

## Debt-for-Equity Swap

Here's a recap of what we did in class today on debt-for-equity swaps. There are at least three parties to the transaction. Each has different incentives for participating. The parties and their incentives for participating can be summarized as follows.

- 1. Creditor bank.** The bank – can be inside the country or abroad – had at some point in the past lent money to a company within the country but needs foreign currency to repay other obligations. The bank now recognizes that the loan has gone bad and will not get repaid. The bank has a choice – it can recognize that it has an unproductive loan and write it off for full face value *or* it can enter a debt-for-equity swap and get some portion of the face value repaid. So it is trying to minimize its losses from a bad situation.

*Example:* Citibank in the US lends US\$ to a Mexican company. The Mexican company doesn't have pesos or US\$. Citibank will take whatever US\$ it can get ahold of. Alternatively, Santander Central Hispano (a Mexican bank) has borrowed money in US\$, converted it into pesos and lent it out in pesos. Either way the creditor bank eventually needs forex.

- 2. Multinational enterprise (MNE).** The MNE wants to enter the foreign country (or expand existing operations there). The MNE knows it needs a certain amount of capital in the local currency in order to establish operations. It wants to use the cheapest possible capital it can find. By participating in the debt-for-equity swap it is effectively converting forex at a preferential exchange rate. The MNE effectively is given for free the bid-ask spread (i.e. if the creditor bank sells the debt at  $x$  cents on the dollar but the central bank buys it for  $y$  cents where  $y > x$  then the MNE is given  $y - x$  for free).

*Example:* Look at the Volkswagen/Mexico example from today's overheads. Volkswagen knew it needed the equivalent of \$260 mn in pesos to open their factory. But it only paid \$170 mn because of the discounts it received on buying the debt and then selling it on to the government.

- 3. Central bank of the less developed country.** The central bank wants to make sure its domestic financial system is in the strongest possible position (i.e. has as few bad loans on the book as possible) and it wants to attract as much productive foreign direct investment (FDI) as possible. Note that here the central bank is often acting as a wing of the government (not like how the Fed works here in the States).

*Example:* Mexico wants more export-oriented firms (i.e. the maquiladoras) because these companies (a) use higher technology than other firms in the country (so they get new technology), (b) create jobs (boost local economy), and (c) earn forex (helps with the country's balance of payments, could impact exchange rate, and helps local banks repay foreign debt). Simultaneously, the Mexican

government knows that if foreign banks think they won't get repaid when lending money to Mexican companies, they won't make further loans in the future. So by arranging this deal, the Mexican government makes foreign creditors think more positively of Mexican investments.

**Example using real company names.**

1. Citibank recognizes \$100mn of bad debt in Mexico.
2. Chrysler wants to invest in Mexico. It needs the equivalent of \$75mn in pesos. Chrysler could take US\$75mn and convert it to pesos at the prevailing exchange rate.
3. The Mexican central bank wants to help Citibank recoup some of the \$100 mn bad loan. That way Citibank will be willing to lend to other Mexican clients in the future.
4. The Mexican central bank approaches Citibank and Chrysler and arranges the deal. Let's say it arranges for Citibank to sell the debt at a 40% discount and agrees to purchase it from Chrysler at 75% of face value.
5. Chrysler then gives Citibank \$60 mn (40% discount off of \$100mn) and is given the \$100mn bad debt. Just a paper asset.
6. Chrysler immediately runs to the central bank and swaps the bad debt for the equivalent of \$75mn in pesos.
7. Chrysler then invests the \$75mn in pesos in Mexico.

**Extensions:**

1. What does the central bank do with this bad debt that is now on their books? Two possibilities – (1) it just takes the loss and moves on or (2) it holds the bad debt on its books and is eventually able to recoup some/all of the face value of the debt from the company.
2. Some countries limit FDI. For example China allows foreigners to own no more than a certain percentage of the equity in a company. Could this situation occur there? As far as I know this has not yet been an issue.
3. How does forex risk affect the whole debt-for-equity swap? It would be priced into the discounts that are offered.
4. Historical data? Latin America in the 80s and 90s. Multiple examples in the book; more can be found in the WSJ archives or in other media sources.