University of Pennsylvania (PENN Law and Wharton Financial Institutions Center) Conference
"Is U.S. Government Debt Different?"

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Comments of Steven L. Schwarcz[1]

I first will comment on the draft paper by Professor Charles W. Mooney, Jr., "United States Sovereign Debt: A Thought Experiment on Default and Restructuring." I then will discuss the federal government's raising financing through special-purpose entities (SPEs) and the possible consequences.[2]

I. COMMENTS ON PROF. MOONEY'S PAPER (ADDRESSED TO HIM)

A. *Specific Comments*.

-What terms of the debt should be restructured? Your paper only mentions principal amount, but what about interest rate and maturities? For example, merely extending debt maturities would arguably be more

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[2] [I should talk for 15-20 minutes.]

constitutionally permitted[3] and also would be less politically and commercially disruptive (because the debt would eventually be honored).

-You may wish to compare the ability of large Treasuries holders to quickly exit the market with the increasing debt-restructuring problem caused by distressed-debt trading—including that debt-holders are increasingly trying to "game" the system.

-Regarding post-default enforcement of Treasuries, your paper observes that the offering circular for Treasuries provides, with respect to the commercial book-entry system, that the federal government does not "have any obligation to any person or entity that does not have an account with a Federal Reserve Bank." Might that restriction itself be unconstitutional since it questions enforceability of the debt? And, if so, would investors be deemed to—and could they even—waive the unconstitutionality?

-To what extent might the federal government be able to achieve a consensual restructuring? For example, do Treasuries contain collective action clauses (CACs) and, if so, do they operate within debt issues or across debt issues?

-I'm not convinced that default should be equated with invalidity. Section Four of the Fourteenth Amendment provides that the "validity of the public debt of the United States . . . shall not be questioned."[4] You observe

[3] *Cf. infra* note 4 and accompanying text.

[4] U.S. CONST. amend. XIV, §4.

that the plurality in *Perry* held that Congress lacks the authority to "alter or destroy" the federal government's obligations to repay borrowed funds." But to question the "validity" of public debt appears more closely tied to questioning the premise of the debt. One could distinguish that from changing *when* the debt is payable or paid, for example. When a debtor refuses to pay, it acknowledges the debt but does not pay. In contract law, a parallel to this would be the distinction between the legality of a contract and breach of a contract.

-Query whether selectively defaulting on debt held by some but not all foreign nations might constitute unfair discrimination by the federal government in violation of the Most-Favored-Nation clause of the WTO agreement, resulting in trade sanctions under the WTO dispute settlement regime? Some of the recent bilateral Free Trade Agreements (FTAs) negotiated by the US have included Most-Favored-Nation (MFN) treatment clauses with regard to sovereign debt issued by the parties.

B. *More General Comments*.

-Compare my state "minimalist" approach to government debt restructuring, especially solving the collective action problem through across-all-debt-issues supermajority voting by classes.[5] How could this type of approach work in a federal debt context?

-I believe that the federal government *should* be able to enact such a law. The Constitution's Contracts Clause applies only to state action. And I

[5] Steven L. Schwarcz, *A Minimalist Approach to State "Bankruptcy*," 59 UCLA L. REV. 322 (2011).

don't believe such a law—even if retroactively applied to federal government debt—would constitute a "taking" under the Fifth Amendment. It is clear that Congress has power under the Bankruptcy Clause of the Constitution to retroactively impair contractual obligations.[6] Of course, that power might not be applicable if the law is promulgated outside of the Bankruptcy Code and does not use the terms bankruptcy or insolvency—essentially, the question you raise of whether the Bankruptcy Clause could apply to federal government debt. *But even without that power*, the law's retroactive application should not violate the Fifth Amendment because retroactive federal legislation is constitutional (and not a "taking") so long as it does not completely destroy property rights in a way that the affected parties could not have anticipated.[7] The consensual relinquishment of rights under supermajority voting should not constitute complete destruction of creditor rights. The only right that is completely destroyed is an individual creditor's right to be a holdout; that right, however, is arguably an unreasonable private expectation that should not be protected.[8]

-What might be the secondary impacts and systemic consequences, including cross-default, currency devaluation, market panic, of (i) a federal government default on Treasuries compared to (ii) a consensual debt restructuring under the foregoing type of law?

[6] Hanover Nat'l Bank v. Moyses, 186 U.S. 181, 188 (1902).

[7] *See* E. Enters. v. Apfel, 524 U.S. 498, 528–29 (1998) ("[L]egislation might be unconstitutional if it imposes severe retroactive liability on a limited class of parties that could not have anticipated the liability . . . ."); United States v. Riverside Bay Homes, 474 U.S. 121, 128 n.5 (1985); Speckmann v. Paddock Chrysler Plymouth, Inc., 565 F. Supp. 469 (E.D. Mo. 1983).

[8] *See* Jan G. Laitos, *Legislative Retroactivity*, 52 WASH. U. J. URB. & CONTEMP. L. 81, 100 (1997).

II. FEDERAL GOVERNMENT FINANCING THROUGH SPEs

A. *Introduction*.

Restructuring Treasuries may be only part of the U.S. Government debt-restructuring picture. I'm currently examining the growth of federal government financing through the use of special-purpose entities ("national SPEs," or "NSPEs").[9]

National SPE financing can strike at the very heart of our system of representative government, placing into question the fiscal integrity of public governance.[10] I have been analyzing, both descriptively and normatively, their monitoring, governance, and accountability and the transparency of their debt liabilities.[11]

Consider the following examples of national SPEs.

B. *Taxonomy*.

1. SPEs Used in the 2008 Financial Crisis.

[9] Steven L. Schwarcz, "Special-Purpose Entities in National Finance" (draft on file with author).

[10] *Cf.* Steven L. Schwarcz, *The Use and Abuse of Special-Purpose Entities in Public Finance*, 97 MINN. L. REV. (forthcoming 2012, issue no. 2) (discussing SPEs used for state-government financing); Cheryl D. Block, *Congress and the Accounting Scandals: Is the Pot Calling the Kettle Black?*, 82 NEB. L. REV. 365, 435-42 (2003) (identifying the problem of national SPEs). Also compare Jonathan Rosenbloom, *Can a Private Corporate Analysis of Public Authority Administration Lead to Democracy*, 50 N.Y.L. SCH. L. REV. 851 (2005-2006) (raising normative questions about state SPEs).

[11] I have not considered, however, NSPE-debt restructuring questions per se.

(a) In order to stabilize and bring liquidity back to the commercial paper markets during the 2008 financial crisis, the U.S. Federal Reserve created, among other facilities, the Commercial Paper Funding Facility ("CPFF") to operate as a lender of last resort for those markets. Because the Fed traditionally used its lender-of-last-resort powers under Section 13(3) of the Federal Reserve Act to only make loans to banks, it structured the CPFF as a series of Fed loans to State Street Bank and Trust Company, which then made back-to-back loans to a newly-created special-purpose entity, CPFF LLC. CPFF LLC used the back-to-back loan proceeds to purchase commercial paper from corporations and other commercial paper issuers.[12]

(b) The Money Market Investor Funding Facility (MMIFF) was designed to provide liquidity to U.S. money market investors. Under the MMIFF, the Federal Reserve Bank of New York could provide senior secured funding to a series of special-purpose entities to facilitate an industry-supported private-sector initiative to finance the purchase of eligible assets from eligible investors.[13]

2. Government Sponsored Enterprises (GSEs).

In addition, I have been examining so-called government sponsored enterprises, such as Fannie Mae and Freddie Mac (used for promoting home ownership).

[12] Tobias Adrian, Karin Kimbrough, & Dina Marchioni, *The Federal Reserve's Commercial Paper Funding Facility*, FRBNY ECON. POLICY REV. (cite). *See also* FRB: OTHER LENDING FACILITIES - CREDIT AND LIQUIDITY PROGRAMS AND THE BALANCE SHEET, http://www.federalreserve.gov/monetarypolicy/bst_lendingother.htm (last visited Apr 24, 2012).

[13] FRB: MONEY MARKET INVESTOR FUNDING FACILITY, http://www.federalreserve.gov/monetarypolicy/mmiff.htm (last visited Apr 24, 2012).

3. Other National SPEs.

(a) I am currently examining the Tennessee Valley Authority (TVA) and other "authorities" and "public benefit corporations."

(b) I'm also examining SPEs used to finance military aircraft, including through leasing.

C. *Identifying Possible National-SPE Abuses*.

Although the use of national SPEs is not inherently wrongful, SPEs have a greater potential to be abused in public finance than in corporate finance.

Several factors contribute to this aggravated potential. Reduced transparency of national SPEs, like corporate SPEs, can undermine financial integrity. Because national-SPE debt is not technically a legal obligation of the federal government, the government does not have to disclose that debt in its financial statements and budget. This lack of disclosure can be misleading; the federal government may have compelling economic and reputational motivations to stand behind that debt, especially if the national SPEs engage in providing critical government services—as occurred when the federal government recently backstopped Fannie Mae and Freddie Mac's obligations—or if the federal government's failure to backstop the debt might cause a downgrading of ratings on federal government debt.

Off-balance-sheet financing can also trigger systemic consequences.[14] Its use by corporate SPEs is seen, for example, as a contributing cause of the

[14] *Cf.* Iman Anabtawi & Steven L. Schwarcz, *Regulating Systemic Risk: Towards an Analytical Framework*, 86 NOTRE DAME L. REV. 1349, 1359 (2011) (observing that

2008 financial crisis.[15] The lack of transparency can also have other serious consequences, such as preventing debt from being priced correctly based on national fiscal risk. Moreover, unlike corporate SPEs, reduced transparency of national SPEs can undermine constitutional and democratic legitimacy.

D. *Assessing the Propensity for Abuse*.

The federal government may have a greater inherent propensity than corporations to want to use SPEs to raise off-balance-sheet and off-budget debt: unlike corporations, the federal government cannot "fail" in the sense of being forced to liquidate, so its lacks that deterrent against non-transparent use of SPEs.

National SPEs are also more likely to be misused than corporate SPEs because, as I explain in my forthcoming publication, public finance is more susceptible than corporate finance to monitoring failures.[16]

Enron's use of SPEs could have triggered a systemic financial crisis if Enron's viability had more closely correlated with the viability of other financial institutions).

[15] *See, e.g.*, Joint Economic Committee, U.S. Congress, *The U.S. Housing Bubble and the Global Financial Crisis: Vulnerabilities of the Alternative Financial System* (2008), *available at* http://www.house.gov/jec/studies/2008/The_US_Housing_Bubble_June_2008_Study.pdf ; *What Went Wrong*, ECONOMIST, Mar. 22, 2008, at 79, *available at* http://www.economist.com/node/10881318; Niall Ferguson, *Wall Street Lays Another Egg*, Dec. 2008, at 190; http://www.economist.com/node/10881318; Mark Jickling, *CRS Report for Congress: Averting Financial Crisis* (2008), *available at* http://fpc.state.gov/documents/organization/103688.pdf; Martin Neil Baily et al., *The Origins of the Financial Crisis* (2008), *available at* http://www.brookings.edu/~/media/Files/rc/papers/2008/11_origins_crisis_baily_litan/11_origins_crisis_baily_litan.pdf.

[16] *See* "Special-Purpose Entities in National Finance," *supra* note 9. In that article, I explain that the federal government is monitored by citizens and creditors whereas corporations are monitored by shareholders and creditors. Creditors monitor only to the limited extent of their negotiated covenants but, unlike corporate debt, there are no covenants in federal debt. Therefore creditor monitoring of national-SPE debt is likely to

E. Restraining National-SPE Abuses.

How should national-SPE abuses be restrained and, whatever the restraints, how should they be implemented? In my forthcoming article, I attempt to answer the first question by arguing that regulatory efforts to reform state and corporate SPEs suggest four overarching organizing principles: improving transparency of national-SPE debt; improving monitoring of national SPEs; limiting national-SPE debt; and improving national-SPE governance.

I also examine and attempt to answer the second question: how should restraints be implemented? Why, for example, would the federal government consider enacting an SPE oversight law?

One answer is that it would be doing the "right thing." Another answer is that as the problem of national-SPE debt becomes more publicly known, the federal government will face reputation costs. Improving national-SPE accountability might then even help the federal government save money.[17]

be de minimis compared to creditor monitoring of corporate SPE debt. The federal government is also monitored by citizens, who have even less incentive to monitor than most creditors because, unlike creditors, few if any citizens are likely to have sufficient amounts at stake to justify the cost of monitoring. In contrast, corporations are also monitored by shareholders, who can have concentrated holdings.

[17] *Cf. The Use and Abuse of Special-Purpose Entities in Public Finance*, *supra* note 10 (observing a savings resulting from improving state-SPE accountability).