

## The Debt Problem: The Baker Plan and the Brady Initiative: A Latin American Perspective\*\*

The Baker and Brady plans reflect in broad terms the U.S. approach to the international debt problem in two different stages of its history. Using a case-by-case approach, U.S. Secretary of the Treasury James Baker based his 1985 plan<sup>1</sup> on three major elements: (1) the promotion of a sustained growth in less developed countries (LDCs) under the application of sound economic policies; (2) the central participation of the International Monetary Fund (IMF) and multilateral development banks, and (3) the increase of commercial bank financing to LDCs, or more specifically, a commitment by banks to lend \$20 billion<sup>2</sup> for the next three years to middle income LDCs.

Four years later U.S. Secretary of the Treasury Nicholas Brady initiated his plan.<sup>3</sup> While it incorporated the basic principles of the Baker plan, it added, based on previous experiences, a proposal of voluntary debt and debt service reduction. The new strategy presented as possible mechanisms IMF and World Bank funds to support collateralized debt for bond exchanges involving a significant discount on the outstanding debt, or funds to be used to replenish banks' reserves following a cash buy-back, or funds to collateralize a portion of interest payments for reductions.

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1. James Baker III, U.S. Secretary of the Treasury, Address Before the Joint Annual Meeting of the IMF and the World Bank (Oct. 8, 1985), reprinted in FOREIGN DEBTS IN THE PRESENT AND A NEW INTERNATIONAL ECONOMIC ORDER 291-301 (D. Dicke & U. Fribourg eds., 1986).

2. All dollar amounts refer to U.S. dollars.

3. Nicholas F. Brady, U.S. Secretary of Treasury, Remarks Before a Third World Debt Conference sponsored by the Brookings Institution and the Bretton Woods Committee (Mar. 10, 1989), reprinted in DEP'T OF STATE BULL., May 1989, at 53-56.

A mere description of the Baker and Brady plans is not enough to obtain a clear understanding of them as part of the U.S. approach to the international debt problem. They must be viewed within the broader context of the U.S. banks' own perspective of the international debt problem, the U.S. legal response, and the evolution of the international debt problem for LDCs. The contextual analysis leads us to observe that the major concern of U.S. policy has been to diminish the effects of the debt problem on the banking industry, which at the beginning of the debt problem exhibited an exposure to Latin American countries of more than 230 percent relative to bank capital. Once U.S. banks showed a strengthened capital position in 1989, the U.S. Government was able to propose, through the Brady plan, a strategy that emphasized debt reduction as a real measure to diminish the burden of debt for LDCs.

This article proposes that the U.S. response to the international debt problem resulted from the concern regarding banks' capital positions. As the debt problem evolved, banks developed a three-step strategy: to keep the loans as current as possible, to gain time to rebuild capital and reserves, and to endeavor to transform LDC loans into better assets. Legislation supported the banks' strategy despite the new legal framework developed since 1983 with the approval of the International Lending Supervision Act (ILSA).<sup>4</sup>

The Brady plan called for debt reductions that had already been incorporated into some restructuring agreements under debt exchanges. However, its real success in reducing the burden of the LDCs' debt will be measured by the magnitude of future debt reductions. In 1988, including debt-for-equity swaps, debt buy-backs, debt exchanges, debt-for-bond swaps, and settlement of debts, the total debt reduction of the banks' debt in Argentina was 3 percent; in the case of Mexico the level was 7.9 percent.<sup>5</sup> After the United States announced the Brady plan, restructuring agreements provided higher levels of reductions, such as the case of the Mexico agreement that implied a reduction of about \$14.5 billion of its banks' debt (around 18 percent of the total). The Philippines obtained in its 1989 agreement a reduction of almost 13 percent of its banks' debt.<sup>6</sup>

However, more substantial debt reductions must be reached; otherwise a rise of interest rates could nullify the effects of reductions by making the remaining debt more expensive.<sup>7</sup> Recent IMF estimates show that the total debt of LDCs (excluding IMF credit) increased by nearly 6 percent in 1990 and reached \$1,306 billion by the end of the year.<sup>8</sup>

4. 12 U.S.C.A. §§ 3901-3912 (1983). For a discussion of ILSA, see text *infra* part II.

5. Libra Bank Report, cited in *Manging Latin Debt: Playing It Close to the Vest*, 7 LATIN FIN. 16, 16 (1989) [hereinafter Libra Bank Report].

6. 1990 INT'L MONETARY FUND ANN. REP. 28-32 [hereinafter 1990 IMF ANN. REP.].

7. *The International Debt Crisis: A Review of the Brady Plan: Hearing Before the Subcomm. on International Economic Policy and Trade of the Comm. on Foreign Affairs*, 101st Cong., 1st Sess. 61 (1989) (statement of Paul Sacks, president of Multinational Strategies).

8. 1991 INT'L MONETARY FUND ANN. REP. 12.

## I. U.S. Banks Perspective of the International Debt Problem

Many analysts see the international debt problem not only as a problem for LDCs, but also as a problem that puts at risk the stability of the U.S. financial system.<sup>9</sup> At the end of 1985 commercial banks worldwide had lent Latin America around \$217 billion. U.S. banks held 41.7 percent of such exposure, European banks 37 percent, and Canadian banks 7.6 percent.<sup>10</sup> When Mexico announced its moratorium in 1982,<sup>11</sup> the nine U.S. largest money center banks showed an exposure to countries with debt-servicing problems equal to 233 percent relative to their primary capital. In the case of the following twelve major U.S. banks, the percentage was 154 percent.<sup>12</sup> In the same year, Citicorp,<sup>13</sup> the United States' largest bank and largest LDCs' creditor, held a \$7.672 billion exposure to Mexico and Brazil that represented 128 percent of its capital. In the case of Manufacturers Hanover, its exposure to those countries was \$3.743 billion, representing 144 percent of its capital.<sup>14</sup>

The high level of U.S. banks' exposure to debtor countries with debt servicing difficulties in 1982 meant that each bank would have to assume the costs of a potential limitation of repayments on its own, when most were financially unable to do so. During the 1977 to 1986 period the eighteen largest U.S. banks, which held approximately 80 percent of the LDCs' debt, had established general reserves

9. In 1988 the president of the Federal Reserve Bank of New York indicated that "in the early days of the debt crisis only swift, decisive; and broadly based cooperative efforts by debtors, creditors, central banks, governments and multilateral institutions allowed us to avert a financial and economic calamity." Corrigan, *A Balanced Approach to the LDC Debt Problem*, 13 FED. RESERVE BANK OF N.Y. Q. REV. 1, 1 (1988). The IMF has constantly referred to the debt problem as a crisis that put in risk the international system of payments as a whole. See 1989 INT'L MONETARY FUND ANN. REP. 23; see also Nicholas Sargen, *Managed Lending: An Assessment of the Current Strategy Toward LDC Debt*, 17 N.Y.U. J. INT'L L. & POL. 533, 533-34 (1985).

10. UNITED NATIONS CENTRE ON TRANSNATIONAL CORPORATIONS, TRANSNATIONAL BANKS AND THE INTERNATIONAL DEBT CRISIS 40, U.N. Doc. ST/CTC/96, U.N. Sales No. E.90.II.A.19 (1991) (table 12) [hereinafter TRANSNATIONAL BANKS].

11. In August 1982 Mexico requested of its commercial bank creditors that all principal payments on short- and medium-term public sector debt be rolled over for a period of 90 days, because of its shortage of foreign exchange. Mark A. Walker, *Mexico: More than a Debt Crisis*, INT'L FIN. L. REV., Aug. 1992, at 33.

12. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., STUDY ON THE RISKS TO THE U.S. BANKING SYSTEM POSED BY TROUBLED FOREIGN LOANS 17 (1990) (table III) [hereinafter RISKS ON BANKS]. The nine U.S. largest money center banks are: Bank of America; Bankers Trust; Citibank; Chase Manhattan Bank; Chemical Bank; Continental Bank; First National Bank of Chicago; Manufacturers Hanover; and Morgan Guaranty. The twelve other large banks are: Bank of New York; First City National Bank of Houston; First Interstate Bank of California; First National Bank of Boston; Midland Bank; NCNB Texas National Bank; National Bank of Detroit; Republic National Bank of New York; Security Pacific; Texas Commerce Bank; and Wells Fargo. *Id.* nn.6, 7.

13. In the debt problem literature most of the authors use the names Citibank and Citicorp synonymously to mean the whole American bank group. Citicorp is the bank holding company and its subsidiaries are all of the Citibank and Citicorp banks, such as Citibank, N.A. New York. See CITICORP, ANNUAL REPORT 1992, at 96.

14. TRANSNATIONAL BANKS, *supra* note 10, at 36 (table 10).

of only \$5.5 billion.<sup>15</sup> In those circumstances the real threat for banks was whether voluntary reserving, legally required reserving, or writing down LDCs' debts would reduce earnings and weaken their capital position.<sup>16</sup>

In retrospect, how banks reacted to this threat allows us to identify three major objectives in U.S. banks' policies: (1) from 1982 to 1987 banks tried to keep their LDC loans as current as possible in order to record them in their original value;<sup>17</sup> (2) banks used the period 1982 to 1987 to gain time for increasing general reserves and capital; and (3) once banks reached a better capital position, they began to look for different mechanisms to transform their LDC loans into improved or more convenient assets (debt exchanges).<sup>18</sup>

#### A. KEEPING LDC LOANS CURRENT

In order to keep their LDC loans as current assets, banks conceived restructuring agreements as a mechanism of lending money to debtor countries for paying due interest on time. The more vulnerable a bank was, the more likely it would extend new financing in an effort to keep loans current.<sup>19</sup> The following example illustrates the dynamic of relending and keeping the assets current:

Assets of a bank basically consist of outstanding loans, and they remain on the Statement as assets so long as they are not in default. If a \$1,000,000 loan carries ten percent annual interest payable quarterly, it brings \$25,000 every three months; if the interest is not paid, say for two quarters, it is considered a non-performing loan and must be written down by 50% on the Statement of Condition; if non-payment of interest continues further, the loan may have to be written off entirely. Thus, for \$25,000 or \$50,000 in additional funds used to keep interest payments current, a bank saves itself from a write-down of \$500,000 or a write-off of \$1,000,000, a reduction in the asset side of the balance sheet that must be matched (once loan reserves are exhausted) by a corresponding reduction in earnings and (if those are insufficient) in net worth.<sup>20</sup>

Restructuring agreements until 1989 only provided the reschedule of principal. They basically established a reschedule of payments of a number of maturities falling due in a given period of time (consolidation period). The first restructuring agreements affected original maturities (debt that had not been previously rescheduled), including consolidation periods of one or two years. However, since 1984

15. OFFICE OF THE COMPTROLLER OF THE CURRENCY ET AL., DEVELOPING COUNTRY LENDING PROFITABILITY SURVEY 3 (1989) (chart 1) (Supplement to: STUDY ON ACCOUNTING AND REGULATORY POLICIES AFFECTING DEBT RESTRUCTURING (hereinafter SUPPLEMENT)).

16. Troland S. Link, *The Value of Bank Assets Subject to Transfer Risk*, 23 COLUM. J. TRANSNAT'L L. 75, 76-77 (1984).

17. Lee C. Buchheit, *The Evolution of Debt Restructuring Techniques*, INT'L FIN. L. REV., Aug. 1992, at 10, 11 (see *Changing Circumstances*).

18. Banks adopted different strategies for coping with the debt crisis, including debt rescheduling, increasing loan-loss reserves, and debt-equity swaps. Stuart M. Berksen & Bruce A. Cohen, *Tax Implications of Debt-for-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575 (1989).

19. V. AGGARWAL, INTERNATIONAL DEBT THREAT BARGAINING AMONG CREDITORS AND DEBTORS IN THE 1980s, at 16 (1987).

20. Andreas F. Lowenfeld, *Foreword*, 17 N.Y.U. J. INT'L L. & POL. 485, 489 (1985).

consolidation periods began to cover longer periods under the so-called Multi-Year Restructuring Agreements (MYRAs) and affected debt already rescheduled. Mexico, for example, five times restructured debt previously rescheduled.<sup>21</sup>

The banks did not reschedule original interest rates. As indicated, they mostly kept payments current. But restructuring agreements and new financing packages were subjected to market interest rates, and spread under higher levels than the original ones.<sup>22</sup>

Charts 1, 2, and 3 summarize the general terms of banks' financial packages for Brazil, Mexico, and Chile during the period 1983 to 1988. Note that in the peak of banks' overexposure period (1983 and 1984), banks rescheduled principal and continued lending money, particularly in the case of Brazil and Mexico (the largest debtor countries). For banks the lengths of the new maturity and the grace periods under restructuring agreements were not as relevant as the levels of interest rates and their "on time" payments.

With restructuring agreements that kept interest current, banks avoided falling into voluntary or mandatory mechanisms that would affect their capital and income power, such as charges to the general reserve, the establishment of special reserves, or writing down of LDC loans. For banks, what mattered in the short term was not the danger of nonrepayment, but the reduction in income while the loan

CHART 1: BRAZIL

	TYPE OF TRANSACTION	AMOUNT	CONS. P	GRACE PERIOD	MATURITY	INTEREST RATE	FEES
1983	Restructuring	4 452	1 year (1983)	2 <sup>1/2</sup>	8	2 <sup>1/4</sup> - 2	1 <sup>1/2</sup>
	New Financing	4 400		2 <sup>1/2</sup>	8	2 <sup>1/2</sup> - 1 <sup>7/8</sup>	1
1984	Restructuring	4 846	1 year (1984)	5	9	2 - 1 <sup>3/4</sup>	1
	New Financing	6 500		5	9	2 - 1 <sup>3/4</sup>	
1986	Restructuring	6 671	1 year (1985)	5	7	1 <sup>1/2</sup>	1
1988	Restructuring	61 000	6 years (1987-1993)	7	19	13/16	
	New Financing	4 600		5	12	13/16	

21. MYRAs were conditioned to the application of stabilizing programs monitored by the IMF, and in some cases banks arranged consolidation periods according to the economic performance of country debtors. Mexico signed a MYRA for maturities falling due between 1985 and 1990 (\$48 billion); Venezuela for maturities falling due between 1983 and 1988 (\$21.2 billion); Ecuador for maturities falling due between 1985 and 1990 (\$4.3 billion); Yugoslavia for maturities falling due between 1985 and 1988 (\$3.6 billion); and the Dominican Republic for maturities falling due between 1985 and 1989 (\$707 million). K.B. DILLION ET AL., RECENT DEVELOPMENTS IN EXTERNAL DEBT RESTRUCTURINGS 15-16 (IMF Occasional Paper No. 40, 1985).

22. *Id.* at 15.

## CHART 2: MEXICO

	TYPE OF TRANSACTION	AMOUNT	CONS. P	GRACE PERIOD	MATURITY	INTEREST RATE	FEES
1983	Restructuring	18 800	2.5 years	4	8	1 <sup>7/8</sup> - 1 <sup>3/4</sup>	1
	New Financing	5 000		3	6	2 <sup>1/4</sup> - 2 <sup>1/2</sup>	
1984	New Financing	3 800		5 <sup>1/2</sup>	10	1 <sup>1/2</sup> - 1 <sup>1/2</sup>	5/8
1985	Restructuring	5 800	1	-	14	7/8 in 1985/86	
	Restructuring	17 800	3	-	14	1 <sup>1/2</sup> in 1987/91	
	Restructuring	5 000	The 1983 Loan	5	10	1 <sup>1/2</sup> in 1992/98	
	Restructuring	20 100	6	1	14	7/8 in 1985/86 1 <sup>1/2</sup> in 1987/91 1 <sup>1/4</sup> in 1992/98	
1986	Restructuring	43 700					

## CHART 3: CHILE

	TYPE OF TRANSACTION	AMOUNT	CONS. P	GRACE PERIOD	MATURITY	INTEREST RATE	FEES
1983	Restructuring	1 150	1 year (1983)	4	8	2 <sup>1/2</sup> - 2	
	Restructuring	1 019	1 year (1984)	4	8	2 <sup>1/2</sup> - 2	
	New Financing	1 300		4	8	2 <sup>1/4</sup> - 2 <sup>1/2</sup>	
1984	Restructuring <sup>23</sup>	1 160		4	8	2 <sup>1/2</sup>	
	New Financing	780		5	9	1 <sup>3/4</sup> - 1 <sup>1/2</sup>	5/8
1985	Restructuring	6 007	3 years 1985/1987	6	12	1 <sup>3/8</sup>	1/8
	New Financing	785		5	10	1 <sup>3/4</sup> - 1 <sup>1/2</sup>	1/2

Source of Charts: International Capital Markets Developments and Prospects (IMF) 1986  
International Capital Markets Developments and Prospects (IMF) 1988  
International Capital Markets Developments and Prospects (IMF) 1990

was in a nonaccrual status.<sup>24</sup> Additionally, banking regulators did not penalize banks that lent money to pay interest.<sup>25</sup>

The following paragraphs briefly analyze the reserves regime (general and specific) in U.S. law and how banks dealt with it during the period of restructuring

23. Conversion of short-term debt into medium and long-term debt.

24. Henry C. Wallich, *International Commercial Bank Lending from a Central Bank Viewpoint*, in *THE INTERNATIONAL DEBT PROBLEM AND ITS IMPACT ON FINANCE AND TRADE* 57, 70 (Barry R. Campbell & Robert E. Hertzstein eds., 1984).

25. James B. Hurlock, *Legal Implications of Interest Rate Caps on Loans to Sovereign Borrowers*, 17 N.Y.U. J. INT'L L. & POL. 543, 549-51 (1985).

agreements. The general reserve is called the Allowance for Loan Losses or loan-loss reserve. The loan-loss reserve constitutes a provision for inevitable loan losses, and the banks establish it by deducting the corresponding amount from the overall income (taken as a percentage of total loans outstanding).<sup>26</sup> The loan-loss reserve, once constituted, is considered part of the capital and surplus. Therefore, a charge against the loan-loss reserve has an immediate negative effect on a bank's capital (in theory, a predicted negative effect).

The special reserve, the Allocated Transfer Risk Reserve (ATRR), was introduced in U.S. law by the International Lending Supervision Act (ILSA)<sup>27</sup> and the body of regulations that followed it. The law establishes the ATRR against current income, but, unlike the loan-loss reserve, the ATRR cannot be considered as part of the capital and surplus or of the loan-loss reserve. The ATRR is established not under a general basis, as is the loan-loss reserve, but with respect to specific loans, mostly corresponding to countries that show transfer risk problems in accordance with the classification of the Interagency Country Exposure Review Committee (ICERC). The ICERC considers the following seven categories of country exposure:<sup>28</sup> strong, moderately strong, weak, other transfer risk problems (OTRP), substandard, value-impaired, and loss.<sup>29</sup> A bank must establish an ATRR

26. Link, *supra* note 16, at 76.

27. International Lending Supervision Act of 1983, Pub. L. No. 98-181, 97 Stat. 1278 (1984).

28. Country exposure is defined as the amount of claim that a bank has on borrowers or persons of the same foreign country. Regulations use the term for all cross-border and cross-currency claims, plus other credits guaranteed by residents of other foreign countries and net local currency assets of the bank's office in the country. Edward Bransilver & Ernest T. Patrikis, *Lending Limits and Regulatory Constraints Under U.S. Law*, in *SOVEREIGN LENDING: MANAGING LEGAL RISK* 1 n.10 (Michael Gruson & Ralph Reisman, eds., 1984).

29. The definition of each category is the following: (1) *Strong*: The country does not experience economic, social, or political problems that could interrupt repayment of external debt. (2) *Moderately Strong*: The country experiences a limited number of identifiable economic, social, or political problems that do not presently threaten orderly repayment of external debt. (3) *Weak*: The country experiences many economic, social, and political problems; if not reversed, these problems could threaten the orderly repayment of external debt. (4) *Other Transfer Risk Problems*: Countries not complying with their external debt-service obligations, as evidenced by arrearage or forced restructurings of rollovers, but which are taking positive actions to restore debt service through economic adjustment measures, such as an International Monetary Fund program; countries meeting their debt obligations but whose noncompliance appears imminent; or countries previously classified in categories (5), (6), and (7) that demonstrate sustained resumption of orderly debt service. (5) *Substandard*: Countries not complying with their external debt service obligations and (a) not in the process of adopting or adequately adhering to an IMF or other economic adjustment program or (b) not negotiating a viable rescheduling of their debts to banks or likely to do so in the near future. (6) *Value-Impaired*: Countries having prolonged debt-servicing arrearage as evidenced by more than one of the following: (a) have not fully paid their interest, (b) have not complied with IMF programs and no immediate prospect for compliance, (c) have not met rescheduling terms for over one year, and (d) show no definite prospects for orderly restoration of debt service in the near future. (7) *Loss*: Countries whose loans are considered uncollectable, such as a country that has repudiated its obligations to banks, to the IMF, or to other lenders. *Impact of Accounting and Regulatory Procedures on the Third World Debt Problem: Hearing Before the Subcomm. on International Development, Finance, Trade and Monetary Policy of the Comm.*

when the ICERC categorizes country exposure as value-impaired or loss. The first year an ATRR must be considered for the equivalent of 10 percent of the loan, which rises to 15 percent in subsequent years.<sup>30</sup> However, regulators can determine higher or lower levels.

A bank must also establish an ATRR when the loan is past-due in principal or interest for more than ninety days. If the loan remains in the same situation for more than six months, the bank must write it off.

The creation of an ATRR brings a direct negative effect over a bank's earnings since its source is income and it is not part of capital. In practice ATRRs represent negative assets and have the same effect as writing off a loan. When a loan is subjected to an ATRR or has been written off, the bank may not report current interest on the loan as part of its income.<sup>31</sup>

For the period 1977 to 1986 the eighteen largest U.S. banks had \$5.5 billion in loan-loss reserves. Notwithstanding, in 1987 banks tripled the level of loan-loss reserves, reaching a total amount of \$22.1 billion.<sup>32</sup> Until 1987 banks did not make any substantial effort to increase their levels of reserves, despite the levels of exposure and the dynamics of restructuring.

With respect to the levels of the mandatory ATRRs in February 1987 the total amount of special reserves reached \$1.7 billion, and in 1989, \$4.9 billion.<sup>33</sup> Despite the complex system of ATRRs, regulators did not impose them in substantial numbers. Allan Mendelowitz, director of the Trade, Energy and Finance Division of the U.S. Accounting Office, stated to the U.S. Congress that the 1989 level of ATRRs was inadequate, and that the level required was \$49 billion considering prices on the secondary market. Mr. Mendelowitz also pointed out that the principal cause of the low level of ATRRs was that regulators had required them only for loans rated "value-impaired" and "loss," which amounted to only 16 percent of loans owed by countries with debt servicing problems.<sup>34</sup>

As a result of the policy of periodically restructuring agreements and keeping interests current, Citicorp, for example, recorded only \$2.5 billion as nonperforming loans (considering domestic and international loans) in 1986.<sup>35</sup>

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*on Banking, Finance and Urban Affairs*, 101st Cong., 1st Sess. 67, 77 (1989) [hereinafter *Hearing: Regulations and the Debt Problem*] (statement of Allan I. Mendelowitz, Director, Trade, Energy and Finance Division, National Security and International Affairs Division, U.S. Accounting Office).

30. 12 C.F.R. § 211.43(b)(2)(ii)(B).

31. Link, *supra* note 16, at 77-78.

32. SUPPLEMENT, *supra* note 15, chart 1.

33. *Hearing: Regulations and the Debt Problem*, *supra* note 29, at 67, 72. The list of value-impaired countries includes Bolivia, Nicaragua, Peru, Poland, and Sudan (in no case a big debtor country). Brazil was not classified value-impaired even after its stopping of interest for a year. Banking regulators already had in 1989 the authority to impose ATRRs for OTRP countries, but they did not use it. See Sparks, *Wrangling over Regulations*, 7 *LATIN FIN.* 50 (1989).

34. *Hearing: Regulations and the Debt Problem*, *supra* note 29, at 10-11.

35. *TRANSNATIONAL BANKS*, *supra* note 10, at 89 (table 26).

## B. GAINING TIME FOR INCREASING GENERAL RESERVES AND CAPITAL

Under the strategy of restructuring agreements to keep loans current, banks gained time to rebuild their capital positions. The year 1987 marked a new period in banks' strategy, with the \$3 billion increase of Citicorp's loan-loss reserves.<sup>36</sup> Banks began to increase general reserves at extraordinary levels, with the immediate consequence of increases in capital. In 1987 banks tripled the amount of loan-loss reserves of the whole period from 1977 to 1986. Following this trend, the nine largest U.S. banks increased reserves at an annual average of 5 percent in the early eighties and reached a 50 percent annual level in 1990.<sup>37</sup>

On the capital side between 1982 and 1989 the twenty-one largest U.S. banks increased primary capital from \$40 billion to \$76 billion. As a percentage of total banking assets capital levels increased from 4.7 percent to 8.2 percent during the same period.<sup>38</sup> In 1990 the minimum capital requirement for a bank consisted of a ratio of total capital to total assets of not less than 6 percent and a ratio of primary capital to total assets of not less than 5.5 percent.<sup>39</sup>

What did banks' increases in capital and loan-loss reserves mean in the context of the debt problem? By improving their capital position, banks were better prepared to absorb eventual nonpayments.<sup>40</sup> By strengthening capital, banks also improved their bargaining power in restructuring negotiations. According to two analysts, by increasing its reserves, Citicorp announced future asset write downs, new equity issues, and a stronger negotiating posture with both LDC borrowers and

36. *Id.* at 87. Following Brazil's moratorium, Citicorp increased its loan-loss reserve to the equivalent of 25 percent of its exposure. Citicorp was trying to show investors that the most exposed U.S. bank in Brazil was taking the problem seriously, being ready to face default. *Id.* at 87-88.

37. Alberto G. Santos, Note, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. Rev. 66, 83-84 (1991).

38. OFFICE OF THE COMPTROLLER OF THE CURRENCY & BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, *STUDY ON ACCOUNTING AND REGULATORY POLICIES AFFECTING DEBT RESTRUCTURING* 16 (1989) [hereinafter *STUDY ON THE RISK*].

39. 12 C.F.R. § 325.3(b) (1990). "Primary capital" means "the sum of common stock, perpetual preferred stock, capital surplus, undivided profits, capital reserves, mandatory convertible debt (to the extent of 20 percent of primary capital exclusive of such debt), minority interest in consolidated subsidiaries, net worth certificates issued, and loan-loss reserve and minus intangible assets other than mortgage servicing rights and assets classified loss." 12 C.F.R. § 325.2(h) (1990). "Secondary capital" means "the sum of mandatory convertible debt that is not included in primary capital, limited life preferred stock and subordinated notes and debentures, in an amount up to 50 percent of primary capital." 12 C.F.R. § 325.2(i) (1990). "Total capital" means the sum of primary capital and secondary capital. 12 C.F.R. § 325.2(i) (1990). "Total assets" means "the average of total assets required to be included in a banking institution's 'Reports of Condition and Income,' (Call Reports) as these reports may from time to time be revised, as of the most recent report date, plus the allowance for loan and lease losses reserve, minus assets classified loss, and minus intangible assets other than mortgage servicing rights." 12 C.F.R. § 325.2(k) (1990).

40. The U.S. banking system is better able to absorb the effects of debt servicing problems of developing countries for three reasons: First, bank capital has been strengthened relative to overall bank lending activity. . . . Second, earnings of large multinational banks are more diversified than in the past. . . . Third, international bank lending has been strengthened through bank policies and procedures on lending to ensure that risk in the loan portfolio is properly evaluated and reserves against further loan-loss reserves have been established.

*STUDY ON THE RISK*, *supra* note 38, at 16-18.

bank regulators.<sup>41</sup> Other analysts thought that the creation of the reserves to cash out through the secondary market would reduce debtors' appetites for continuing debt service.<sup>42</sup> However, since 1987 no major debtor has withdrawn from the renegotiating process with banks. Banks made clear that the wave of provisioning did not mean a willingness to write off or even to forgive sovereign debt.<sup>43</sup>

The increases of capital substantially helped to reduce the level of banks' exposure to LDCs relative to primary capital. For the nine largest U.S. banks the exposure to countries with debt servicing problems declined from 233 percent in 1982 to 94 percent at the end of 1989. For the twelve other large banks the exposure to the same countries declined from 154 percent of primary capital to 43 percent during the same period.<sup>44</sup>

### C. LOOKING TO TRANSFORM LDC LOANS

While rebuilding their capital position, some banks also looked to transform their LDC loans into better assets through mechanisms like debt exchanges, debt-for-equity swaps, and the "securitization" of the debt. Transforming LDC loans was only a component of financial packages of the early eighties. However, after 1987 these mechanisms had a dramatic influence on banks' strategy.<sup>45</sup> The debt reduction programs under the Brady plan were the final step of the transforming loan policy.

#### 1. *The Secondary Market of LDC Debts*

The decision of some banks to transform a portion of their LDC loans in large part explains the appearance of the secondary market. Banks have tried to get rid of LDC debts through exchanges in the secondary market since 1982.<sup>46</sup> Banks interested in equity investment tried to eliminate their claims on one country and to concentrate claims on another country where prospects and future relations

41. Musumeci & Sinkey, *The International Debt Crisis and Bank Loan-Loss Reserves: The Signaling Content of Partially Anticipated Events*, 22 J. MONEY, CREDIT & BANKING 370, 371-74 (1990). The examination of security returns for the 25 largest U.S. banks that followed Citicorp provisioning reveals positive and significant abnormal returns for them. *Id.*

42. See Luke, *Under the Overhang*, 20 LATIN FIN. 22 (1990).

43. See Schulman, *Reduction? Banks Need Incentives*, 7 LATIN FIN. 6 (1989). Announcing the reserve increases Citicorp stated that "this increase in the reserve is related to the sovereign debt issue and our commitment to play a constructive and continuing role in its resolution." Musumeci & Sinkey, *supra* note 41, at 371.

44. STUDY ON THE RISKS, *supra* note 38, at 17.

45. Lee C. Buchheit, *The Capitalization of the Sovereign Debt: An Introduction*, 2 U. ILL. L. REV. 401, 407 (1988). The foreign commercial bank creditors of many sovereign borrowers no longer have any realistic hope that their credits will be repaid in the foreseeable future. Instead some banks see a dismal prospect of repeated reschedulings, periodic new money requests . . . . In the face of these unpleasanties, some banks are prepared to sell their sovereign loan assets for cash, even though this may involve accepting a discount from the face value of the loan. *Id.* at 402.

46. Sebastian R. Sperber, Note, *Debt-Equity Swapping: Reconsidering Accounting Guidelines*, 26 COLUM. J. TRANSNAT'L L. 377, 377 (1988).

were foreseeable. Purchasing banks could have a special relationship with the debtor country, which increased the banks' chances of seeing the obligations repaid.<sup>47</sup> Some banks simply sold the loans at a discount in order to get cash for loans with expectation of repayment and others purchased debts to reflect a better outlook with a business-profitable country.<sup>48</sup>

In the late eighties the secondary market became more active, developing a business not only based on banks' interest in getting rid of their old debts. Investors interested in participating in debt-for-equity swap programs, traders (banks and nonbank entities),<sup>49</sup> and also debtor countries, attempting to buy their own debt at high discount rates, made the secondary market a new business.

## 2. Debt-for-Equity Swaps

For some banks debt-for-equity swap programs have emerged as a profitable debt transforming mechanism. In a debt-for-equity swap the debtor agrees to exchange, at a discount, bank claims for local currency cash or other financing instruments, provided that these resources are used to purchase equity holdings or other assets in new or existing companies within the debtor countries.<sup>51</sup>

Banks can assume diverse roles in debt-for-equity swaps; they can act as sellers of the debt, as simple traders of the operation, or as direct investors in the debtor country. In all of the roles they benefit. For example, when selling or swapping the debt, banks reduce their exposure; when transforming the financial assets (LDC loans) into investment assets (equity holdings), banks get healthier assets; when buying debts, banks benefit from the difference between the discount at which they bought the debt and the discount they get from the debtor country; and finally, when acting as simple traders, banks obtain a fixed percentage of the loan value.<sup>52</sup>

However, for banks the benefits of debt-for-equity swaps have some limitations regarding the return of equity investments and the recognition of losses that the programs can imply. Many of the programs are part of privatization policies of state-owned companies with deep financial problems. Banks, therefore, will not likely be able to convert newly privatized enterprises into sufficiently profitable businesses in the short term. For this reason, U.S. banks, in the search for more

47. Lee C. Buchheit, *Legal Issues in Trading Sovereign Debt*, INT'L FIN. L. REV., Feb. 1986, at 17, 18.

48. Buchheit, *supra* note 45, at 403.

49. FRYDL & SOBOL, PROSPECTS FOR LDC DEBT MANAGEMENT: DEBT REDUCTION 28 (Federal Reserve Bank of New York Research Paper No. 8826, 1989).

50. A good example of the broader dynamic of the secondary market of LDC debts is the Nissan Swap in Mexico in 1986. Using Citibank as a broker, Nissan Motor Co. bought \$60 million of Mexican debt for \$40 million. Then Nissan exchanged the debt in the Banco de Mexico for an equity investment in Mexican pesos, equivalent to \$54 million. Sperber, *supra* note 46, at 388.

51. INTERNATIONAL MONETARY FUND, INTERNATIONAL CAPITAL MARKETS DEVELOPMENTS AND PROSPECTS 34 (1990) [hereinafter CAPITAL MARKETS].

52. See Sperber, *supra* note 46, at 381-85.

lucrative areas to make equity investments, have requested regulators to extend the areas in which they may invest.<sup>53</sup>

As a general principle U.S. law does not limit U.S. investments abroad; however, some restrictions exist for the banking industry. The Bank Holding Company (BHC) Act prohibits BHCs from acquiring and retaining direct or indirect ownership or control of any voting share of nonbanking institutions.<sup>54</sup> However, the Act provides, under the authorization of the board of governors of the Federal Reserve System, an exceptional regime for BHCs to own shares of nonbanking related companies that do not have business in the United States.<sup>55</sup> Based on its authority the Federal Reserve System enacted Regulation K, which permits banks to invest in the public and private sector of LDCs and in nonfinancial institutions.<sup>56</sup> Regulation K defines "eligible country" for the purpose of debt-for-equity programs as a country that "since 1980 has restructured its sovereign debt held by foreign countries, and any other country the Board deems to be eligible."<sup>57</sup>

A BHC may acquire up to 100 percent of the shares of any foreign financial or nonfinancial company located in an eligible country if the BHC acquires the shares from the government of the eligible country or from its agencies or instrumentalities (privatization).<sup>58</sup> A BHC may also acquire up to 40 percent of the shares of any other foreign company (a company that is not being privatized) located in an eligible country subject to the following conditions: (1) A BHC may acquire more than 25 percent of the voting shares of the foreign company only if another shareholder or controlling group of shareholders unaffiliated with the BHC holds a larger block of voting shares; (2) the BHC and its affiliates may not lend to the foreign company amounts greater than 50 percent of the total loan and extension of credit to the foreign company; and (3) the representation of the BHC on the board of directors or in the management of the company may be no more than proportional to its shareholding in the foreign company.<sup>59</sup>

Since 1985 restructuring agreements provided that original obligations, due in foreign currency, could be payable in equity investments at a discount. Chile's restructuring agreements of 1985, for instance, permitted the conversion of debt for direct investment (the operation implied \$325 million in equity investments).

53. Javier H. Rubinstein, *The Federal Reserve Board's "Liberalization" of Restrictions on LDC Debt-Equity Swaps*, 20 L. & POL'Y INT'L BUS. 163, 175 (1988).

54. 12 U.S.C. § 1843(a)(1) (1988). Bank holding companies are those that own and control one or more banks. The major part of the U.S. banking industry is owned by the BHCs. WILLIAM A. LOVETT, *BANKING AND FINANCIAL INSTITUTIONS LAW IN A NUTSHELL* 179 (1988).

55. 12 U.S.C. § 1843(c)(13) (1988).

56. 12 C.F.R. § 211.5(a) (1990). Generally, banks are not allowed to make these investments directly, but must invest through their corresponding BHC. The official justification of this regime is to erect an effective barrier between the banks and the commercial and industrial activities of the company to be acquired. Rubinstein, *supra* note 53, at 172.

57. 12 C.F.R. § 211.5(f)(1) (1990). Many of the debt-for-equity programs have been part of privatization programs in LDCs supported by the IMF and U.S. banking regulators.

58. 12 C.F.R. § 211.5(f)(i) (1990).

59. *Id.* § 211.5(f)(ii).

The Mexican agreement of 1985 also provided that, subject to specific agreements between debtor and creditors and the approval of Mexican regulators, external loan claims could be exchanged for qualified investments.<sup>60</sup>

### 3. Debt Buy-backs

In debt buy-back operations a debtor country purchases with cash its own debt, directly from creditor banks or on the LDC secondary market, at a discount. In this way banks recoup a portion of their loan asset, repayment of which had been difficult to get under the original terms.<sup>61</sup>

Before the announcement of the Brady plan debtors and banks expressly agreed to two significant debt buy-back operations: the Chilean and Bolivian agreements, which reveal two different approaches to the same mechanism.

In 1988 Bolivia retired \$253 million from the market paying \$28 million (the price was 11 cents on the dollar). Bolivia had previously obtained a \$28 million donation from foreign governments to be managed by the IMF. Banks had the option of choosing the amount of debt they wanted to sell and also of being paid in cash or in the form of a zero coupon collateralized by triple-A rated zero coupon bonds held in trust by the IMF. The transaction represented the elimination of about 50 percent of Bolivian debt with commercial banks and was approved in large part because many banks had already written off much of their exposure to Bolivia.<sup>62</sup>

In 1988 Chile agreed to extinguish \$439 million of its external debt for \$248 million.<sup>63</sup> Chile convinced its bank creditors to enter into the agreements because of its good record of timely debt service and the windfall of foreign exchange earnings that accumulated during 1987 and 1988 after the surge of world copper prices.<sup>64</sup>

Most banks do not favor buy-backs that use existing foreign exchange reserves, arguing that those reserves should be used to repay them.<sup>65</sup> It has also been argued that debt schemes that rely on buy-backs produce a negative effect for the return of the debtor country to financial markets. The stigma of having bought its own debt at a high discount only labels the debtor country as one to which prospective lending business would be unacceptable.

### 4. The "Securitization" of the Debt

"Securitization" of the debt is another way of transforming LDC debts. Banks exchange an LDC debt for an enhanced new instrument, generally a bond, that holds

60. MAXWELL WATSON ET AL., *INTERNATIONAL CAPITAL MARKETS: DEVELOPMENTS AND PROSPECTS* 153 (1986).

61. The debtor country retires a portion of its foreign debt from the market and reduces the present value of its contractual debt service burden. *CAPITAL MARKETS*, *supra* note 51, at 34-35.

62. DILEO & REMOLONA, *VOLUNTARY CONVERSION OF LDC 2-3* (Federal Reserve Bank of New York, Research Paper No. 8903, 1989).

63. Chile bought back \$299 million in November 1988 at an average price of 56 cents on the dollar and \$140 million in November 1989 at an average price of 58 cents on the dollar. *CAPITAL MARKETS*, *supra* note 51, *tbl. A32*.

64. FRYDL & SOBOL, *supra* note 49, at 34.

65. *Id.*

a reduced amount of the original debt. In theory these operations benefit both parties because debtor countries obtain a reduction of their liability and banks transform the old loan into a new and improved asset, primarily guaranteed by the IMF, the World Bank, or the United States Government. This kind of conversion is called "securitization" of the debt because, given the features of the new instrument, it is a more tradable instrument (the bond) than the old debt.<sup>66</sup> The bonds are also categorized as "exit" bonds because, thanks to them, banks exit from the original country risk since the bonds hold enhanced guaranties (IMF or United States Government).

These transactions have been part of some financial packages since 1987. In 1987 Argentina exchanged at par \$5 billion of its debt for bearer bonds that carried a 4 percent coupon and a twenty-five-year maturity. The 1988 Brazilian agreement provided exit bonds with 6 percent interest and a twenty-five-year term. Those banks that accepted bonds were exempted from new money commitments and eligible for debt-for-equity conversions.

In 1988 Mexico and J.P. Morgan, one of Mexico's major creditors, attempted to develop an exit bond scheme. Taking advantage of its strong reserve holdings, Mexico tried to exchange up to \$20 billion of foreign debt for bonds with their principal secured by twenty-year zero coupon bonds of the United States Government. The scheme aimed to obtain a 50 percent discount, canceling \$20 billion in external debt through the purchase and exchange of \$10 billion in U.S. bonds. Mexico achieved an average discount of only 30 percent on \$3.7 billion that corresponded to bids of almost ninety banks.<sup>67</sup>

Exit bonds have been included in most of the financial packages under the Brady plan as the major mechanism for debt and debt service reduction. In the Mexican agreement of 1989, for instance, banks had the option of exchanging their loans for two kinds of bonds: discounted bonds and par bonds. Discounted bonds were offered at a 35 percent discount from the face amount of the original debt, but carried a market rate of interest (at a spread of 13/16 percent over LIBOR). Par bonds were exchanged for an equal amount of existing debt and carried a fixed interest rate of 6.25 percent. The parties agreed on the repayment of principal, par and discounted bonds, in the form of one lump sum after thirty years.<sup>68</sup> The pledge of zero coupon U.S. Treasury obligations secured the discount and par bonds. Interest payments in both cases were partly

66. *Id.* at 29-32. For a general discussion of exit bonds, see Chamberlin et al., *Sovereign Debt Exchange*, in *LATIN AMERICAN SOVEREIGN DEBT MANAGEMENT* 114-51 [hereinafter *LATIN AMERICAN DEBT*].

67. *TRANSNATIONAL BANKS*, *supra* note 10, at 90. Two major factors explain the poor results of the Morgan model: bank rivalries and the impact of banking regulations. "Citicorp, for example did not even bid, thereby perhaps demonstrating its pique at being upstaged by Morgan with so important a client as Mexico." *Id.* Regarding regulations, "many United States banks thought that existing United States regulations required that, if they accepted discounts superior to their reserves . . . they would be obliged to top up their reserves to the discount level." *Id.*

68. See Buchheit, *Debt Reduction Techniques*, in *LATIN AMERICAN DEBT*, *supra* note 66, at 83. 1990 IMF ANN. REP., *supra* note 6, at 28.

secured for an amount equal to eighteen months of interest payments due.<sup>69</sup>

In the case of the 1992 agreement of Argentina and its creditor banks, thirty-year par and discounted bonds were also included. Par bonds will pay a gradually increasing interest rate; from 4 percent in year one to 7 percent in years seven to thirty. Discounted bonds represent a reduction of 35 percent in capital and will carry an interest rate of LIBOR plus 13/16 percent. Both types of bonds will be collateralized with thirty-year zero coupon U.S. Treasury bonds and will also have a twelve-month rolling interest guarantee.<sup>70</sup>

##### 5. Debt Reductions in the Brady Era

As indicated, debt reduction programs under the Brady plan constitute the last step of the asset transformation strategy of banks. In a sale, exchange, or swap of a loan a bank transforms its original asset and reduces the original interest or principal. For this reason the Brady plan uses the term "menu approach" to refer to swaps, debt exchanges, debt buy-backs, and in general the mechanisms developed along the international debt problem to settle LDC debts.

For a bank a sale, exchange, swap, or renegotiation of a loan, which provides for a reduction in interest or principal, at least in theory, generates a difference between the original book value of the loan and its new value. That difference generally constitutes a loss for the bank that it must charge against the loan-loss reserve.<sup>71</sup> Then, any of those transactions, including debt-for-donation swaps,<sup>72</sup> may affect bank capital and income.

69. *Mexican Debt Agreement: Hearing Before the Subcomm. on International Development, Finance, Trade, and Monetary Policy of the House Comm. on Banking, Finance and Urban Affairs*, 101 Cong., 2d Sess. 53 (1990) (prepared testimony of Nora Lusting) [hereinafter *Statement of Nora Lusting*].

70. See *Betting on Brady*, 5 *LATIN FIN.* 14 (1992).

71. When that type of operation changes the status of a bank's asset, the Generally Accepted Accounting Practices (GAAP) require that any indicated loss be reflected in the statement of the bank. See *Joint Memorandum*, reprinted in *Proposed Solutions to International Debt Problems: Hearing Before the Senate Comm. on Banking, Housing, and Urban Affairs*, 98th Cong., 1st Sess. 39 (1983) [hereinafter *Joint Memorandum*].

72. Banks can donate their loans to a U.S. corporate charitable entity (debt-for-donation swap), obtaining thereby a charitable contribution deduction for the donation. For that purpose the IRS in 1987 issued Rule 47 IRB 5, accepting tax allowances for the total of the donated debt. The creditor bank delivers its loan to the Central Bank of the LDC in order to receive domestic currency, with the only purpose of donating it to a U.S. charitable entity, which will realize a charitable project in the same LDC. The IRS recognizes as a loss the difference between the tax basis in the loan and the received domestic currency. Then the bank is entitled to a charitable contribution deduction equivalent to the fair market value of the domestic currency. If the same debt were written off and not donated, the IRS could be expected to challenge part of the write-off, if it were submitted in its entirety as a deduction. Peter Connors, *Current Developments—Recent IRS Ruling Focuses on LDC Debt Transactions*, 14 *INT'L TAX J.* 285-91 (1988); see also Griffith-Jones, *Trading Debt for Development*, 7 *LATIN FIN.* 38-39 (1989). The debt-for-donation swap has been extended in many different areas of development. For example, in Costa Rica, Fleet Norstar donated a \$250 million loan for a conservation project; in Nigeria, American Express donated a \$1 million loan to the International Foundation for Education and Self-Help. *Id.* at 38.

In regard to debt-for-equity swaps, regulations provide some rules governing the recognition of losses. A debt-for-equity swap is an exchange of a monetary asset for a nonmonetary asset and should be considered at fair value at the date on which both sides agree to the transaction.<sup>73</sup> If the fair value received is less than the recorded investment in the loan, a loss should be recognized. The following factors are considered in the fair value of a debt-for-equity swap: (1) similar transactions for cash; (2) estimated cash flows from the equity investment or net asset received; (3) the market value of similar equity investments; and (4) any currency restrictions affecting dividends, the sale of the investment, or the repatriation of dividends.<sup>74</sup>

Reduction of the debt value as a consequence of a debt swap or a debt sale can create what is called the "contamination" of the remaining portfolio. When a bank sells a debt at a significant discount, the question is whether the remaining portfolio should be written down. For some scholars it is critical for the expanded use of debt-for-equity conversions that no write-down be required. The collectibility of all of the loans should not be related to the write-down resulting from a particular swap.<sup>75</sup>

The issue of recognition of losses by banks includes the issue of the consequent tax effects. Swap operations generally modify the tax basis of the old asset. The bank is treated as having a loss measured by the excess of its tax basis in the loan and the fair market value of the domestic currency received in exchange (to be converted into an equity investment). The bank can also be considered to have no gain on the exchange of the loan for an equity stock, if its tax basis in the loan equals the fair market value of the equity stock.<sup>76</sup> The other hypothetical situation is that the fair market value of the new investment exceeds the tax basis in the loan, in which case the bank could have a taxable gain.

The Brady announcement coincided with the solution to the debate, in the United States, through the application of the Financial Accounting Standards Board Statement No. 15 (FASB 15).<sup>77</sup> FASB 15 makes it possible to structure debt reduction operations in a way that an upfront capital loss need not be recognized. In a letter from the Securities and Exchange Commission (SEC) to the U.S. Treasury the SEC stated that loss is not recognized if the total future undiscounted cash receipts specified by the new terms of the loan, including receipts designated as both principal and interest, are not less than the book value of the loan. The SEC

73. Bauman & Harvey, *LDC Strategies: Accounting and Tax Issues*, in *LATIN AMERICAN DEBT*, *supra* note 66, at 198, 201; *see also* AICPA Practice Bulletin No. 4.

74. Chamberlin et al., *supra* note 66, at 111, 160.

75. Shubbin & Gibby, *The Promotion of Debt-Equity Swaps in Latin America: A Survey of the Regulatory Regimes and the International Framework*, 20 U. MIAMI INTER-AM. L. REV. 31, 80-83 (1988).

76. Michael Chamberlin et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415, 460-61 (1988).

77. JONATHAN HAY & NIRMALJIT PAUL, REGULATION AND TAXATION OF COMMERCIAL BANKS DURING THE INTERNATIONAL DEBT CRISIS 29 (World Bank Technical Paper No. 158, 1991).

letter concluded that FASB 15 permits both types of bonds (1988 and 1989 Mexican bonds) to be accepted without recognition of loss upon satisfaction of the criteria noted. Therefore banks can account for both the par and discount bonds in Mexican agreements.<sup>78</sup> Hay and Paul point out that the application of FASB 15 does not override the principle that banks must recognize loan losses when they are probable and reasonably estimable. "When a specific loan is determined to be uncollectible in whole or in part, banks are required to reduce (to charge-off) the book value of the loan to its collectible amount."<sup>79</sup>

## II. The Relevance of U.S. Legislation During the International Debt Problem

The previous sections have analyzed some regulations that affected banks' strategies, such as accounting and tax rules regarding debt-for-equity swaps, the general reserves regime; and the ATRRs under the International Lending Supervision Act. Now the analysis turns to the issue of whether the legislation really directed the development of the solution to the debt problem for banks or whether it was strongly influenced by banks' strategies.

U.S. banking laws provided no rule about sovereign lending until 1983, when the U.S. Congress passed the International Lending Supervision Act (ILSA),<sup>80</sup> and when U.S. banking regulators, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Company (FDIC), and the Board of the Federal Reserve System (FRS) produced a vast number of the subsequent regulations. The loans that U.S. banks extended to LDCs during the 1970s and the early 1980s were subjected to the general regulations as to lending limits.<sup>81</sup>

Banking loans to foreign public entities (governments, agencies, and state-owned companies) should meet the limits for lending to single borrowers. According to banking regulations the total loans and extensions of credit by a national bank to any "person" outstanding at one time shall not exceed 15 percent of the impaired capital and surplus of the bank.<sup>82</sup> The original version of the statute did not define the concept of "person."<sup>83</sup> In consequence, "persons" such as Electrolima, PetroPeru, Minero Peru, and the Republic of Peru could be considered individually as "persons." All of these legal entities were independent for

78. *Id.* at 114-15.

79. *Id.*

80. International Lending Supervision Act of 1983, 12 U.S.C.A. §§ 3901-3912 (1983).

81. Bransilver & Patrikis, *supra* note 28, at 1.

82. National Banking Act, 12 U.S.C. § 84(a)(1) (1982). The U.S. banking legal system is a dual system in which federal and state provisions regulate banking business. In the case of lending limits for banks chartered by state governments, the rules are quite similar to federal rules. Ricki R. Tigert, *Recent Regulatory Perspectives on Debt-for-Equity Swaps and Securitization of Third World Debt*, 2 U. ILL. L. REV. 481 n.43 (1988).

83. Cynthia C. Lichtenstein, *The U.S. Response to the International Debt Crisis: The International Lending Supervision Act of 1983*, 25 VA. J. INT'L L. 401, 405-06 (1985).

the purpose of lending limits, but not economically. In practice those legal entities belonged to the same owner, the Peruvian Government, and basically had the same economic source. The external debt of these public entities constituted the major part of the Peruvian public debt. Thus, the lack of specificity of U.S. banking laws in the definition of the concept of "person" contributed to the over-exposing trend of U.S. banks.<sup>84</sup>

Another element of the pre-ILSA legislation was the lack of authority of banking regulators to prevent or sanction concentration of loans. "Although federal bank examiners were supposed to monitor imprudent loan practices, they did not have the statutory authority to prohibit large loans that did not violate the single-borrower rule or the concentration of those loans in several similarly situated developing countries."<sup>85</sup> The ICERC was created in 1979 in order to monitor banks' exposure and management of country risk. However, the ICERC failed to prevent the escalation of risky sovereign debt because banks ignored ICERC classifications (without being concerned about any sanction).<sup>86</sup>

On April 7, 1983, almost six months after Mexico announced its moratorium, the OCC, the FDIC, and the board of the FRS submitted to the U.S. Congress a Joint Memorandum concerning a Program for Improved Supervision and Regulation of International Lending.<sup>87</sup> The main objective of the program was:

to encourage prudent private decision-making in foreign lending that appropriately recognizes the risks while permitting the exercise of lenders discretion in the funding of creditworthy borrowers both here and abroad. The proposed procedures reinforce two of the basic principles of sound banking—diversification of risk and maintenance of adequate financial strength to deal with unexpected contingencies.<sup>88</sup>

84. *Id.* at 408.

85. *Id.* at 408-09.

86. *Id.* See ICERC classification, *supra* note 29. The lack of authority of U.S. banking regulators was not a reason for regulators not to react aggressively against over-lending. Lack of perception of coming debt crisis cannot be attributed to institutions (banking regulations) that were created, among other reasons, in response to serious distresses in the American financial system. The Federal Reserve Act of 1913, for example, was adopted because of the instability of the American economy, as evidenced by the financial panics of 1873, 1884, 1893, and 1907. STEPHEN HUBER, BANK OFFICER'S HANDBOOK OF GOVERNMENT REGULATION 2-6 (1984). In the same way the FDIC was created to "prevent bank failures, pay off depositors of failed banks, and restore public confidence in the safety of the banking system." *Id.* at 4-14. "[W]here were the regulators"? That was the question that Professor Lowenfeld asked himself, considering that the principle then in force was that no member bank of the FRS was permitted to lend more than 10 percent of its capital and surplus to a single fully secured borrower. Lowenfeld, *supra* note 20, at 486. (The limit is 15 percent since the 1982 amendment. See 12 U.S.C. § 84(a)(1) (1982).) The then 10 percent limit obviously implied a special regard to banks' exposure that called for preventive actions. The international debt problem did not spontaneously erupt in 1982, but had its origins in the 1970s. Thus, still under debate is whether the alarming voices of federal banking regulators should have been heard at the time of the crisis formation. Professor Lichtenstein indicates that some evidence shows that during the 1960s and 1970s U.S. policy encouraged bank lending to LDCs as part of a foreign policy strategy. Lichtenstein, *supra* note 83, at 402. The influential presence of that foreign policy perspective could explain the lack of concern about the formation of the international debt crisis.

87. *Joint Memorandum*, *supra* note 71, at 24-52.

88. *Id.* at 25.

The Joint Memorandum program consisted of the following five main points:

1. Strengthening of the existing program of country risk examination and evaluation;
2. Increased disclosure of banks' country exposures;
3. A system of special reserves;
4. Supervisory rules for accounting for fees; and
5. Strengthening international cooperation with foreign banking regulators and through the International Monetary Fund.<sup>89</sup>

The proposal of banking regulators did not call for any legislative action from Congress. Regulators argued that, using existing authority, they would be able to implement a flexible and consistent plan. However, some senators, such as Senator Proxmire, replied that Congress had no guarantee that reforms would be carried out and that the legal authority of regulators in some aspects was doubtful. In consequence the proposal required statutory backing.<sup>90</sup>

Finally, Congress passed ILSA, which gives regulators specific statutory power to enforce the Joint Memorandum program. ILSA includes new principles of banking reserves, public disclosure, bank reports, capital adequacy, and loan evaluations, but all of them rely on regulatory enforcement. The only mandatory rule of ILSA forbids banks to charge any fee exceeding the cost of restructuring, unless they amortize such fee over the effective life of each loan.<sup>91</sup> The rest of the principles of ILSA are not self-executing; they refer to the discretion of regulators and an eventual implementation. ILSA expressly provides federal banking regulators with general authority to interpret and define ILSA terms and to prescribe rules or regulations or issue orders as necessary to effectuate the purpose of ILSA and prevent evasions thereof.<sup>92</sup>

Regulators pointed out in the Joint Memorandum that one of the basic banking principles that supported its proposal was to reinforce the maintenance of adequate financial strength to deal with unexpected contingencies. In the context of ILSA and the body of regulations that followed it, the strategy put particular emphasis on reserve requirements as part of a better assessment of bank capital adequacy.<sup>93</sup> In that context one of the novel aspects of ILSA is the creation of the ATRR to

89. *Id.*

90. *Id.* at 70. Senator Garn, chair of the Committee on Banking, Housing, and Urban Affairs, was even more conclusive, saying that, given that the program of regulators was part of a general strategy calling for a congressional authorization to increase the U.S. quota in the IMF, the absence of a legislative pronouncement relating to the debt problem would make the quota increase politically unsustainable. *Id.* at 95.

91. International Lending Supervision Act of 1983, 12 U.S.C.A. § 3905(a)(1) (1989); see also Lichtenstein, *supra* note 83, at 418-19.

92. 12 U.S.C.A. § 3909(a)(1) (1989). ILSA also authorizes regulators to impose civil penalties on any banking institution violating any ILSA or regulatory rules. *Id.* § 3909(d).

93. OCC, FRS & FDIC, *Preliminary Report-Study on the Adequacy of Reserve Levels Maintained by U.S. Banking Institutions Against Loans to Highly Indebted Countries*, RISKS ON BANKS, *supra* note 12, at 3, app. A.

cover LDC loans in problematic situations, as a complement to the traditional loan-loss reserve. However, as discussed earlier,<sup>94</sup> regulators did not impose significant levels of ATRRs, and banks began to rebuild their general reserves only after 1987.

The issue of traditional lending limits regarding sovereign lending and the non-definition of the concept of "person" was, in theory, resolved at the regulatory level, considering the proposal of the OCC. The borrower should be submitted to the means and purposes tests.<sup>95</sup> According to the means test, the borrower must show that it has resources or revenues of its own sufficient over time to service its debt obligation. The purposes test requires that the purpose of the loan or the extension be consistent with the purpose of the general business of the borrower. However, restructuring agreements are not subjected to the means and purposes tests. The technical consolidation of loans, which occurs in sovereign debt restructurings, makes loans to be treated as loans outstanding to their original obligators.<sup>96</sup>

ILSA marked new general rules for international lending in other areas, such as the obligation of banks to report and disclose the levels of their exposure to foreign countries. ILSA orders regulators to require each banking institution with foreign country exposure to submit no fewer than four times each calendar year information regarding such exposure.<sup>97</sup> In practice, the ILSA system bases its efficiency on a continuous regulator examination of the exposure of banks to LDCs by requiring current data and information.

At the same time, ILSA takes the issue of information beyond the sphere of regulators by strengthening public disclosure principles with regard to bank capital and loans.<sup>98</sup> Clearly, banks have a high sensitivity to loss of confidence by depositors and investors. New regulations subject banks to general standards of disclosure.<sup>99</sup> The goal is that all of the information connected with the business of banking be available for the "players of the game." Good and bad loans, and restructuring agreements should be known to investors, depositors, and the market community as a whole.<sup>100</sup> Banks must disclose information on exposures to any

94. *Supra* text part I.A.

95. 12 C.F.R. § 32(5)(d) (1990); see also Bransilver & Patrikis, *supra* note 28, at 2.

96. See, HAY & PAUL, *supra* note 77, at 119-20.

97. 12 U.S.C.A. § 3906(a) (1989).

98. *Id.* § 3906(b).

99. The National Bank Act, 12 U.S.C.A. §§ 21-216(d) (1982); The Bank Holding Company Act, 12 U.S.C.A. §§ 1841-1850 (1982); Security Laws, 15 U.S.C.A. §§ 77(a)-78(k) (1982).

100. In effect, regulators pointed out in the Joint Memorandum that more routine disclosure, centered around the concept of concentration, may strengthen other approaches, helping to bring appropriate marketplace discipline to bear on lending decisions. Depositors and investors, through their individual decisions, will have the information to assess better the prudence of foreign lending and require greater risk diversification and adequate reserves as the condition for their increased deposits and investments in banks' equity and other securities. Banks will need to be prepared to defend policies leading to large and concentrated country exposure as a consequence of their continued reporting requirements . . . .

*Joint Memorandum, supra* note 71, at 28. Coombe and Lopic indicate that contemporary criticism, increasingly accepted by the public, emphasizes the fact that corporate disclosure has a role in regulating corporations as major power centers in our society and, therefore, should be society-oriented and not solely investor-oriented.

country that exceed the lesser of 0.75 percent of total assets or 15 percent of primary capital. For each country exposure that exceeds the lesser of 1 percent of total assets or 20 percent of primary capital, the bank must disclose claims outstanding after mandated adjustments for transfer exposure. For countries that exceed the lesser of 0.75 percent of total assets or 15 percent of primary capital, but do not exceed the lesser of 1 percent of total assets or 20 percent of total capital, the bank must list the countries and give total amount of exposure to all countries listed.

Finally, ILSA provides that regulators submit to the Committee on Banking, Housing, and Urban Affairs of the Senate and the Committee on Banking, Finance and Urban Affairs of the House of Representatives a report informing them about: the level of loan exposure of those banking institutions rated value-impaired, substandard, OTRP, or in any other troubled debt category as may be established by regulators; the progress achieved in reducing the risk to the U.S. economy posed by the banks' exposure (regulatory action); the relationship between lending activity by U.S. banks and foreign banks in countries experiencing debt difficulties and other lending countries to these markets; the response of regulatory agencies in other countries to the international debt problem; and the steps taken by debtor countries to remove the causes of their debt service difficulties.<sup>101</sup>

### III. Assessment of the Baker and Brady Plans

The Baker plan emphasized new financing by banks as the way to direct the solution of the international debt problem (\$20 billion). However banks, under the strategy of new lending to keep loans current, reacted by giving the net sum of only \$4 billion. The Baker plan not only did not include debt reduction, it opposed it on the assumption that banks would be unwilling to lend to countries that had failed to repay their debts and that stretching out the debt repayments was sufficient to restore prosperity to debtors and creditors.<sup>102</sup> Rather, the Brady plan recognized that "a further stretching out of the debt payments without debt reduction [was] unlikely to restore prosperity, because of the continuing crisis engendered by the large stock of bad debt."<sup>103</sup>

Now that the debt problem is not as significant for banks as in 1982,<sup>104</sup> the Brady plan can mean a real shift in the international debt problem if significant

Society, not merely investors, should be informed not only as to corporate financial affairs but also as to the impact of corporate behavior on society. Indeed, the major thesis of such criticism is that the public, informed through such increased disclosure, should, in some form, participate in corporate decision making.

George W. Coombe & Jeffrey R. Lopic, *Problem Loans, Foreign Outstandings, and Other Developments in Bank Disclosure*, 40 BUS. LAW. 485, 486 (1985).

101. 12 U.S.C.A. § 3912(d) (1989).

102. Jeffrey Sachs, *Making the Brady Plan Work*, 68 FOREIGN AFF. 87, 92 (1989).

103. *Id.*

104. Chemical's reserve problems today have less to do with Latin America than with the U.S. oil patch; its acquisition of Texas Commerce Bank's shares looks like a bigger risk than its loans to Mexico. *Managing Latin Debt: Playing It Close to the Vest*, 7 LATIN FIN. 16, 25-26 (1989).

debt reductions occur. In 1988 an examination of the figures of debt reduction programs prior to the Brady plan, including debt-for-equity swaps, debt buy-backs, debt exchanges, debt-for-bond swaps, and settlement of debts, shows that the total debt reduction of the bank debt of Argentina was \$1.1 billion (3 percent of its commercial banks debt); of Brazil, \$6.9 billion (8.59 percent); of Chile, \$2.9 billion (21.2 percent); of Mexico, \$5.9 billion (7.9 percent); and of Venezuela, \$0.3 billion (1 percent).<sup>105</sup> For 1990 it was estimated that the reduction of the Latin American debt would reach \$25 billion (almost 6 percent of the total external debt of the region).<sup>106</sup>

In the Brady agreement with Mexico, the nominal debt reduction implied was about \$14 billion. However, if one considers the combination of the debt reduction and new financing, the nominal debt of Mexico does not change. The amount reduced through the discount bond option, approximately \$6.7 billion, is roughly the same amount as the loans required for collateralizing the loans provided by the banks that chose the option of new financing.<sup>107</sup>

The evolution of the international debt problem confirms that the debt reduction scheme of the Brady plan needs larger amounts of reductions. The 1990 IMF Annual Report indicates that at the end of 1989 the total external debt of LDCs was almost unchanged at \$1,235 billion.<sup>108</sup> Only in the case of the highly indebted countries did the net flows to them decline from an annual average of \$41 billion during 1980 to 1982 to \$8 billion a year during 1986 to 1988.<sup>109</sup> Considering the aggregate net annual transfers to the same countries, net transfers started to turn negative in 1982 and accelerated to an outflow average of about \$29 billion a year between 1986 and 1988. By the end of 1989 the debt of these countries was estimated at \$500 billion, almost 30 percent higher than in 1982, and the debt-GNP and debt-exports ratios almost doubled.<sup>110</sup>

Increasing the levels of reductions under the Brady plan is not only restricted by banks' willingness to recognize losses, but also by the financing of debt reductions. One commentary raises the question whether the \$20 billion to be made available over the next three years through the IMF and the World Bank and the \$4.5 billion allocated by Japan are sufficient to collateralize or to guarantee the reduced or to-be-reduced debt amounts of all of Latin America.<sup>111</sup> The debt reduction that takes place in a voluntary scheme is effective under two variables: secondary market prices and cash value of the transaction. The elimination of \$25

105. Libra Bank Report, *supra* note 5, at 16.

106. *A Brave New Market*, 20 *LATIN FIN.* 27, 29 (1990).

107. *Statements of Nora Lustig*, *supra* note 69, at 61.

108. 1990 IMF ANN. REP., *supra* note 6, at 10.

109. I. Hussain & I. Mitra, *Future Financing Needs of the Highly Indebted Countries*, in *DEALING WITH THE DEBT CRISIS 199* (Ishrat Hussain and Ishac Dinan eds., 1989).

110. *Id.* at 200.

111. Santos, *supra* note 37, at 19-80.

billion is only a fraction of the total LDCs' debt. In the view of one author an IMF commitment of \$90 billion is needed to give the strategy credibility.<sup>112</sup>

#### IV. Conclusion

The main concern of the U.S. policy on the international debt problem, including the regulatory framework, has been to reduce the effects of the problem on the U.S. banking industry. The Baker and Brady plans were developed on the basis of that main concern. However, the fact that U.S. banks have rebuilt their capital position opens the possibility of substantial reduction of the burden of the debt for LDCs under the Brady plan. The success of the plan depends on the banks' willingness to assume losses and the increase of IMF financing for debt reduction programs.

112. Rosenthal, *Beyond Brady Latin America's Three Point Plan for Deeping Debt Relief*, 20 LATIN FIN. 17, 18 (1990).