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# **LDC Debt Problem: Potential for New Financial Mechanisms**



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**A Research Paper**

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August 1987*

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# **LDC Debt Problem: Potential for New Financial Mechanisms**

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**A Research Paper**

This paper was prepared by  Office of  
Global Issues. Comments and queries are welcome  
and may be directed to the Chief, Economic  
Division, OGI

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**LDC Debt Problem:  
Potential for New  
Financial Mechanisms**



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**Scope Note**

As part of the ongoing OGI effort to monitor the broader political and economic strains created by the LDC debt problem, this Research Paper examines the potential impact of new financial mechanisms being suggested to ease those strains. In particular, it identifies and assess the various financing options open to debtor countries and how these options might affect them. Our evaluation of the potential role of the new mechanisms is intended to help the reader assess the degree of flexibility available to debtors and creditors in current and future debt negotiations.



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**LDC Debt Problem:  
Potential for New  
Financial Mechanisms**

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**Summary**

*Information available  
as of 31 May 1987  
was used in this report.*

The growing variety of new financial mechanisms coming onto the LDC debt scene appear capable of making only marginal inroads against the LDC debt problem. Although a number of mechanisms are capable of providing relief to debtors, they run up against important constraints on their implementation or widespread use:

- Interest-delaying mechanisms—such as interest capitalization and caps on debt service—probably would entail substantial losses for banks in several countries, including the United States, without significant changes in bank regulations or accounting standards. Such changes do not appear to be immediately forthcoming.
- Secondary market mechanisms—such as debt-for-equity swaps—are handling only small amounts of obligations compared with the overhang of debt that stands between the LDCs and creditworthiness.
- Outright forgiveness of some debts would also entail substantial losses for creditors, making them even more reluctant to extend new credit to the debtors.
- Concessionary mechanisms, including interest capitalization, carry the risk of spillover to other debtors. If relief is granted to one country, others are certain to insist on similar treatment and, failing to receive it, might act unilaterally to curtail payments.
- All the mechanisms share the characteristic of shifting some of the burden of the debt, or at least its risk, from debtors to creditors.

At the same time, mechanisms to stimulate fresh lending to the LDCs appear stalemated by creditors' continuing concerns about LDC repayment prospects, on the one hand, and by developed country governments' reluctance to protect private creditors on the other hand. Existing World Bank programs to guarantee commercial bank loans, for example, are judged by many private bankers as inadequate to motivate significant new commercial lending to LDCs.

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Within their limited role, we believe some new mechanisms will be more important than others. The issue of interest-delaying mechanisms, in particular, is likely to come to the fore over the next 12 months as debtors continue to focus on interest relief. Use of marketable interest bonds, such as those recently implemented by the Philippines, also may expand.

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Secondary market mechanisms probably also will be increasingly adopted by both creditors and debtors in coming months, especially in view of recent moves by key international banks to increase sharply loan-loss reserves and position themselves to sell off bad loans or convert them to equity investments. Exit bonds—which allow banks unwilling to provide fresh loans for a debtor to withdraw after paying a financial penalty—may become a common feature of debt rescheduling deals for the LDCs, streamlining future debt negotiations somewhat. Packaging of new or existing LDC debts into marketable securities probably also will gain increasing attention, but will remain confined to only a handful of the most creditworthy debtors.



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Nevertheless, we expect that new mechanisms this year will remove only about \$5 billion of the more than \$800 billion LDC debts outstanding, reduce LDCs' \$115 billion debt service bill by roughly \$2 billion, and channel about \$3 billion of new funds to the debtors. Debt-for-equity swaps, for example—the biggest and potentially most promising mechanism—probably will have canceled only about \$10 billion of debts between 1982 and the end of this year. By comparison, we calculate that new mechanisms would need to effect a debt reduction of roughly \$100-200 billion to bring the 10 major Latin debtors alone within desired creditworthiness levels. Even as these results improve somewhat in 1988 and 1989, as appears likely, we can see only about \$15 billion in debt relief being generated by new mechanisms over that time.



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For the LDCs as a group, therefore, we see little prospect that new mechanisms will significantly improve the LDC debt problem over the next two years, and we believe the debt situation will continue to be marked by a lurching from crisis to crisis. The relatively slow pace at which new mechanisms are being applied indicates it will be years before they remove the debt overhang. While a few countries will achieve modest debt relief through new mechanisms, most will continue to have problems servicing their debts. LDC debt negotiations will remain contentious, and talks might even be further complicated by new mechanisms as debtors and creditors haggle over their implementation.



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**LDC Debt Problem:  
Potential for New  
Financial Mechanisms**

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At the April 1987 meeting of the International Monetary Fund Interim Committee, Treasury Secretary Baker encouraged new and creative ways of providing debt relief and new financing to Third World debtors. Commercial creditors were called upon to develop a menu of alternative financial options from which all banks could choose in supporting the LDCs. This Research Paper examines a number of new approaches that might appear on such a menu in coming months and evaluates how they would affect both debtors and creditors.

European creditors, for example, already have suggested a preference for interest capitalization rather than extend new loans to debtors, against which they are required to set aside additional reserves.

Several key US bank creditors now also have greater flexibility to implement new mechanisms because of recent large additions to loan-loss reserves. In addition, Japanese creditor banks, if they follow through on their plans to transfer some troubled LDC loans off their own balance sheets and onto that of a new shell company, will be better able to use new debt relief approaches.

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**Pressure for New Mechanisms**

With the LDC debt problem now well into its fifth year, pressures are growing for greater modification of the current debt management strategy. Even with the widespread use of a variety of debt relief measures, such as lower interest rate spreads; longer repayment periods; and multiyear debt reschedulings, and increasing use of incentives for new financing, such as marketable LDC debt instruments and some limited multilateral guarantees, pressures continue to build for even more relief. Debtors, tired of economic adjustment but not appreciably closer, in their view, to manageable debt service levels, are interested in new approaches to reducing interest payments on their debts, particularly since they have already deferred most principal repayments to the future through rescheduling.

In this environment, an increasing number of players are moving toward new, so far untried, debt relief mechanisms:

- Mexico's latest financial package, agreed to in 1986, contains several innovative and important new concessions, including IMF economic targets adjustable in case of oil price declines or sluggish economic growth, and guarantees of extra new lending if oil prices drop sharply.
- The Philippines and its bankers recently agreed that some interest may be paid to banks in the form of Philippine Investment Notes (PINs)—a form of interest-for-equity swap in which banks would be issued bonds redeemable in pesos for investment in the Philippines. Brazil is also considering trying to reduce its interest payments through such interest-for-equity swaps.

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Creditors, for their part, remain divided between those who are able to use—and are pushing for—new financial mechanisms, and those who essentially remain captives of the current debt management strategy. Bank creditors with fewer LDC loans, stronger loan-loss reserves, or more liberal regulatory requirements and accounting standards are in a position to be the most flexible in considering new mechanisms, and these creditors already are taking the lead in proposing and implementing them. Some well-reserved West

- Argentina and its bankers have agreed on the use of exit bonds, which allow small banks unwilling to participate in new money packages to withdraw as creditors after paying a financial penalty. Exit bonds also appear likely for Costa Rica.



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**Table 1**  
**New Financial Mechanisms and the Debt Problem**

Debt Relief Mechanisms	Countries Involved	Estimated Volume of Activity, 1983-87 (million US \$)	Pros	Cons
<b>Interest delaying</b>				
Interest capitalization	Philippines (via interest-for-equity swaps)	60	<ul style="list-style-type: none"> <li>• Reduces debtor's current interest payments: cash flow relief</li> <li>• Stabilizes debt service at known level</li> <li>• Payment delay should put debtor in better position to make future payments</li> <li>• Preserves value of loan to creditors</li> </ul>	<ul style="list-style-type: none"> <li>• For banks, deferred interest unlikely to be accruable unless guaranteed or specified in original loan terms</li> <li>• Potential significant damage to banks if broadly applied</li> <li>• Moves closer to view that interest may be left unpaid entirely</li> <li>• Spillover effects on other debtors</li> </ul>
Debt service contingencies	In effect for Peru, Zambia; imposed then rescinded by Nigeria; considered by Zaire and Ecuador	NEGL	<ul style="list-style-type: none"> <li>• Makes debt service more commensurate with ability to pay</li> <li>• Cash flow relief for debtor</li> <li>• Attractive to debtors receiving no new loans in any case</li> </ul>	<ul style="list-style-type: none"> <li>• Same accounting problems for creditors as interest capitalization because most debtors paying only interest</li> <li>• Moves away from voluntary lending</li> </ul>
<b>Secondary market</b>				
Debt-for-equity swaps	Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Honduras, Mexico, Philippines, and Venezuela	10,000	<ul style="list-style-type: none"> <li>• Reduces external debt and related debt service</li> <li>• Accelerates foreign investment</li> <li>• Banks gain freedom from reschedulings, new money</li> </ul>	<ul style="list-style-type: none"> <li>• Investors discouraged by LDC investment restrictions and tight swap regulations</li> <li>• Few good investment opportunities</li> <li>• Can fuel inflation in debtor country</li> <li>• Politically sensitive for debtor</li> </ul>
Interest-for-equity swaps	Philippines	60	<ul style="list-style-type: none"> <li>• Reduces external debt and related debt services</li> <li>• Accelerates foreign investment</li> </ul>	<ul style="list-style-type: none"> <li>• Few good investment opportunities</li> <li>• Could fuel inflation in debtor country</li> <li>• Uncertain if creditors can accrue deferred interest</li> </ul>
Debt buybacks	Bolivia; under consideration by Costa Rica	As much as 670	<ul style="list-style-type: none"> <li>• Reduces external debt and related debt service for fraction of full value</li> </ul>	<ul style="list-style-type: none"> <li>• Organized recognition that LDC debts not worth full value could spill over to other debtors</li> </ul>

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Table 1 (continued)

Debt Relief Mechanisms	Countries Involved	Estimated Volume of Activity, 1983-87 (million US \$)	Pros	Cons
Securitization of existing debt	Nigeria	Less than 5	<ul style="list-style-type: none"> <li>Spreads LDC loan risk to nonbank creditors</li> </ul>	<ul style="list-style-type: none"> <li>Low investor interest</li> <li>No reduction of debt service unless debtors buy their own debts</li> </ul>
Exit bonds	Argentina and Costa Rica	800 maximum	<ul style="list-style-type: none"> <li>Direct reduction of debtor debt service obligations</li> <li>Streamlines debt talks by facilitating removal of reluctant creditors</li> </ul>	<ul style="list-style-type: none"> <li>Further damages LDC credit reputation</li> <li>Erodes lending base for new-money loans</li> <li>Income loss for creditors</li> </ul>
<b>Forgiveness</b>				
Interest forgiveness		0	<ul style="list-style-type: none"> <li>Cash flow relief; modest increases in economic growth</li> </ul>	<ul style="list-style-type: none"> <li>Reduces bank earnings; also capital loss equal to amount of forgiveness—grave damage to banks if broadly applied</li> <li>Moves away from voluntary lending</li> </ul>
Principal forgiveness		0	<ul style="list-style-type: none"> <li>Greater benefits for debtor than interest forgiveness</li> </ul>	<ul style="list-style-type: none"> <li>Greater costs for creditors than interest forgiveness</li> </ul>
<b>New financing incentives</b>				
Securitization of new debt	Algeria, India, Indonesia, Malaysia, Panama, Singapore, and South Korea	5,000	<ul style="list-style-type: none"> <li>Credit risk channeled to creditors willing to accept it</li> <li>Lower cost, more flexibility for debtors</li> </ul>	<ul style="list-style-type: none"> <li>Creditworthiness criteria even higher than for standard loans</li> <li>Low investor interest</li> </ul>
Cofinancing	Brazil, Chile, Colombia, Hungary, Ivory Coast, Thailand, and Turkey	2,200	<ul style="list-style-type: none"> <li>Dilutes banks' risk, attracts more funds</li> <li>More lenient terms for debtors</li> </ul>	<ul style="list-style-type: none"> <li>Reluctant banks believe protection does not go far enough</li> </ul>
Guarantees and insurance		0	<ul style="list-style-type: none"> <li>Dilutes banks' risk, attracts more funds</li> </ul>	<ul style="list-style-type: none"> <li>Requires substantial startup funds or capital increases for multilateral institutions</li> <li>Vulnerable to criticism as taxpayer bailout of private corporations</li> </ul>
Factoring company	Japan; under consideration by South Korea	580	<ul style="list-style-type: none"> <li>Improves creditor banks' capital adequacy</li> <li>Could free up funds for new lending to debtors</li> <li>Possible tax advantages for creditor banks</li> </ul>	<ul style="list-style-type: none"> <li>Government involvement and regulatory changes probably required in most countries</li> <li>No direct relief of obligations for debtors</li> </ul>

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- Chile received an innovative retiming of commercial bank interest payments that postpones until 1989 \$450 million of interest in 1988, allowing Chile to close its 1987-88 financing gap.

the Philippines, and Venezuela—now have programs in effect to convert foreign debts into equity investments, and the programs' cumulative debt reduction could total as much as \$10 billion by yearend. [ ]

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- Bolivia reportedly is seeking to buy back its own debt at a discount on the secondary market. [ ]

Other secondary market mechanisms also are beginning to gather steam. The Philippines new *interest-for-equity swap* program, for example, combines some features of interest capitalization with some from debt-for-equity swaps. The secondary market has also made *exit bonds* possible, and some debtors are considering using the secondary market to *buy back* large portions of their own debts at a discount and retire them. In addition, entrepreneurs are trying to repackage LDC debts bought on the secondary market and resell them to speculative investors as *securities*. [ ]

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### Options Under Consideration: A General Look

The debt relief and financing options being used and proposed vary widely in mechanics, impact, and likelihood of implementation.<sup>1</sup> All, however, share the characteristic of shifting some of the burden of the debt, or at least its risk, from debtors to creditors. [ ]

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### Debt Relief Options

Because most debtors now pay only the interest on their debts—having rescheduled principal repayments to future years—the next step in debt relief for the LDCs probably will entail some type of deferral or reduction of interest obligations. This might be accomplished by *interest capitalization*, which would set a ceiling on interest payments—either in dollar terms or as a “maximum” interest rate—and defer any unpaid interest until the end of the loan. Alternatively, debtors might choose, as Peru and Zambia already have, to establish unilateral *debt service contingencies* that limit debt service to a specified percentage of export earnings, leaving the unpaid interest for future negotiation. [ ]

Finally, some observers even have suggested that a portion of LDC debts be forgiven. *Forgiveness* might encompass interest or principal obligations, or both, and proposals range from further reducing or eliminating the interest rate spreads debtors pay, to simply canceling 30 percent or more of LDCs' debts. Forgiveness proposals also differ on the scope of relief. Some suggest forgiveness only for the most acutely troubled debtors, such as Sub-Saharan African nations, while others call for across-the-board forgiveness, which would not discriminate between more-deserving and less-deserving debtors. [ ]

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### New Financing Incentives

With creditor banks increasingly unwilling to cooperate on new money loans and with prospects bleak for a return soon to traditional voluntary bank lending to LDCs, attention is also increasingly shifting to possible incentives for, and alternatives to, new money for the LDCs. Over the next several months, in particular, international banks will be putting forward new proposals in response to Treasury Secretary Baker's encouragement of a menu of options for LDC financing instead of new money. [ ]

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A second category of debt relief mechanisms stems from the secondary market for LDC debts. This market for troubled LDC loans, where creditors buy, sell, and trade existing loans at less than their face value, has grown much larger and more open over the past two years, and has gained increasing attention for the large discounts at which some countries' debts are traded. *Debt-for-equity swaps* remain the most significant secondary market mechanism. Eleven LDCs—Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Honduras, Mexico,

Several financial mechanisms have been suggested, or already are being used, as incentives for new lending to the LDCs. The World Bank, for example, has been

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<sup>1</sup> See appendixes for a detailed discussion of how each option works, the benefits to debtors, and the costs to creditors. [ ]

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successful in stimulating about \$2 billion in new commercial lending to LDCs through *cofinancing*, whereby the Bank dilutes the commercial banks' risk with its own guarantees of repayment, but some commercial banks claim that a much more extensive program of *official guarantees* or insurance is needed to mobilize significant amounts of new private loans. At the same time, the process of *securitization*—the shift away from traditional bank loans toward marketable borrowing instruments—has raised hopes that debtors might increasingly be able to obtain funds directly from world capital markets rather than from commercial banks. Colombia, for example, recently raised \$50 million from capital markets by issuing floating-rate debt obligations in its own name. [redacted]

In addition, creation by Japanese commercial banks of a *factoring company* to buy troubled LDC loans from the banks at a discount might yield new funds for the debtors. Although the mechanism functions primarily for the tax benefit of the creditor banks, resulting improvements in the banks' capital adequacy will free up funds that could be made available to the LDCs. [redacted]

### An Evaluation

Although a variety of mechanisms are capable of providing financial relief to debtors, the mechanisms encounter important constraints on their implementation or widespread use. For example:

- Interest-delaying mechanisms, if broadly applied, are likely to entail substantial losses for banks in several countries, including the United States, without significant changes in bank regulations or accounting standards to allow banks gradually to phase in the losses from such delays. Such changes do not appear to be immediately forthcoming.
- Secondary market mechanisms, although growing, still handle only small amounts of debt, compared with the overhang of debt that stands between the LDCs and creditworthiness. Even with heavily reserved banks now interested in increasing their use of debt-for-equity swaps, for example, swap

experts say there are not enough profitable investments in the developing countries to absorb the amount of debt banks want to shed.

- Outright forgiveness of some debts also would entail substantial losses for bank creditors, making them even more reluctant to extend new credit to the debtor countries. Forgiveness probably would worsen the problem of capital flight by fueling domestic concerns in debtor countries about their governments' economic policies, and it ultimately would reduce the valuation of banks' remaining LDC loans, including those to countries that were not granted forgiveness.
- Concessional mechanisms, such as interest capitalization and forgiveness, carry the risk of spillover to other debtors. If such relief is granted to one country, others are certain to insist on similar treatment and, failing to receive it, might act unilaterally.

At the same time, mechanisms to catalyze fresh lending to the LDCs appear stalemated by creditors' continuing concerns about LDC repayment prospects, on the one hand, and by developed country governments' reluctance to protect private creditors on the other hand. [redacted]

We believe some new mechanisms will be more important than others. The issue of interest-delaying mechanisms, in particular, is likely to come to the fore over the next 12 months as debtors continue to focus on interest relief. Use of marketable interest bonds, such as the Philippines's PINs, may expand in this regard. [redacted]

Secondary market mechanisms also are now certain to be increasingly adopted by both creditors and debtors in coming months, in view of recent statements by major bank creditors. Debt-for-equity swaps, in particular, will continue to be a focus of attention. In addition, exit bonds may become a common feature of debt rescheduling deals for the LDCs, streamlining future debt negotiations somewhat. Securitization of

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**The Debt Overhang**

*The debt problem arises from LDCs having more external debt than they are capable of fully servicing while also sustaining domestic economic growth. In short, the LDCs have too much debt. The external debt of 10 major Latin American debtors<sup>a</sup> amounted to \$362 billion at the end of 1985, but reducing that figure to zero would clearly be going further than necessary to "solve" the problem. How much debt, then, would have to be repaid or otherwise removed before the remainder would no longer be "too much?"*

*There is no precise way to measure how much debt is sustainable. The amount depends on the volume of foreign capital inflows, growth of imports and exports, and exogenous factors, such as commodity prices and interest rates. Ultimately, the breaking point comes when creditors perceive the load as too heavy and begin to pull back their credit lines. In weighing these factors, creditors use several arithmetic ratios:*

- Total debt as a share of GDP. A number above 40 percent is worrisome; above 50 percent is dangerous.
- Total debt as a share of exports of goods and services. Any number above 200 percent indicates trouble.

<sup>a</sup> The 10 debtors are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Peru, Uruguay, and Venezuela. [redacted]

- Total interest as a share of exports of goods and services. This ratio is considered critical at levels above 20 percent.

*By comparing desired levels for these ratios with the actual levels for 10 major Latin American debtors, we calculate a roughly 40-percent overhang of debt beyond the desired level. This translates into a hypothetical reduction of \$144 billion from the current \$362 billion debts of these countries to place them within desired levels. It is this debt overhang, rather than the entire debt, against which new financial mechanisms are targeted and judged:*

Indicator	Actual 1985 Level	Maximum Desired Level	Reduction Implied To Achieve Desired Level (billion US \$)
Total debt/GDP	73	40	163
Total debt/exports of goods and services	364	200	163
Interest/exports of goods and services	28	20	105
Average reduction implied to achieve desired level			144

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LDC debts—either existing or new—probably will gain increasing attention but will remain confined to only a handful of debtors. [redacted]

to the debtors. By comparison, we calculate that new mechanisms would need to effect a debt reduction of \$100-200 billion to bring the 10 major Latin debtors alone within desired levels of creditworthiness. [redacted]

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On balance, in our view, the new financial mechanisms at this time appear capable of making only marginal inroads against the LDC debt problem. This year, for example, we expect that new mechanisms will remove only about \$5 billion of the more than \$800 billion LDC debts outstanding, reduce the LDCs' \$115 billion debt service bill by roughly \$2 billion, and channel about \$3 billion of new funds

Even as these results improve somewhat next year and in 1989, as appears likely, we can see only about \$15 billion in debt relief being generated by these new mechanisms over that time. It will therefore take years before the process removes the debt overhang. Moreover, if the application of new mechanisms shows no signs of restoring LDC debtors to

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creditworthiness, even the small amounts of funds now directed to these programs may dry up as creditors again become concerned about repayment.

[Redacted]

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For the LDCs as a group, therefore, we see little prospect that new financial mechanisms will significantly improve the LDC debt problem over the next two years, and we believe the debt situation will continue to be marked by a lurching from crisis to crisis.<sup>2</sup> While a few countries—Chile, for example—will achieve modest debt relief through new mechanisms, most will continue to have problems servicing their debts. LDC debt negotiations will remain contentious, and talks might even be further complicated by new mechanisms as debtors and creditors haggle over their implementation.

[Redacted]

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[Redacted]

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**Appendix**

**Debt Relief Mechanisms**

**Interest Delaying Mechanisms**

**Secondary Market Mechanisms**

**Forgiveness**

**New Financing Incentives**

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### Interest Delaying Mechanisms

#### Interest Capitalization

##### How It Works

Interest capitalization is the primary mechanism for delaying interest payments. Under this mechanism, a ceiling is set on interest payments and any interest owed above the ceiling is added to the principal outstanding on the loan, or capitalized. The ceiling could be expressed as an annual dollar amount, or as a "maximum" interest rate—either would have the same effect of reducing current interest payments. Capitalization temporarily delays "excess" interest payments until the end of the life of the loan, when they either become due in a balloon payment or are spread over additional years. In this way, capitalization supposedly preserves the value of the loan to creditors. [redacted]

##### Benefits to Debtors

For the debtor, interest capitalization offers cash flow relief and stabilizes interest payments that, because most LDC debt is contracted at floating interest rates, otherwise would vary with market interest rates. Stabilizing interest payments at a known level would help protect against the risks that result from interest rate increases: cuts in imports and drawing on foreign exchange reserves on the debtor side, and, on the creditor side, the need for new lending to enable the debtor to meet higher interest payments. At the same time, putting off some interest payments into the future theoretically gives debtors the opportunity to put themselves in a better position to pay when those payments finally fall due. [redacted]

Recent experience suggests, however, that debtors are likely to be concerned about just how the capitalized interest will eventually have to be paid. The current US initiative to permit interest capitalization on debts owed under the Foreign Military Sales (FMS) program stipulates balloon payments of capitalized interest, plus interest on the capitalized interest, at the end of the loan. Even though the real value of the FMS loans would remain unchanged under the capitalization proposal, the large nominal value of the final

balloon payments startled debtors and was an important reason behind some debtors' rejection of the plan. [redacted]

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##### Costs to Creditors

Deferral of interest payments under any circumstances is a particularly sensitive subject with creditors, however, because of an important accounting principle and bank regulatory concern. Under that principle, commercial bank creditors generally may not count, or accrue, delayed interest payments as current income. That is, delayed interest generally cannot be added into income as though it had been received on schedule. Instead, delays in interest payments usually cause a loan to be shifted from an accrual basis to a cash basis, where interest can be counted as income only when it is actually received. If deferral of interest payments is part of the original loan agreement, the deferred interest probably would be accruable as current income. If the deferral were applied retroactively, however, as part of a debt rescheduling agreement—and this is where the real relief lies—allowance of accrual would be unlikely. This inability to record delayed interest in income is a major stumblingblock for bank creditors because it would cut earnings, in turn eroding profits or even causing an operating loss. [redacted]

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Interest capitalization also presents other problems. Even if delayed interest payments could be counted as current income, deferring some interest until the end of the loan—and possibly until additional years afterward—would cause a loss of liquidity for creditors. The liquidity loss only occurs, however, if the debtor would be servicing its debts fully, even in the absence of new money from banks. We see this prospect as unlikely given the recent experience of Mexico and Nigeria, which needed new money even in the absence of a big rise in market interest rates. Finally, creditors fear deferring interest also moves debtors a significant step closer to leaving interest unpaid entirely. [redacted]

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**Variations**

One variation on interest capitalization is the interest-averaging cap. Like capitalization, this mechanism would specify a ceiling on the interest rate, and any interest in excess of the ceiling would be added to the principal outstanding on the loan. If interest rates subsequently fell below the ceiling, however, the debtor would continue to pay interest at the ceiling rate until it paid off any interest that had previously been capitalized. After this, if market interest rates remained below the ceiling, the interest rate would revert to the original terms of the loan—a market reference rate plus a spread. Interest averaging, while it shares the same pitfalls as interest capitalization, has the extra benefit of helping to avoid huge balloon payments of capitalized interest at the end of the loan.

[redacted]

Another device related to interest capitalization is the variable maturity loan. This type of loan allows the interest rate to vary in response to market conditions, but adjusts the size of principal repayments to offset fluctuations in the interest charges. Thus, an increase in interest payments triggers a cut in principal repayments to keep the total debt service payment stable. The “missed” principal repayments are then added to the end of the loan in the form of a longer loan life, or maturity, not as a balloon repayment.

[redacted]

Most major debtors, however, currently are repaying very little principal because of recent reschedulings, and a variable maturity loan offers no relief if there is no principal to vary. The value of this mechanism, then, is limited to new loans in the future. In addition, it is uncertain whether there would be accounting or regulatory problems with this type of loan. Variable maturity mortgages have been used in the United Kingdom and in Australia for years, but mortgages are secured with collateral while sovereign loans are not.

[redacted]

**Debt Service Contingencies**

**How It Works**

A second debt relief proposal is based on the premise that debtors’ servicing capability is to some extent out of their control, being determined by shifts in global

economic conditions. As such, many LDCs have argued that their debt service should be more commensurate with what they perceive as their ability to pay. LDCs have for some time considered limiting all debt service payments to a specified fraction of export earnings. A handful of countries have taken concrete steps to adopt such a limitation, but only Peru and Zambia have actually imposed limits, and only Peru has sustained a limitation over a significant period. Even for Peru, the limit achieved little more than to formalize preexisting debt service levels, leaving this mechanism essentially untested as a means of debt relief. Debt service limitations are usually ambiguous about whether payments in excess of the ceiling should be capitalized or simply forgiven, but in practice creditors have done neither. Instead, they have built reserves against the loans and allowed arrearages to accumulate but have not abandoned their claims on the countries.

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As a close alternative to total export revenue, some have proposed that debt service instead be made contingent on the market price of a key export commodity. Argentina’s debt service, for example, could be linked to world wheat prices, or Mexico’s payments could be adjusted with oil price fluctuations. Debt service could also be linked to world interest rates, or to a debtor’s GDP. Before its suspension of debt service in February, Brazil had targeted 2.5 percent of its GDP as an informal goal, although not a limit, for its debt payments.

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**Benefits to Debtors**

For major debtors, reducing debt service by half, for example—from an average of 40 percent of exports to 20 percent—would appear to free up substantial foreign exchange for other uses. Against this benefit, however, the limitation almost certainly would result in a cutoff of new lending by commercial creditors, which remains a critical component of the debt management strategy. Nevertheless, debtors probably would receive some modest cash-flow and economic growth benefits; and, for a debtor receiving no new lending in any case, this option becomes even more attractive.

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**Table 2**  
**Examples of LDC Debt Service Contingencies**

	Contingency	Date implemented	Status	Effect
Peru	10 percent of export revenues	August 1985	In effect	Formalized existing debt service levels
Nigeria	30 percent of export revenues	December 1985	Repealed; IMF standby in effect; reschedulings completed	Formalized existing debt service levels
Zaire	10 percent of export revenues	October 1986	Used as bargaining position with creditors; never implemented	Would have been a 50-percent cut in debt service
Zambia	10 percent of net export earnings	May 1987	In effect	Estimated 50-percent cut in debt service
Brazil	2.5 percent of GDP	Goal for 1987 before suspension of debt service in February	Publicly stated policy target	Probably would have been achievable with commercial and official debt reschedulings and new money
Ecuador	30 percent of export revenues	Under consideration for 1987 before earthquakes occurred in February	Overtaken by debt service moratorium in response to earthquake	If implemented, would have been a slight reduction from scheduled debt service

[Redacted]

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#### Costs to Creditors

Because most major debtors' debt service currently consists mainly of interest, debt service contingencies create the same accounting difficulties for creditors as interest capitalization. The more a contingency mechanism cuts debt service payments, the larger nonaccrued interest would be and the more banks' earnings would be reduced. For smaller debtors like Peru,

creditors' strong reserves against their relatively small loan exposure have minimized the impact of the country's debt service limit. If a debt service ceiling of 20 percent of exports were applied to larger debtors, however, creditors would suffer huge cuts in earnings, up to nearly two-thirds for the largest US banks, according to one private study. [Redacted]

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## Secondary Market Mechanisms

### Debt-for-Equity Swaps

#### How It Works

In a typical debt-for-equity swap, a commercial bank sells its debt at a discount to a multinational corporation or other private investor who transfers it to the debtor country for redemption at near or full face value in local currency or government notes. The investor then uses the proceeds to buy equity shares in a local business. Alternatively, a bank creditor can swap its debt for an equity investment of its own, buying additional debt on the secondary market if necessary to afford the desired investment. [redacted]

Debt-for-equity swaps have been one of the most significant factors in the growth of the secondary market. Eleven countries—Argentina, Bolivia, Brazil, Chile, Costa Rica, Dominican Republic, Ecuador, Honduras, Mexico, the Philippines, and Venezuela—currently have debt-for-equity swap mechanisms in effect, and the programs together have reduced Latin America's \$219 billion commercial bank debt by about \$5 billion. Chile's program has been the most successful, eliminating about \$1.5 billion, or roughly 7 percent, of the country's debt. Mexican debt-for-equity swaps have been taking place at the rate of about \$100 million per month and total some \$1.6 billion to date. [redacted]

#### Benefits to Debtors

For the debtor countries, debt-for-equity swaps reduce the external debt outstanding and the related interest obligations. At the same time, foreign investment can be stimulated as investors are attracted by the prospect of obtaining local currency more cheaply—through secondary debt market discounts—than through the foreign exchange markets. A key pitfall of debt-for-equity swaps for the debtor, however, is the domestic monetary effects. An LDC government must either create new local currency or borrow it on domestic markets to buy back its debts through the swap mechanism. Excessive money creation could send already troublesome LDC inflation even higher, and borrowing at higher domestic interest rates could result in an increased overall debt burden. In addition,

**Table 3**  
**Recent Secondary Market Prices**  
**for Selected LDC Debts**

*In US cents per  
dollar of face value*

	May 1987	January 1986
Argentina	59-60	62-66
Bolivia	20-25	8-9 <sup>a</sup>
Brazil	63-65	75-81
Chile	68-70	65-69
Colombia	86-89	86-89 <sup>a</sup>
Ecuador	54	68-71
Egypt	49-51	NA
Ivory Coast	79-80	NA
Mexico	58-61	69-73
Nicaragua	10-12	10-12 <sup>a</sup>
Nigeria	37-40	NA
Peru	14-16	25-30
Philippines	70-71	NA
Poland	45-46	50-53
Romania	88-89	80-82 <sup>a</sup>
South Africa	61-62	75-80 <sup>a</sup>
Venezuela	74-75	80-82
Yugoslavia	76-78	78-81

<sup>a</sup> July 1986 price.

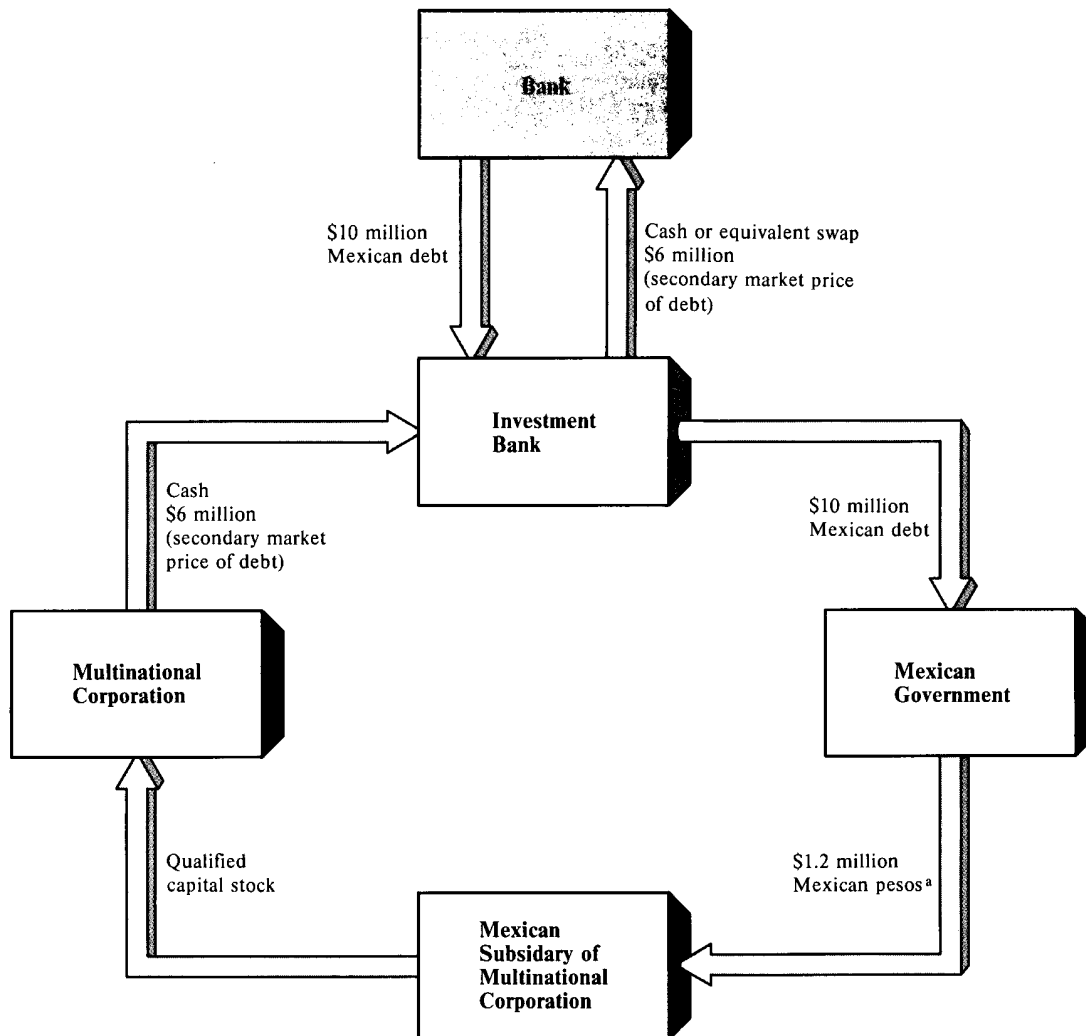
LDCs are concerned about "round tripping," where the investor profits by reconverting the swap proceeds into hard currency and then taking the money out of the country, leaving the central bank with a loss and the country without the investment. [redacted]

Debtors also are politically sensitive to swaps, which are vulnerable to criticism as a capitulation to foreign interests under the pressure of the debt problem. Political opposition and labor groups in Ecuador, for example, have accused the government of "selling out

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**Figure 1**  
**Mexico: An Example of How a Debt/Equity Swap Works**



<sup>a</sup> The price at which the Mexican Government repays the debt in local currency varies according to the type of investment, from 75 to 100 cents per dollar of face value of the debt.

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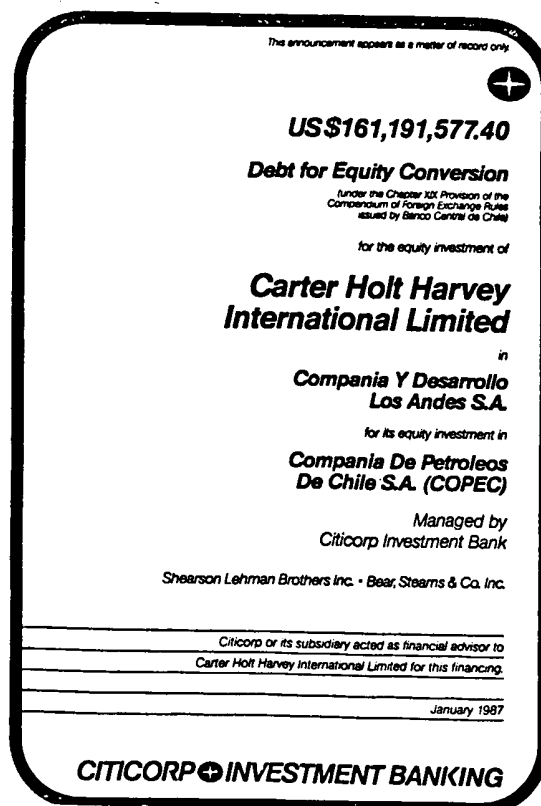
the country to foreigners," and Mexican businessmen complain that swaps give foreigners an additional steep discount in a currency that already is substantially undervalued. [redacted]

### Costs to Creditors

Trading loans on the secondary market can help individual creditors cut their risk, or consolidate their risk within a preferred geographic region. For creditors with small LDC loan exposures, selling off their loans can be a way out of the liquidity loss they suffer when loans become tied up in successive debt reschedulings. Banks that have already written off much of their LDC loans may even be able to recoup more than their book value. The marketability of loans does not by itself eliminate the risk for the system as a whole, however, when a debtor is not in a position to repay them. [redacted]

One important concern about the secondary market is that the source of new money in rescheduling packages for the LDCs might be eroded if both the buying and selling banks disclaim responsibility for participation. Under Mexico's \$6 billion new money package agreed to last year, for example, banks' participation was determined according to their 1982 loan exposure. Creditors that had sold or swapped their Mexican loans since then resisted—and in some cases refused—new money contributions. [redacted]

Bank creditors converting debt into equity for themselves probably view the swap as a middle ground between remaining caught in a cycle of successive debt reschedulings and new money requirements and simply writing off the debt, taking a straightforward loss. Against these benefits, however, creditors and investors also face important disadvantages. Investors confront a variety of discouraging investment restrictions and regulations attached to the swap programs, including cumbersome and expensive host country approval procedures, sharp limits on profit repatriation, and restriction of foreign investors to minority participation in local firms. Commercial bank investors, in addition, are deterred by LDC restrictions on foreign involvement in the financial sector—the investments banks are most willing to make—and by limits in their home country on the activities they can undertake abroad. [redacted]



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Figure 2. Public announcement of a debt-for-equity swap completed under Chile's swap program. [redacted]

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### Interest-for-Equity Swaps

#### How It Works

Just as LDC debt principal now can be converted into equity investments in some debtor countries, so too could LDC interest payment obligations. Although Brazil has hinted to creditors that it would favor such a mechanism, only the Philippines has implemented a program whereby bank creditors have the option of converting interest obligations into Philippine Investment Notes (PINs). Banks that buy the six-year, dollar-denominated PINs, which are sold at a discount from their face value, have three options: they can hold the PIN to maturity and receive the full face value of the note in dollars; they can redeem the note

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anytime before maturity for its full value in local currency and invest the proceeds in government-approved projects; or they can sell the PIN on the secondary market to other investors wanting to cash in the note for local investment. [redacted]

**Benefits to Debtors**

Like debt-for-equity swaps, interest-for-equity swaps offer the dual benefits of easing current debt service obligations and stimulating foreign investment. In the Philippines' case, even if creditors do not invest with the PINs but instead hold them to maturity, the country still has succeeded in delaying current interest obligations until years into the future. At the same time, however, interest-for-equity swaps suffer from the same domestic inflationary drawback as debt-for-equity conversions—the local currency for investment conversion must be either borrowed or created anew.

[redacted]

**Costs to Creditors**

Creditors, too, face essentially the same difficulties with interest-for-equity conversions as they do with debt-for-equity swaps—limited LDC investment opportunities and restrictive financial regulation. In addition, it is uncertain whether the interest payments deferred by the conversion process can be counted as current income by creditors. Some international accounting firms have argued that banks may record receipt of the notes as interest, but others contend the notes are not interest.

[redacted]

**Debt Buyback**

**How It Works**

The secondary debt market has also given rise to proposals for some LDC debtors to buy back their own debts outright at the market's deeply discounted prices. These proposals have centered on smaller debtors, such as Bolivia and Costa Rica, where the country's debt is small and creditors have accumulated large reserves against their loans or have already written down the debts. Bolivia and its commercial bank creditors, for example, recently agreed to a plan

allowing the country to buy back as much as \$670 million of its debt at a discount. The discount has not yet been determined, but at the going secondary market price for its debts of about 15 cents per dollar of face value, Bolivia could clear its debt to commercial banks with only about \$100 million.

[redacted]

**Benefits to Debtors**

Debtors able to finance a buyback would receive immediate and substantial debt relief. They would reduce their outstanding debt directly by the face value of the debt bought back, as well as eliminate the corresponding interest payments. Debtors also would save substantial principal repayments because the debts would be bought back on the secondary market for less than their full face value.

**Costs to Creditors**

Bank losses probably would be minimal for the most troubled small debtors, for which most banks have built strong reserves. As with debt-for-equity swaps, banks that have already written down their loans could even recoup more than their book value. At the same time, however, such a visible and organized recognition that LDC debts are not worth their face value could lead other debtors to argue that their obligations should be correspondingly adjusted downward. For example, Mexico might argue that, with the market price of its debt only 58 cents on the dollar, its debts should be only \$60 billion, rather than the \$104 billion the country actually owes.

**Securitization of Existing Debt**

**How It Works**

The secondary market could also help spread the risk of LDC loans away from the banks if new nonbank investors became active participants in the market, but, in practice, banks have traded debts mainly among themselves. One reason is that most bank loans

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are not standardized in such a way that individual investors can know what they are getting. Recently, however, entrepreneurs have begun using the secondary market to buy up LDC debt, repackage it into tradable securities—sometimes referred to as sovereign junk—and resell the securities to speculative nonbank investors at a deep discount from face value. So far, this activity appears to be focused on Nigeria's debts. [redacted]

**Benefits to Debtors**

Debtors receive no direct benefit from this mechanism because principal is not forgiven, and they must continue to make full interest payments. Debtors could benefit indirectly, however, by buying securities made from their own debts and retiring the obligations at a discount. [redacted]

**Costs to Creditors**

Although some of the world's largest banks are involved in marketing these sovereign junk securities, according to press reports, investors so far remain cool to the innovation because of concerns about prospects for repayment and less than \$5 million of LDC debt has been repackaged to date, according to industry experts. Another obstacle is that many bank loan agreements require the permission of the debtor country to turn them into marketable securities. In addition, like most secondary market mechanisms, securitization of existing debt can erode the source of new money in debt rescheduling packages if both the buyer and seller of the securities disclaim responsibility for participation. [redacted]

**Exit Bonds**

**How It Works**

Still another mechanism involving the secondary market is exit bonds, which would allow individual creditors to withdraw entirely from the business of lending to a particular LDC by paying a financial penalty. Creditors wishing to withdraw would accept payment from the LDC in the form of bonds that would carry

an exemption from future debt reschedulings and participation in new loans. In exchange for this exemption, the bonds probably would carry a lower interest rate and longer term than the loans they replace. Creditors could then resell the exit bonds on the secondary market, completing the withdrawal. In the first-ever application of exit bonds, Argentina and its commercial bank creditors agreed in April 1987 to permit the bonds for small creditors who want to close down their loans to the country. The 25-year, 4-per-cent government-backed bonds will be available to creditors who are owed up to \$30 million—perhaps as many as half of Argentina's 360 creditor banks, according to press reports. [redacted]

**Benefits to Debtors**

Exit bonds would provide debtors with a direct reduction in debt service obligations because of the bonds' lower interest rate. If used on a large scale, however, the bonds almost certainly would work against returning a debtor to market creditworthiness because the use of exit bonds would indicate that the debtor's financial prospects had become so poor that creditors were prepared to accept sizable losses to leave the country. [redacted]

**Cost to Creditors**

For creditors, exit bonds carrying a lower interest rate would mean a loss of some income. Creditors willing to accept the bonds, however, would view the freedom from future loan problems as outweighing the income loss. For remaining creditors, however, exit bonds would erode the lending base for new-money loans and thereby increase the amounts of new money that remaining banks would be expected to provide. [redacted]

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**Forgiveness**

**How It Works**

Some observers have suggested that LDC debts should simply be forgiven. Proposals for forgiveness have involved canceling either interest obligations or principal repayments, or both, and range from further reducing or eliminating the interest rate spreads debtors pay, to simply erasing 30 percent or more of LDCs' debts off their creditors' books. Several observers have suggested that debts should be forgiven to an extent commensurate with their secondary market discount, which they claim indicates what the market believes debtors can actually pay. [redacted]

Forgiveness proposals also differ on the scope of relief that would be offered. Some believe forgiveness should be granted only to the most acutely troubled debtors, such as Sub-Saharan African nations, while others call for across-the-board forgiveness without discrimination among more-deserving and less-deserving debtors. Still others believe forgiveness should be reserved as an incentive and reward for LDC economic policy reform. [redacted]

**Benefits to Debtors**

Like proposals to limit debt service payments, simply forgiving a portion of interest payments due could benefit debtors in the short run by freeing up the foreign exchange that otherwise would have been used to pay interest. This would allow increased imports and capital investments that would translate into modest increases in economic growth in the short run. The almost certain loss of new lending, however, would erode these gains over the longer run. [redacted]

Forgiveness of principal presumably also would entail cancellation of interest payments on that portion of principal that is forgiven, which would benefit debtors. Forgiveness of principal as such, however, would

yield little immediate benefit because most debtors have delayed principal repayment until future years through rescheduling agreements with creditors.

[redacted]

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**Costs to Creditors**

For creditors, any cuts in interest payments would reduce earnings and impair profits. Moreover, because interest would be forgiven rather than deferred, creditors would suffer a capital loss on the value of the affected loans equal to the forgiven interest. If a substantial amount of interest were forgiven for the major debtors, the resulting reductions in bank profits and losses of bank capital would be huge and could create serious risks for the global financial system. Interest forgiveness could be limited to a select group of extremely troubled smaller debtors, with less destructive bank losses, but larger debtors almost certainly would demand similar treatment and might even be spurred to unilateral curtailment of interest payments. [redacted]

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Forgiveness of debt principal would increase the benefits to debtors over interest forgiveness, but would be costlier as well. Creditors would suffer capital losses equal to the forgiven principal, in addition to losing both earnings and capital from the corresponding interest. Because commercial creditors would be unlikely to offer new loans to countries whose debts they had forgiven, debt forgiveness in either form almost certainly works against returning debtors to market creditworthiness. [redacted]

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**Table 4**  
**Cumulative Effects of LDC Debt Forgiveness, 1987-89**

	Effects on Debtors <sup>a</sup> (billion US \$)		Effects on US Banks (Resulting reduction in average annual after-tax earnings, 1987-89, as a percentage of 1985 after-tax earnings)	
	Interest Reduction	Principal Reduction	Nine Moneycenter Banks	15 Other Large Banks
<b>Scenario 1 <sup>b</sup></b>				
Elimination of spreads	8.4	0.0	13.4	5.7
<b>Scenario 2 <sup>c</sup></b>				
30 Percent forgiveness	12.9	57.8	50.8	21.5
<b>Scenario 3 <sup>d</sup></b>				
Forgiveness referenced to secondary market discount	14.7	82.3	57.6	25.3
<b>Scenario 4 <sup>e</sup></b>				
Three-year program of interest and principal concessions	18.9	17.4	56.6	24.0
Memorandum: total 1985 interest obligations of the 15 debtors	36.9			
Memorandum: total debt owed by banks and public-sector borrowers of the 15 debtors		192.8		

<sup>a</sup> All data are for the 15 Baker Initiative countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia. Assumes that all banks, not just US banks, would grant the same concessions.

<sup>b</sup> Scenario 1: Interest rate spreads on all bank debt are eliminated.

<sup>c</sup> Scenario 2: 30 percent of bank debt is forgiven and written off over 10 years.

<sup>d</sup> Scenario 3: A proportion of each debtor country's bank equal to the current secondary market discount on that debt is forgiven and written off over 10 years.

<sup>e</sup> Scenario 4: During a three-year period, interest rates on bank debt are reduced by 3 percentage points and each year 3 percent of bank debt is forgiven and written off.

Source: Federal Reserve

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## New Financing Incentives

### Securitization of New Debt

#### How It Works

A major trend in international financial markets in recent years has been the shift of credit flows away from traditional bank loans and toward debt obligations that can be easily traded among a variety of creditors. In the late 1970s, for example, as much as 80 percent of global lending was in the form of syndicated bank lending, and lending in the form of tradable securities was small. By the end of 1985, however, this relationship was reversed (figure 3). This shift to marketable debt securities is referred to as securitization. [ ]

Traditional fixed-rate bonds and floating rate notes (FRNs) account for most securitized longer term credit, while note issuance facilities (NIFs) are the main form of securitized short-term credit. A NIF, rather than lending money directly to a country, instead provides only a mechanism for placing the country's own short-term notes with other investors. For a fee, banks manage the placement of the notes, and they often underwrite them—that is, they agree either to buy any notes that the issuing country is unable to sell directly to investors or to make cash advances against unsold notes. [ ]

Another tradable borrowing instrument that has attracted attention concerning the LDCs is the zero-coupon bond because it defers all interest payments until it is redeemed at its face value at maturity—typically some 10 to 20 years in the future. These bonds are sold initially at a deep discount from their face value and the return on the instruments depends entirely on the relationship of the purchase price, the face value, and the time remaining until maturity. [ ]

#### Benefits to Debtors

Bank for International Settlements data indicate the LDC's get little out of securitization because the criteria of creditworthiness are even stricter for securities than for bank loans. While LDCs accounted for roughly half the global volume of syndicated lending annually between 1981 and 1986, their share of fixed-

rate bonds was less than 2 percent, and less than 10 percent of both FRNs and NIFs. Even these small shares were confined to several LDCs, such as South Korea, Singapore, India, Indonesia, and Panama. Moreover, they consisted mainly of commercial, non-governmental, borrowers, and were mostly for small amounts. Most recently, Colombia completed a \$50 million FRN issue in April and plans another \$60-70 million issue later this year. Even though the country is one of only two in South America that have not rescheduled external debts—the other is Paraguay—Colombia is paying substantially higher interest than other Latin debtors to attract voluntary funds. [ ]

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Creditworthiness concerns make it unlikely, in our view, that the range of borrowers that has relied on syndicated loans will be able to arrange bonds, FRNs, or NIFs in the near future. For the few LDCs that are sufficiently creditworthy to do so, however, the instruments allow much more flexibility than bank credits and can be a cheaper source of funds because they tap the market directly, reducing the role of commercial banks as middlemen. [ ]

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#### Costs To Creditors

With the risk of extending longer term credit to LDCs no longer acceptable to many commercial creditors, creditors find securitization attractive because it channels the risk of lending to those willing to accept it. The investment banks and commercial banks that arrange the securities enjoy the certainty of an up-front fee for their services rather than riskier interest income spread out over many years. Moreover, an underwriting commitment remains off the underwriter's balance sheet and thereby often not subject to the same capital adequacy regulations as traditional loans. [ ]

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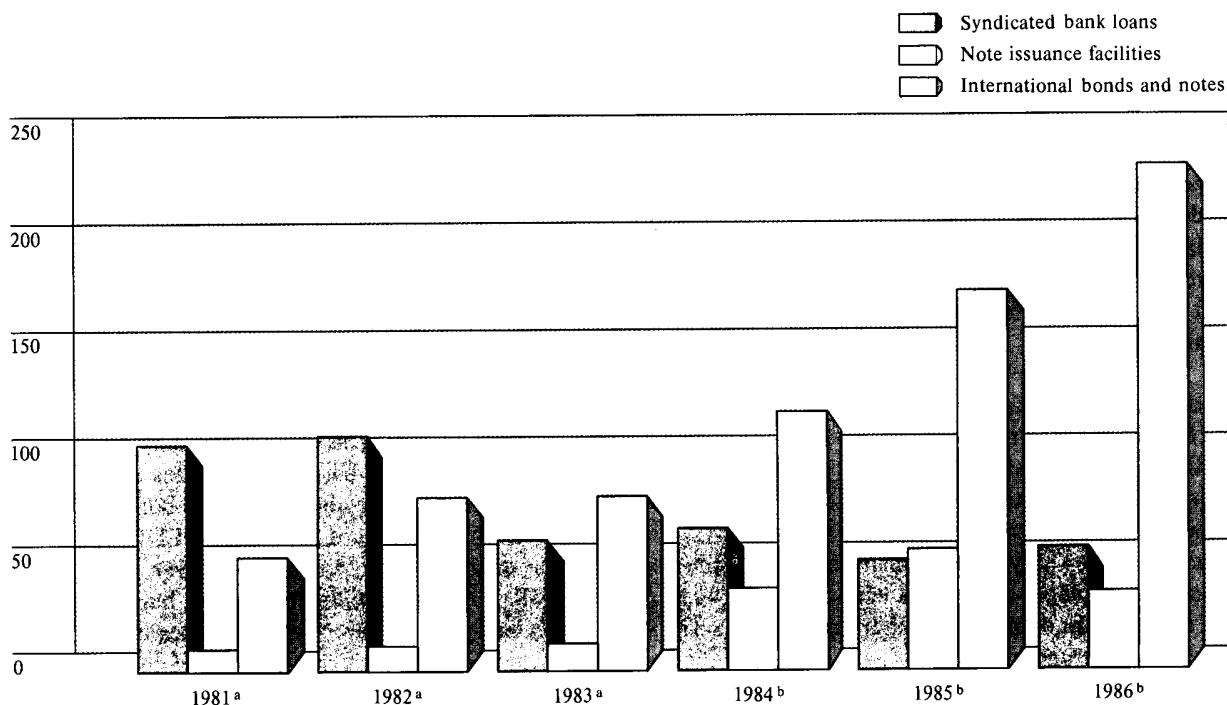
The credit risk of securitization—the risk that the borrower will be unable to pay, which lending banks traditionally have borne—is borne by the ultimate

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**Figure 3**  
**The Securitization Trend in International Capital Markets**

US \$

<sup>a</sup> OECD data.<sup>b</sup> BIS data.

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holders of the securities. Little is known about the identity of these creditors, but they are thought by the BIS to be primarily European, Middle Eastern, and Asian banks. Securitized LDC debt could help spread the risk of LDC lending away from banks if nonbank participants became active buyers, but in practice nonbank investors—mainly investment funds, corporations, insurance companies, and wealthy individuals—remain unwilling to hold more than a small fraction of the instruments.

#### Cofinancing

##### How It Works

Since 1983 the World Bank has attempted to increase the flow of commercial bank lending to LDCs by offering banks a partnership arrangement, referred to as cofinancing, with the World Bank. For its part, the World Bank can help arrange a syndicated loan with private banks and take on a share of the loan for itself, guarantee part of a loan provided entirely by private

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banks, or provide contingency financing to help the borrowing country meet its commercial loan payments if interest rates rise sharply. Although it was hoped these options would speed the restoration of voluntary commercial lending to LDCs, the program has mobilized only about \$2 billion of new commercial lending in the four years since its inception. [ ]

#### **Benefits to Debtors**

Because cofinancing helps dilute commercial banks' risks, debtors receive more funds from the banks than they would expect without World Bank involvement. In addition, cofinancing arrangements often carry somewhat more lenient terms for the debtor than standard bank loans, including a longer repayment period, smaller fees, and lower interest rate spreads. [ ]

#### **Costs to Creditors**

The World Bank's guarantee and contingency funding options help assure creditor banks that they will be repaid. The syndication option also offers a degree of repayment assurance because the World Bank's participation effectively exempts these loans from rescheduling and because the debtor risks having other World Bank loans cut off if it does not repay. [ ]

The cofinancing program makes continued LDC lending more attractive for marginally reluctant commercial banks, but some more recalcitrant banks believe it does not go far enough. They want the World Bank to forgo its preferred creditor status, which entitles it to be paid before other lenders, for example; and they want a firm commitment from the Bank that it will declare its loans in default if an LDC defaults on payments to another cofinancing creditor—something the Bank has resisted. [ ]

#### **Guarantees and Insurance**

##### **How It Works**

Clearly, an effective incentive for commercial lending to LDCs would be to guarantee or insure the banks that they will be repaid. Because private insurers remain unwilling to share the risks of sovereign lending to any significant degree, proposals have centered on official guarantees or insurance and range

from expansion of existing programs, such as cofinancing, to the creation of new multilateral institutions. [ ]

#### **Benefits to Debtors**

As with cofinancing, debtors would receive more money than otherwise would be the case. At the same time, however, the existence of a widespread safety net for debtor nonpayment might possibly encourage some debtors to avoid their obligations—unless they expected a reprisal similar to the cutoff of funds, which usually follows missed payments to commercial banks. [ ]

#### **Costs to Creditors**

Under this mechanism, creditor banks benefit from straightforward protection of their loans. This protection would, however, have to be funded almost entirely by the developed country governments. Any new institution would entail substantial startup funds to provide credible backing for the guarantees or insurance, and even existing institutions would need new capital infusions. In the case of the World Bank, for example, guarantees are treated as if they were new loans and, unless its capital is not raised commensurately, it must forgo new lending by the amount of the guarantees. Official guarantees thus are primarily a domestic political issue for the developed country governments, which would effectively be underwriting the activities of the large international banks. Governments certainly would draw criticism for a taxpayer bailout of private corporations. [ ]

#### **Factoring Company**

##### **How It Works**

Factoring companies, as they exist in the private sector, for years have functioned typically by buying accounts receivable at a discount from manufacturers and then later collecting full or near-full payment on the accounts. In what may be the most innovative approach yet to handling troubled LDC loans, 28 Japanese commercial banks formed an offshore company—which will function essentially like a factoring company—to buy bad LDC loans from the banks at a discount. [ ]

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The new company, called JBA Investments, Inc., will

[redacted] be managed by Fuji Bank, the world's third-largest commercial bank. The 28 member banks each contributed money to get the company started. Payments the company receives from LDCs on the troubled loans will be passed along to its commercial bank "shareholders" as dividends. Japan's Finance Ministry has publicly expressed support for the idea [redacted]

only 1 percent of bad loans annually as a tax deduction. The discount at which a bank sells loans to the new company, however, will be fully tax deductible. In addition, some Finance Ministry officials had hoped to allow a tax deduction of 5 percent of new loans provided to LDC debtors, but this component of the mechanism now appears uncertain at best. [redacted]

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The plan also will help Japanese banks improve their capital adequacy—a step other developed country financial authorities have been urging—by reducing the amount of loans the banks hold. For other creditors, the Japanese Government's support of the plan brings greater prominence to the issue of new mechanisms that could be employed as part of an approach to the LDC debt problem. [redacted]

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**Benefits for Debtors**

Although the Japanese debt plan functions primarily for the benefit of the creditor banks, debtors may benefit from additional loans that could be made available by the banks once old loans are shifted to the factoring company. [redacted]

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**Benefits for Creditors**

The major purpose of the plan for Japanese banks is tax relief. Japanese banks are required to set aside 5 percent of bad loans as reserves, but they can claim

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