrowers in the short term, as an extremely high proportion of LDC debt is tied to such rates. Higher rates, on the other hand, could lead to lessened economic activity in the developed world, translating directly into decreased LDC exports and less need to invest in LDC enterprises.

At any rate, debt-equity swaps are a mechanism of immense importance and should be closely monitored as events unfold.