

SECURITIZATION AND NEW TREND OF THE ACQUISITION OF THE THIRD WORLD'S ASSETS

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INTRODUCTION

A growing number of Japanese companies are purchasing Third World countries' U.S. dollar debts in order to swap them for local currencies needed for investments in these countries. Japanese corporations are using this, "debt to equity" conversion technique to raise capital for their subsidiaries in Third World countries. This technique enables them to exchange the discounted dollar debt for local currencies at rates considerably cheaper than would be possible by changing yen into the local currencies on the

foreign exchange market. But this new method of financing, which acts as a catalyst for direct investment of Japanese firms, reflects a sweeping change in the world financial markets and causes serious problems both for the commercial banks of the developed countries, and those of the Third World countries. Commercial banks are losing their traditional intermediary roles in international finance and this, in turn, is weakening their ability to control the domestic finance of the Third World countries.

TABLE 1.

INTERNATIONAL BORROWING

	(US\$ billion)			
	1983	1984	1985	1986
Floating-rate bond issues	19.5	38.7	58.4	54.8
Other bond offerings	57.6	73.3	109.3	177.4
Syndicated loans	67.2	57.0	42.0	40.1
NIFs and other back-up facilities	9.5	28.8	46.8	26.0
TOTAL	153.8	197.3	256.5	298.3
Share of securitized forms of financing (%)	54.5	65.3	79.5	84.2

Notes:

1. January - September at annual rate.
2. Excluding merger-related standbys and renegotiations.

Source: *Financial Market Trends, 35, OECD, Nov. 1986, p.6.*

The shift of Japanese production overseas is causing serious tension in the Third World. This shift has been caused by the high yen and realized through "debt to equity" conversion.

It works like this: a U.S. investment firm finds a bank which has extended, say, a US \$ 100 million loan to a debtor country and is worried that the loan may not be repaid. The bank agrees to sell its credit through the investment firm for US \$ 70 million and to take a loss of US \$ 30 million. The investment firm then tracks down a company which needs the currency of the debtor country to make an investment. The firm arranges for the sale of the loan to the concerned corporation (investor). The company then approaches the central bank of the debtor country and tenders

the loan for, say, 89-90 percent of its local currency value. It can thereby save 10-20 percent of the foreign exchange expenditure. Through this transaction the investment firm can charge fees of 0.25-1 percent of the value of the deal. This system is also advantageous to the bank (original lender) which can get an undesirable loan off the books for most of its cash value. In practice, the technique is far more complicated, involving swap deals among many participants.

Eclipsed Bank Loans

The technique of securitization has lowered costs for fund procurement and allowed greater liquidity, and has thus drastically reduced the reliance of non-financial companies on direct bank financing. Borrowing by U.S. non-fin-

cial companies from banks, which had been their primary source until recently as 1984, amounted to only a fourth of their total fund-raising in 1986. Now the U.S. companies are securitizing anything: mortgages automobile loans and consumers loans etc., which were not placed on the market formerly and were difficult to trade.¹ Firms of European countries and Japan are following this trend. Thus in international markets, securitized loans now account for 80 percent of the whole new fund supply, a large increase from approximately 50 percent in the mid-1970s. Syndicated bank loans have decreased not only as a share of finance but also in real dollar terms. The weight of Euro-bond and Euro-commercial paper has increased in international markets and the Euro capital market depends totally on these two. As a result of the extraordinary expansion of these two forms of financing, the volume of international financing has increased by 28 percent in 1986 from the previous year. (See Table 1)²

But these trends only reflect, factually, the severe decline of commercial banking in financial markets. The performance of the markets seems to be the results of refinancing older and more expensive loans. The volume of early repayments of outstanding bonds has soared to US \$ 38 billion (annually) in 1986, as compared with US \$ 19 billion in the previous year.

Increased Debt-to-Capital Ratio

Today, the major U.S. companies are finding more advantageous financing sources not inside but outside of U.S. boundaries, so they prefer to hold debt in foreign currencies, even if they do not operate overseas, and to swap them for other dollar debts. Interest and currency swapping afford them the cheapest vehicles. Such swapping has become a permanent fixture of firms' financing schedules. Big companies are tending more and more to operate independently from banks by transferring from one new financial item to another.

The situation, however, is still difficult to assess, because financial items do not have an indefinite market. Placement of bonds by final investors may be difficult, resulting in a large overhang of unsold paper. And for banks there seems to be little alternative but to continue to be the heavy tankers of securities because of the weak loan demand by high-quality borrowers.

The availability of a wide range of financial tools is causing a shift in priorities by companies financial strategists. Instead of locking in long term rates, many companies are continuously searching for better loan opportunities, and swapping old obligations for new ones. In this situation, many banks are being forced to sell off their loans to other investors. In the past, banks often sold off their loans when they were bumping up against their legal lending limits. Now they plan from the beginning to sell loans to other investors who can accept them for various reasons. Such downstream financing makes a lot of prominent companies able to finance below LIBOR (the London inter-bank rate on dollar borrowings). As a result, the aggregate debt-to-equity ratio of corporate America has become 3-to-1, a big increase from the 2-to-1 ratio that held for most of the 1960s, though lower than Japan's ratio of 6-to-1. The signs of speculative excess are clearly there. Nevertheless, big business is becoming increasingly comfortable with using debt to put a higher market value on their assets. This fat money, though, has deprived the commercial banks of their proud,

the U.S. largest banks, and is likely to keep rising.⁴

The most immediate problem for U.S. banks, which are now forced to find the path to survival in business other than those essential to commercial banks, is the volume of shaky loans to the Third World. More and more banks are refusing to lend new money to debtor countries. They would rather seek a more far-reaching solution, even if this means writing down the value of their loans. In effect, "debt-to-equity swap" is one example for solution.

Shearson Lehman, which is alleged to have pioneered various techniques for repacking these loans, has said that the secondary market of this kind reached US \$ 5 billion in trading volume in 1986 and could double in 1987.⁵ Although the market is small compared with estimated total debts, roughly US \$ 1 trillion, these transactions have surely inspired many Japanese companies which hope to increase their investments in the Third World.

TABLE 2

DEBT FIRESALE: PRICES FOR DEVELOPING COUNTRIES' DEBT AS A PERCENTAGE OF ITS FACE VALUE

	Dec. 1986	June 1986	Jan. 1986
Argentina	62 - 66	63 - 67	62 - 66
Brazil	74 - 77	73 - 76	75 - 81
Chile	65 - 68	64 - 67	65 - 69
Colombia	-	80 - 82	82 - 84
Ecuador	63 - 65	63 - 66	68 - 71
Mexico	54 - 57	55 - 59	69 - 73
Peru	16 - 19	17 - 23	25 - 30
Philippines	72 - 76	n.a.	n.a.
Poland	41 - 43.5	43 - 46	50 - 53
Romania	86 - 89	89 - 92	91 - 94
Venezuela	72 - 74	75 - 78	80 - 82
Yugoslavia	77 - 81	77 - 79	78 - 81

Source: Shearson Lehman Brothers, cited from *Far Eastern Economic Review*, 29 January, 1987, p. 43.

old line status in the money market. Chase Manhattan Bank, the third largest in the United States, has a lower value in the stock market than Toys "R" US, a toy Company.³

Bad Debt to the Third World

One indication that banks are being bypassed in the financial process is that non-interest income now accounts for as much as 30 percent of the earnings of

Japanese Companies, the Largest Buyers of the Third World Debt

A growing number of Japanese companies are now eager to buy up the U.S. dollar debts of the Third World in order to swap them for local currencies needed for various investment projects. Nissan Motors was the first participant in these transactions. By using the debt-to-equity swap technique, it boosted

capital in its Mexican subsidiary. This method was also followed by a Japan-Mexico hotel joint-venture company. In the Philippines, Kawasaki Steel,⁶ Japan Air Lines (JAL), and Kao (a soap manufacturer) are now trying to finance projects in the same way.⁷

This method of financing is indeed acting as a catalyst for direct investment by Japanese companies. Along with Chile, the Philippines and Mexico are the only countries so far to have officially endorsed the repurchase of U.S. dollar debts, though acceptance of this method seems to be spreading to other Third World countries. Only the reselling of U.S. dollar debts (without converting them into local currencies) is widely done as shown in Table 2.

Japanese banks, which have hesitated to join the queue of loan-sellers, are now said to have begun to reconsider their hands-off policy. Some Japanese banks, such as Sumitomo and the Industrial Bank of Japan (IJB) are attempting to gain fee business by acting as intermediaries in this market. Though these transactions do not involve the bank's own loan selling, they may soon begin to. In November 1986, the IJB brokered a debt-to-equity swap on behalf of the Japan-Mexico Hotel Investment Co. (Jamex), a group of 54 Japanese companies with a 49 percent stake in Hotel Nikko Mexico in Mexico City. Jamex bought Mexican debt worth US \$ 9 million at a reported discount of around 60 percent and converted it into Mexican pesos at 80-90 percent of the market rate. Sumitomo Bank offered to arrange the purchase of some of the Philippines' U.S. dollar debt on behalf of a Scandinavian company in November 1986.⁸

Among U.S. investment banks, Shearson Lehman and Citicorp International have been actively encouraging Japanese companies to tap the debt market for their investment finance. When both

banks got the news that JAL was planning to refurbish the Manila Garden Hotel, owned mostly by JAL, they made rapid proposals for debt conversion into Philippine pesos. JAL went with Citicorp, and in December 1986 bought US \$ 1 million worth of Philippine debt for US \$ 700,000. The Philippine government was assumed to have charged 5-10 percent for stamping this deal. So the final cost for JAL, after paying fees to Citicorp and charges to the Philippine government, was estimated to be US \$ 800,000.⁹

In November 1986, Kawasaki Steel Corp. similarly raised US \$ 1.2 million in a deal arranged by Shearson Lehman for a 30 percent discount. It got pesos at 95 percent of the face value to boost its wholly owned Philippine Sinter Corp. Kao Corp. in attempting to acquire US \$ 17 million worth of Philippine debt for an expansion of its coconut oil plant in Mindanao and for a new shampoo factory in Manila.¹⁰ These big Japanese conversions of Philippine debt into equity may largely affect the debt market, and many other Japanese companies may soon follow suit. The Central Bank of the Philippines is reported to have received a total of 42 applications from foreign companies seeking to convert debt worth US \$ 220 million. Of those, 15, worth US \$ 33 million, have been approved.¹¹

Concluding Remarks

During the past three years (1984-86), Japanese firms have sunk an estimated US \$ 100 billion worth of surplus funds into the New York bond market, realizing heavy capital gains as U.S. bond prices have risen. But if depreciation of the U.S. dollar continues and if the prospect of further decline in New York interest rates disappears, the Japanese investors will surely sell off their New York bonds in great quantities, resulting in further depreciation of the U.S. dollar. The experience of March 1987 when the yen went up to US\$1 = ¥ 140s shows the strong possibility of such a

situation occurring.¹²

A time will come when, in accordance with the MITI plea for stepped up investment into offshore production,

some of this money will be diverted to activities in the Third World, which in turn will force the U.S. dollar to be sold heavily. Thus the only resort left for those with speculative money of both the United States and Japan may be the investment by Japanese companies in the Third World, because out-sourcing the manufactured goods is rapidly generalizing and commercial banks are losing weight in their traditional function. Selling the bad loans and short-term circulation of their assets are required for banks to get out of the pressure by depreciation of U.S. dollars and lowering bond price. Thus debt-to-equity has become common.

But needless to say, this type of transaction means that the debtor countries are forced to sell their domestic assets at much discounted rates to the powerful multi-national companies, thereby limiting their control to the MNCs.

NOTES:

1. "Global Financial Change," *World Financial Market*, Morgan Guaranty Trust Company of New York, December '86, p.1.
2. "Highlights: International Financial Markets," *Financial Market Trends*, 35, OECD, November 1986, p.5.
3. "Another Great Year- for Defaults," *Business Week*, January 12, 1987, p.76.
4. *Business Week*, January 12, 1987, *op.cit.*, p.77.
5. "New Profit from Old Losses," *Far Eastern Economic Review*, 29 January 1987, p.43.
6. *Asahi Shimbun* (in Japanese), January 16, 1987.
7. *Sankei* (in Japanese), September 14, 1986.
8. *Far Eastern Economic Review*, 29 January 1987, *op.cit.*, p.42.
9. *ibid.*, p.43.
10. *Nihon Keizai Shimbun* (in Japanese), October 22, 1986.
11. *Nihon Keizai Shimbun*, December 1, 1986.
12. *Nihon Keizai Shimbun*, March 28, 1987.

COURTESY: AMPO Japan-Asia Quarterly Review

DEFINITIONS

Security:

1. Any income-yielding document that can be traded, as on a stock exchange. Securities may carry fixed interest, as in the case of debentures, bonds, preference shares, and gilt-edged securities, or variable interest as with ordinary shares; they may be redeemable or irredeemable. The term is also used in reference to such commercial documents as bills of exchange and convertible assurance policies.
2. Policies pledged as collateral for a loan by a borrower, or the document concerned with such collateral.

Securitization:

The term is most often used narrowly to mean the process by which traditional bank assets, mainly loans or mortgages, are converted into negotiable securities. More broadly, the term refers to the development of markets for a variety of new negotiable instruments.