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Cover Page Footnote
I wish to thank Thomas L. Amenta and Steven F. Bracy, Esq., for reading an initial draft of this Note and to express my sincere gratitude to Michael A. Vaccari, Esq., for his guidance throughout the development of this Note.

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STATE AND LOCAL GOVERNMENTAL ENTITIES: IN SEARCH OF... STATUTORY AUTHORITY TO ENTER INTO INTEREST RATE SWAP AGREEMENTS

JEANETTE REDMOND*

INTRODUCTION

The Eastern Municipal Water District in Riverside County, California, entered into an interest rate swap agreement in connection with a bond refunding, saving the water district nearly $2 million.1 Florida’s Dade County entered into an interest rate swap agreement in connection with a financing arrangement for fifty-nine municipal projects and saved the county $6 million.2 The State of New Jersey executed a $1 billion interest rate swap agreement in connection with the issuance of notes and lowered its cost of raising capital from 3.10% to 2.69%, saving the state nearly $3 million in interest costs.3

An interest rate swap agreement ("IRSA") is one of a variety of financial instruments generically referred to as a "derivative."4 A derivative is typically described as a financial product that derives its value from an underlying security, asset or index.5 An IRSA is a tech-

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* I wish to thank Thomas L. Amenta and Steven F. Bracy, Esq., for reading an initial draft of this Note and to express my sincere gratitude to Michael A. Vaccari, Esq., for his guidance throughout the development of this Note.


This Note addresses IRSAs in particular as a means of focussing in a concrete manner on the proposition that state legislatures should grant certain governmental units express authorization to use modem financial tools when doing so enables governmental units to reduce risks and costs. There are, however, a variety of other financial instruments that also may be appropriate for use by governmental units to achieve these goals. While this Note does not specifically investigate the legal issues, benefits and risks of other forms of derivatives as they may apply to governmental units, the guidelines and recommendations contained herein with respect to IRSAs may be applicable in other cases.


There is no consensus on exactly what types of instruments the term "derivatives" includes. For example, R. Fenn Putman, chairman of the Public Securities Association, believes that the term derivatives should apply "only to interest rate swaps, caps, floors, options, and other products whose value is derived from an underlying security through a contract[, but not to] inverse floaters, [which] he maintains, are securities
nique that allows two parties to "swap" future interest payments. A simple IRSA is a contract between two parties (often referred to as "counterparties") to exchange a series of payments. The payments are determined based on an agreed-upon dollar value and an agreed-upon interest rate or method of determining the interest rate. The agreed-upon dollar value is referred to as the "notional" value of the swap. In an IRSA no principal ever changes hands.

Since the early 1980s, the volume of these transactions has increased phenomenally. In 1982, the outstanding notional value of IRSAs worldwide was approximately $3 billion. By the end of 1993, the aggregate notional value of outstanding IRSAs was estimated to be over $6 trillion. The bulk of this growth is attributable to private with adjusted cash flows, not derivatives. Aaron Pressman & Lynn S. Hume, Regulators, Market Wonder: Would Derivatives, By Any Other Name, Appear as Risky as Feared?, Bond Buyer, May 4, 1994, at 6. In an inverse floater, "ownership of the bonds is divided between primary investors and residual investors. The primary investor may receive a floating-rate . . . The inverse floater investor receives the remainder of the interest on the underlying bonds, after expenses of the arrangement have been paid . . . ." George G. Wolf et al., Certain Legal Aspects of Secondary Market Municipal Derivative Products, 49 Bus. Law. 1629, 1630 (1994).

7. Typically, IRSAs are only one part of a larger, complex financing package. See David Watts, The Structure and Mechanics of Interest Rate and Currency Swaps, in Inside the Swap Market 19, 19 (3d ed. 1988).
10. Id.
11. Id.
12. Id.
13. The volume of derivative investments is often measured in terms of the notional value of contracts outstanding because this data is relatively easy to gather, not because it is an accurate estimate of the actual market value of these instruments. See Hu, supra note 5, at 1459 n.6. Furthermore, the notional value does not measure the financial risk involved in these investments. Depending on the type of derivative product involved, the amount at risk may be significantly less than the product's notional value. United States General Accounting Office, Report to Congressional Requesters, Financial Derivatives: Actions Needed to Protect the Financial System 35 (1994) [hereinafter G.A.O. Survey]. The G.A.O. Survey revealed that for 14 major derivatives dealers in the United States, their aggregate "gross exposure to credit risk" from certain derivatives was 1.8%, or $114 billion, of the total $6.5 trillion notional value of their derivative contracts. Id. at 53; see also infra note 79 (discussing the replacement value of derivatives as a measurement of credit risk in connection with the use of swap contracts).
institutions. IRSAs have been extremely popular in the private sector because, when used properly, they help financial managers hedge against risk associated with interest-rate volatility and reduce the cost of capital. IRSAs also have been used to speculate with the hope of financial gain.

Since the mid-1980s, the volume of IRSAs entered into by governmental units has also increased, albeit relatively modestly when compared to the growth in the use of IRSAs in the private sector. Governmental units, like entities in the private sector, have used IRSAs to avoid or minimize risk associated with changes in interest rates.

ISDA’s original members were: Bankers Trust Co., Citicorp, First Boston Corp., Goldman Sachs, Kleinwort Benson Ltd., Merrill Lynch, Pierce, Fenner & Smith Inc., Morgan Guaranty Trust Co., Morgan Stanley & Co., Salomon Brothers Inc. and Shearson Lehman Brothers Inc. John P. Forde, *Big Firms Involved in Rate Swaps Form Dealers Association*, Bond Buyer, Mar. 8, 1985, at 4, 13. At the end of 1993, ISDA’s membership included 69 swaps and derivatives dealers from 13 countries: Australia, Canada, Denmark, France, Germany, Italy, Japan, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom and the United States. ISDA 1993 Market Survey, supra, at Introduction, Members Responding to the YE 1993 Survey. ISDA works towards the standardization of documentation, accounting practices and procedures for quoting prices. *Trade Group is Formed on Interest Rate Swaps*, Wall St. J., Mar. 8, 1985, at 14. “Given the breadth of the membership of ISDA, its data is the most comprehensive, and is used extensively as a reference by both market participants and regulators.” *Group of Thirty, Derivatives: Practices and Principles, Global Derivatives Study Group* 53 (1993).

16. At year-end 1993, corporate, financial and other private entity IRSAs accounted for 89% of the total notional value of IRSAs outstanding. ISDA 1993 Market Survey, supra note 15, at chart, Interest Rate Swaps: Non-ISDA Business/Location Analysis, Total Notional Principal (U.S. $ Equivalent) By Percentage, Year End 1993.


19. “A single descriptive term for the issuers of securities in public finance is difficult” because of the diversity of forms of public institutions. Robert A. Fippinger, *The Securities Law of Public Finance* 2 n.6 (2d ed. 1994). Because of the variety of sources upon which this Note draws, the terms “governmental entities,” “governmental units,” “municipalities,” “the public sector,” “state and local governments” and “tax-exempt issuers” are used in this Note interchangeably to refer to state, city, county and other local municipalities as well as state and local public corporations and public authorities.

20. In 1986, the municipal swaps market was estimated to be $1.7 billion and by the end of 1989 was expected to reach $8 billion. Steven Dickson, *Municipal Swaps: A Growing Market Could Challenge Merrill Lynch Stronghold*, Bond Buyer, Dec. 11, 1989, at 1. By year-end 1993, the notional value of IRSAs issued by governmental units in the United States was estimated at approximately $34 billion. ISDA 1993 Market Survey, supra note 15, at chart, Interest Rate Swaps: Non-ISDA Business/Location Analysis, Total Notional Principal (U.S. $ Equivalent) By Percentage, Year End 1993.
and to lower the cost of capital. Some governmental units also have used IRSAs to speculate.

Despite their potential benefits, the results of two recent surveys indicate that relatively few governmental units use IRSAs. These "Joint Surveys," performed by the United States General Accounting Office in 1993 and the Government Finance Officers Association in 1994, combine data compiled from over 3727 of the estimated 50,000 state and local governmental units in the United States concerning their use of derivative products. The Joint Surveys revealed that no more than six percent of the respondents have used IRSAs as part of their debt management strategy.

Unlike private institutions, before governmental units can enter into IRSAs, they must first establish that they have statutory authority

21. See, e.g., G. Kris Rao & Emete Hassan, Reducing Risks Tied To Swap-Based Derivatives, Standard & Poor's CreditWeek Mun., Oct. 31, 1994, at 93 (noting that governmental units are using IRSAs "in conjunction with bond issues to save interest costs, increase financial flexibility, synthetically advance refund bond issues, . . . access different investor markets[ and] to lock in fixed rates of return on debt service funds and other floating-rate assets without sacrificing liquidity"); The Effect of Interest Rate Swaps on the Evaluation of Municipal Credit, Moody's Pub. Fin., Perspective on Mun. Issues, June 1, 1994, at 1 (noting that IRSAs "can be beneficial debt management tools for state and local issuers, which may allow issuers to achieve a lower cost of capital than otherwise available using traditional financing alternatives"); J. Chester Johnson, Swapping for a Better Rate, Am. City & County, June 1993, at 12 (noting that under certain conditions IRSAs "can be an effective instrument for state and local government debt management and investment programs").

22. Government speculation with public funds implicates a variety of public policy concerns. For example, government fiscal mismanagement, such as taking excessive risks with public funds, violates the public policy principles of "balancing stability with flexibility, . . . maintaining political responsiveness" and "intergenerational equity." M. David Gelfand, State & Local Gov't Debt Fin. § 9:02, at 5-7 (1993). The principle of intergenerational equity means that governmental entities should ensure that each "generation of taxpayers" pays for its own "stream of use" of governmental projects and services." Id. at 5 & n.7 (quoting R. Musgrave & P. Musgrave, Public Finance in Theory and Practice 585-91 (1973)). This principle "is violated when one generation of residents is permitted to enjoy a low tax level by borrowing to finance a project that will produce no benefits for future generations, who will have to bear the burden of debt service on the project." Id. See also Joanne Morrison, PSA's President Advises Municipalities Not to Run Scared From Derivatives, Bond Buyer, Nov. 4, 1994, at 3 [hereinafter Morrison, PSA's President] (explaining that governmental units should use derivatives "as a hedge and not to speculate"); Joanne Morrison, Derivatives Transactions Could Lead to Credit Downgrades, S&P Report Says, Bond Buyer, Nov. 1, 1994, at 7 [hereinafter Morrison, Derivatives Transactions] (noting that speculative use of IRSAs by governmental units could result in a credit rating downgrade).


24. The Government Finance Officers Association conducted a survey of governmental units in the United States in 1994 and combined the results of its survey with those of the G.A.O. Survey, supra note 13, that was completed in 1993. The combined results of these surveys are reported by Betsy Dotson et al., Financial Derivatives: Governments as End Users, Gov't Fin. Rev., Aug. 1994, at 13 [hereinafter Joint Surveys].

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to enter into IRSAs. One reason that relatively few governmental units use IRSAs is that most governmental units in the United States lack express statutory authority to enter into IRSAs. Over the past several years, however, a growing number of state legislatures have expressly authorized some or all of the governmental units in their jurisdictions to enter into IRSAs. In 1987, California and Florida adopted legislation giving governmental units in their respective jurisdictions access to a variety of modern financial tools to enable them to maximize their use of public funds. The California Legislature found that while a variety of financial instruments are available to help reduce risk and costs, many of its governmental units within its jurisdiction did not have express statutory authority to use those tools. The California Legislature responded by expressly permitting all governmental units within the state to enter into IRSAs and other forms of derivative instruments. The Florida Legislature made a similar finding and enacted legislation specifically enabling certain governmental units to enter into IRSAs and other types of derivative contracts.

Providing express authority, however, is not enough to make the benefits of IRSAs available to governmental entities. Many existing statutes expressly granting governmental units the authority to enter into IRSAs share a common defect: an absence of adequate systems of oversight and control of governmental units' use of these financial tools. Although the Joint Surveys revealed that eighty-seven percent of the governmental units that have used IRSAs report favorably on the use of these agreements to manage debt or to lower the cost of capital, the 1994 bankruptcy filings by Orange County, California,
and the Orange County Investment Pool\(^{36}\) indicate that the lack of adequate oversight of governmental unit’s use of derivatives can result in increased costs and risks.

Yet, IRSAs, when used and monitored properly, can actually help reduce risks and costs.\(^{37}\) The lack, however, of express statutory authority, combined with the absence of adequate oversight and control of governmental units’ use of IRSAs, results in a variety of undesirable consequences. By failing to grant certain governmental units express statutory authority to enter into IRSAs and to monitor their use, state legislatures effectively compel governmental units to take unnecessary risks with public funds or to forgo opportunities to reduce costs.\(^{38}\)

This Note argues that state legislatures\(^{39}\) should protect and optimize the use of public funds by enacting legislation that expressly au-

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36. See infra notes 252-306 and accompanying text.

37. See supra notes 1-3 and infra notes 131-51 and accompanying text.


“The economic costs of lost opportunities are real for taxpayers, though less overt and sensational than the kind of portfolio blunders that have made the evening news . . . . [T]he risk . . . includ[es] the risk that a municipality will pay 10 basis points more than it needed to on a bond because of fear and loathing of the ‘D’ word.” Morrison, PSA’s President, supra note 22, at 3 (quoting Heather Ruth, former President of the Public Securities Association).


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thorizes major governmental units to enter into IRSAs and by establishing and enforcing appropriate control and oversight procedures.40

Part I of this Note examines the fundamental structure of IRSAs and their development, benefits and risks and explores why more governmental units do not use IRSAs as part of their overall fiscal strategies. Part II focuses on some of the undesirable consequences that attend governmental units' lack of express statutory authority to enter into IRSAs, and, in cases where express statutory authority does exist, the undesirable consequences that result from an absence of sufficient oversight and controls. Part III reviews legislation enacted by some states expressly authorizing governmental units to enter into IRSAs as well as some of the ways in which authority to enter into IRSAs may

municipal bond industry" because "it [is] clear that Congress did not contemplate the direct or indirect regulation of municipal issuers with the passage of the 1975 Amendments").

There has been considerable debate over the Tower Amendment's provisions exempting state and local governmental units from securities regulation. For example, in 1975, then-SEC Commissioner A.A. Sommer, Jr., called for its repeal. The Big Push to Revive Municipal-Bond Market, U.S. News & World Rep., Dec. 22, 1975, at 72, 73. Mr. Sommer commented that it is "'amazing' that neither the SEC nor the new [Municipal Securities Rule-Making Board, which was established by the 1975 amendments to the Securities Acts of 1933 and 1934 to develop, for the first time, standards of conduct for municipal bond dealers,] has the power to require municipal-bond issuers to give investors the information they need." Id. at 73. Tower Amendment proponents, mainly municipal bond dealers and issuers, argued that separation of powers issues were at the heart of the debate. Id. "'The very essence of the federal system is at stake. The separation of powers between State and Federal Government is fundamental to our freedom in this country.'" Id. (quoting R.E.D. Chase, then-managing partner of the municipal-bond firm of R. E. D. Chase & Partners).

More recently, in the wake of the 1994 Orange County, California, bankruptcies, the rallying call for the Tower Amendment's repeal has intensified. Republican United States Representatives Jim Leach, House Banking Committee Chairman, and Christopher Cox, a member of the House Commerce Committee, have vowed to repeal the Tower Amendment. Joanne Morrison & Lynn S. Hume, Next Banking Chairman Plans Bill to Repeal Tower Amendment, Bond Buyer, Dec. 20, 1994, at 1. Rep. Leach noted that repealing the Tower Amendment would require municipal issuers to make "'the same full disclosures as private sector enterprises that go to the market.'" Id. See also John H. Allan, Repeal Tower, Bond Buyer, Dec. 27, 1994, at 6 (arguing that the Tower Amendment should be repealed because it "has blocked a healthy, full-fledged development of the municipal bond market").

40. Mark Brickell, a former chairman of the International Swaps and Derivatives Association, Inc., stated, "'It's our view that if governments are to use swaps effectively to manage their risks, they need to have unambiguous authority to enter into them.'" Lynn S. Hume, Issuers Anxious to Participate in Swaps Must First Surmount Two State Law Hurdles, Bond Buyer, Oct. 22, 1991, at 2A. Furthermore, "[m]ost bond officials and lawyers say the municipal swap market would benefit if issuers had model legislation for swaps." Id. New York City's Comptroller has noted that "[i]t would be appropriate for the Legislature to ensure that municipalities have sufficient oversight, checks and balances and disclosure" in connection with their use of derivatives. Alan G. Hevesi, Testimony on the Use of Derivatives to the New York State Assembly Ways and Means Committee 3 (Jan. 17, 1995) (on file with the Fordham Law Review).
be implied from other existing statutory powers. This part also re-
views some of the benefits of express statutory authority to enter into
IRSAs. In addition, this part proposes principles and guidelines that
should be embodied in legislation specifically authorizing governmen-
tal units' use of IRSAs. Most importantly, such legislation should in-
clude specific guidelines governing governmental units' use of IRSAs
as well as periodic reporting requirements by governmental units to
legislative and regulatory bodies.

This Note concludes that state legislatures' failure to enact legisla-
tion expressly authorizing governmental units to enter into IRSAs, as
well as their failure to ensure that governmental units use these finan-
cial instruments in an appropriate and prudent manner, forces govern-
mental financial managers to take unnecessary risks with public funds.
State legislatures, to fulfill their responsibilities as administrators of
public funds, should enact legislation that incorporates the principles
and guidelines proposed in part III of this Note.

I. BACKGROUND

This part outlines the development of the use of IRSAs, describes
IRSAs' structural components, discusses the functions and purposes
of IRSAs and explores why more governmental units do not make
greater use of IRSAs.

A. Interest Rate Swap Agreements: A Modern Financial Tool

Innovations in financial services over the centuries have included a
wide variety of financial tools, from the use of coinage by the Greek
state of Lydia in the 7th century B.C. to the use of automatic teller
machines.²¹ Developments in financial services have continued in re-
cent decades at an exceptionally rapid pace.²² As one observer noted:

The past decade has been a golden age for innovation in corporate
and international finance. Fueled by advances in computer technol-
y and financial theory and attracted by opportunities created by
extreme volatility in financial markets, financial institutions have
been introducing capital market instruments and techniques at an
unprecedented rate . . . [T]hese new products punctuate and de-
define the modern financial landscape.²³

IRSAs are among the most popular of the relatively new financial
tools that have been developed and used by private and public institu-
tions worldwide.²⁴ In a simple IRSA, one counterparty agrees to pay
to the other a fixed-interest rate on the notional value of the contract,

²¹ See Mark D. Flood, Two Faces of Financial Innovation, 74 Fed. Reserve Bank
²² Id.
²³ Henry T.C. Hu, Swaps, The Modern Process of Financial Innovation and the
²⁴ Hu, supra note 5, at 1464-65; G.A.O. Survey, supra note 13, at 34-35.
and the other counterparty agrees to pay a floating rate of interest on the same amount.\textsuperscript{45} Generally, the two counterparties periodically net out their positions so that, for example, if the fixed rate of interest is higher than the floating rate of interest, the counterparty paying the fixed rate will make a payment of the difference between the two rates to the counterparty whose payments are based on the floating-interest rate.\textsuperscript{46} Typically, IRSAs are investment banks that charge a fee for entering into IRSAs.\textsuperscript{47}

To better understand the basic structure of a "plain vanilla" IRSa, it is useful to put "Wall Street" aside for the moment and look to more familiar territory.\textsuperscript{48} Suppose that you have a mortgage of $100,000 with a fixed-interest rate of eight percent. Suppose further that the income from which you must pay your mortgage is earned from variable-rate investments such as a portfolio of short-term Treasury bills that mature and are rolled over frequently. They are secure and highly liquid but offer a relatively low rate of return. In this situation, the rate at which you earn interest is less than the fixed rate you must pay on your mortgage. You decide that it is in your interest to improve your cash flow by more closely matching your income rate with your expense rate. Assume, however, that your mortgage loan agreement does not permit you to refinance your mortgage and convert it to a lower floating-rate mortgage.

Now suppose that your sister also has a mortgage of $100,000. Your sister’s mortgage is at a variable rate, currently six percent. (For this example, also assume that your sister’s mortgage has the same amortization schedule as your own.) Suppose further that your sister earns income at a fixed rate produced from long-term municipal bonds. While her investment income easily covers her costs for now, she wants to avoid the risk that higher short-term rates will drive up the cost of her mortgage. It would, therefore, be in her best interest to make mortgage payments at an acceptable fixed rate. While your sister’s mortgage company will permit her to refinance her mortgage from a variable rate to a fixed rate, it will charge her points to complete the transaction, and it is currently charging nine percent on fixed-rate loans.

The solution for the two of you may be to enter into an IRSa. Because your banks will not allow either of you simply to exchange your mortgage obligations, you agree to "swap" interest obligations based on $100,000, the principal amounts of your outstanding mortgages.

\textsuperscript{45} See supra notes 6-12 and accompanying text.
\textsuperscript{46} Satyajit Das, Swap Financing 32-33 (1989).
\textsuperscript{47} Id. at 34.
\textsuperscript{48} Id. at 354.
\textsuperscript{49} This hypothetical scenario is based on an example developed by Thomas L. Amenta, Deputy Director of Finance, and Steven F. Bracy, Esq., of the State of New York Metropolitan Transportation Authority.
You will pay your sister a variable rate, pegged perhaps to a published short-term Treasury bill rate, which is currently six percent, based on the agreed-upon amount of $100,000. Your sister will pay you a fixed rate of eight percent on the same amount. You and your sister will then periodically net out the payments you owe to each other. For example, in the first period, your sister owes you eight percent, but you owe your sister six percent. Therefore, your sister will pay you two percent, which you can then apply to your mortgage payment.

Even though you cannot refinance your fixed-rate mortgage and convert it to a variable-rate mortgage, you have nevertheless accomplished your goal of improving your cash flow, at least at the outset. But, more importantly, you have effectively converted your fixed-rate expense into a variable-rate expense that more closely matches the variable-rate income you earn.

Your sister also has accomplished her goals. While her interest cost initially has risen two percent, she has, in effect, converted her variable-rate expense into a fixed-rate expense of only eight percent, as opposed to the nine percent fixed-rate expense she would have incurred had she refinanced her variable-rate mortgage. She also has avoided the payment of points to refinance her variable-rate mortgage. But, more significantly, she has stabilized her liability and tailored it in relation to her assets. As a result, she has protected herself against additional exposure due to upward fluctuations in the interest rate on variable-rate mortgages. She will also forgo any spread benefits if mortgage rates decrease. She has elected, however, to pay this "price" to achieve her goal of financial stability.

It is, of course, important to remember that back on "Wall Street," swap agreements are not limited to interest-rate exchanges; they can and do include much more complex transactions. Typically, an IRSA is a custom-tailored agreement devised to meet the particular needs of the contracting parties. Thus, even within the category of IRSAs, any particular agreement can be structured in a variety of ways—limited only perhaps by the needs, technology and innovation of the parties involved. Despite the potential complexity of these customized financial arrangements, two fundamental types of IRSAs exist: fixed-to-floating-rate IRSAs and floating-to-fixed-rate IRSAs.

In a fixed-to-floating-rate IRSA, counterparty A makes payments to counterparty B based on a floating rate of interest. Counterparty

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50. See, e.g., Rogers, supra note 14, at 11 (noting that the overall swap market involves various "swap" techniques including interest rate swaps, currency swaps, cross-currency swaps, swap options and commodity price swaps).
51. Group of Thirty, supra note 15, at 3.
53. Id. at chart, Fixed-to-Floating Interest Rate Swap.
A calculates the interest by using an agreed-upon index, such as LIBOR\textsuperscript{54} or the J.J. Kenny Index,\textsuperscript{55} multiplied by the agreed-upon notional value of the contract. A then receives payments from B based on an agreed-upon fixed rate. The net result is that A achieves a fixed-rate liability in exchange for a floating-rate liability.

In a floating-to-fixed-rate IRSA, A makes payments to B based on an agreed-upon, fixed-interest rate and receives payments based on a floating rate of interest determined by the agreed-upon index. The net result is that A effectively converts a floating-rate liability into a fixed-rate liability. Thus, an IRSA is a form of derivative because its value is based upon, or derived from, the interest rates or indices utilized by the counterparties and the notional value of the contract.\textsuperscript{56}

As with any other financial transaction, the decision to enter into an IRSA requires an assessment of its risks.\textsuperscript{57} The risks associated with IRSAs "are the same kinds of risks found in traditional financial products."\textsuperscript{58} These risks can be grouped into four broad categories: legal, credit, market and operational.\textsuperscript{59}

The legal risk is the risk that losses may result because the agreement is not enforceable.\textsuperscript{60} For example, an IRSA may be unenforceable if the IRSA documentation is insufficient,\textsuperscript{61} or in the case of a governmental unit, if it does not have the legal capacity to enter into the contract.\textsuperscript{62} This risk can be avoided if the governmental unit has express statutory authority to enter into IRSAs.\textsuperscript{63}

Credit risk is the risk that a counterparty to an IRSA may default or suffer serious financial difficulties.\textsuperscript{64} A default may occur if an IRSA counterparty fails to make interest payments in accordance with the

\textsuperscript{54} The London Interbank Offered Rate is typically associated with variable-rate financing of taxable projects. LIBOR is the "rate that most creditworthy international banks dealing in Eurodollars (U.S. dollars on deposit in foreign banks) charge each other for large loans." \textit{Id.} at chart, Peg to an Index.

\textsuperscript{55} The J.J. Kenny Index is typically associated with variable-rate financing of non-taxable, municipal projects. \textit{Id.} at chart, The J.J. Kenny Index.

\textsuperscript{56} Joint Surveys, \textit{supra} note 24, at 13.

\textsuperscript{57} Das, \textit{supra} note 46, at 521.

\textsuperscript{58} Group of Thirty, \textit{supra} note 24, at 13.

\textsuperscript{59} \textit{Id.}

\textsuperscript{60} \textit{Id.} at 51.

\textsuperscript{61} \textit{Id.}

\textsuperscript{62} \textit{Id.; see also} Kenneth S. McCormick, \textit{Pricing and Risk Evaluation}, in Inside the Swap Market 29, 30 (3d ed. 1988) (discussing "customer risk assessment, i.e., the relative likelihood of a given customer to default, thus requiring a higher or lower credit fee applied to the measured exposure" when pricing an IRSA); Aaron Pressman, \textit{Dealers Take Risks if Authorization for Municipalities' Swaps Is Unclear}, \textit{Bond Buyer}, Mar. 2, 1994, at 6 (noting that counterparties to IRSAs with governmental units "take[ ] on one risk the municipality probably will not—authorization risk").

\textsuperscript{63} Group of Thirty, \textit{supra} note 15, at 2; \textit{see also} Joan Pryde, \textit{Issuers Pulling Plugs on Swaps That Lacked State's Legal Authority}, \textit{Bond Buyer}, May 5, 1993, at 4 (noting that some governmental units have had to rescind IRSAs because they later discovered that they were prohibited from entering into IRSAs under state law).

\textsuperscript{64} Group of Thirty, \textit{supra} note 15, at 47.
This risk can be minimized by requiring payment netting at frequent periodic intervals during the IRSA’s term, requiring the counterparty to collateralize the IRSA or obtain insurance, or selecting only financially sound, highly rated counterparties.

Market risk is the risk associated with changes in interest rates over the term of the IRSA. How one assesses this risk and attempts to minimize it is largely dependent upon the structure of the IRSA and the parties’ financial positions and goals in entering into the IRSA. For instance, in the mortgage example used earlier, your sister may forgo savings in interest costs if mortgage rates go down, but she has decided that it is in her best financial interest to enter into this arrangement to protect herself against the possibility that the variable rate on her mortgage will increase. Market risk assessment also is dependent upon market conditions during the IRSA’s term and at its conclusion—factors that cannot be determined at the IRSA’s inception. This risk can be hedged, for example, by monitoring the IRSA over its term, budgeting for interest-rate payments or making the interest-rate payment obligation subordinate to other debt obligations a party may have.

Finally, operational risk is described as the risk that losses will occur due to deficient “systems and control, human error, or management failure.” Operational risk can be mitigated, among other ways, by

65. Id.
66. In payment netting, the payment obligations of the IRSA counterparties to each other are netted out so that only one counterparty is obligated to make a payment to the other. Michael Canby, The Group of Thirty Global Derivatives Study: Enforceability Survey—England, in Swaps and Other Derivatives in 1994, at 417, 432 (PLI Corp. L. & Prac. Course Handbook Series No. 848, 1994).
67. Das, supra note 46, at 536.
68. Group of Thirty, supra note 15, at 49.
69. Das, supra note 46, at 521.
70. Rao & Hassan, supra note 21, at 94.
71. Das, supra note 46, at 521 (emphasis omitted). Other “key considerations” include: basis risk, liquidity risk and swap rollover risk. Standard & Poor’s Mun. Fin. Criteria 1994, Municipal Derivatives in the Primary Market 150, 151 (1994). Basis risk is the risk that an index used to calculate interest payments under an IRSA, such as LIBOR or the J.J. Kenny index, and the counterparties’ contemplated target rate of interest may “diverge sharply because of market or issuer-specific changes,” and that the governmental unit will have to pay the “difference between the interest rate on its floating rate debt and the rate paid by the counterparty” to the IRSA. Id. at 151. Liquidity risk is risk associated with short-term, variable-rate demand obligations. Id. Swap rollover risk is the risk associated with a gap that could occur if the IRSA’s term does not match the term of the governmental unit’s outstanding debt. Id.
72. See Rao & Hassan, supra note 21, at 94.
73. Group of Thirty, supra note 15, at 50. For example, in 1991, Lehman Brothers, which had been commissioned by the Public Parking Authority of Pittsburgh to review the parking authority’s finances, issued a report critical of an IRSA entered into by the parking authority in 1989 with Merrill Lynch Capital Markets. Mary Radford, Lehman Takes on Merrill in Swap Controversy, Investment Dealers’ Dig., Mar. 25, 1991, at 5. The Lehman Brothers report indicated that the IRSA resulted in “an
maintaining a system of oversight by "informed and involved senior management," documentating procedures and policies and conducting independent audits to verify that the procedures and policies are followed.

While IRSAs, like other financial products, are not risk free, the tremendous expansion of the IRSA market and the relatively low rate of losses associated with IRSAs suggest that the risk of losses relative to the benefits derived is acceptable to many institutions.
B. Private Sector Use of IRSAs

The total notional value\(^79\) of IRSAs outstanding worldwide mushroomed from $3 billion in 1982 to over $6 trillion in 1993.\(^80\) Private sector IRSAs accounted for over $5 trillion of the total notional value of IRSAs outstanding at the end of 1993.\(^81\) The development and use of IRSAs accelerated over the past two decades as financial managers sought ways to hedge risks associated with interest rates that were becoming increasingly volatile.\(^82\) Financial managers, with the aid of advances in finance, information processing and communications technologies, devised IRSAs, among other financial tools, as a means of hedging against the risks associated with this volatility.\(^83\) The benefits of these transactions, while clearly advantageous for the institutions involved, often indirectly inure to consumers as well.\(^84\)

\(^79\) While the size of the derivatives markets is typically measured by the total notional value outstanding because of the relative availability of these figures, this measurement does not accurately reflect the value of these investments or the amount of risk associated with derivatives overall. Hu, supra note 5, at 1464-65. Recently, ISDA announced the results of a pilot survey that measured the cost to replace derivatives, a more accurate measurement of the credit exposure tied to derivative transactions. ISDA News Release, ISDA Announces Results of Pilot Survey That Measures Derivatives Replacement Values 1 (June 9, 1994).

The survey, conducted among 14 leading dealers around the world who are represented on ISDA’s board of directors, clearly demonstrates that replacement values—the current credit exposures of outstanding derivatives transactions—are a small percentage of their notional amounts.

At yearend 1993, the net replacement value of the interest rate and currency swaps outstanding at the firms participating in the pilot survey was $101.3 billion, or 1.22% of their $7.6 trillion notional amount. The gross replacement value of the swaps outstanding was $178.4 billion, or 2.15% of the notional amount. The difference between net and gross values is that net value reflects the netting of transactions written under an enforceable master agreement. Such agreements reduce derivatives credit exposure.

\(\text{Id.}\) The survey also indicated that the participants’ “credit exposure from derivatives was significantly less than their credit exposure from other financial activities” such as loans and letters of credit. \(\text{Id.}\) at 2.

\(^80\) See supra notes 13-16 and accompanying text.


\(^82\) Hu, supra note 43, at 336-37.

\(^83\) Joint Surveys, supra note 24, at 13.

\(^84\) Jeffrey L. Seltzer, a managing director at Lehman Brothers and chairman of the Securities Industry Association’s swaps and derivatives committee, observed: “Consumers are the ultimate beneficiaries of the swap market, even though they’re not directly involved in the transactions.” Kenneth Silber, Derivatives Lend Fear to Market, Insight, Jan. 31, 1994, at 12, 13. For example, “McDonald’s . . . gets cheaper financing for its franchises through interest-rate swaps—an activity that helps keep hamburger prices down.” \(\text{Id.}\) at 13.

IRSAs also help banks to provide a very beneficial product, pre-approved mortgages, to home buyers every day:

Thousands of home buyers offered up silent prayers of thanks for pre-approved mortgages as consumer interest rates suddenly shot up by two percentage points in [mid-1994]. But few realized that their prayers should have been directed to the god of financial engineering. Pre-approved mortgage
SWAP AGREEMENTS

The Student Loan Marketing Association ("Sallie Mae"), a federally chartered, private company, for example, uses IRSAs to help provide billions of dollars in government-guaranteed student loans to college students. As "[o]ne of the biggest players in the swaps markets," Sallie Mae regularly issues fixed-rate bonds to raise funds to buy student loans from the country's colleges and banks. The loans it buys earn interest at a floating rate. Sallie Mae uses IRSAs to convert synthetically the variable rate of interest it earns on its loans to a fixed rate that more closely matches the fixed rate it must pay on its outstanding bond obligations. By using IRSAs, Sallie Mae is better able to manage risks associated with changes in interest rates. If interest rates were to rise sharply, Sallie Mae could end up collecting less interest on the loans it buys than it must pay out on the bonds it issues. "As lots of savings and loans learned in the early 1980s, that can be fatal." Sallie Mae could avoid this interest-rate risk by issuing floating-rate bonds directly to investors, however, investors prefer to purchase fixed-rate bonds so that they will know with certainty the amount of interest they will earn on their investments. Because it can use IRSAs as part of its financial strategy, Sallie Mae's options are expanded. Rather than simply issuing floating-rate bonds, which, in this case, is likely to be more costly than issuing fixed-rate bonds, Sallie Mae enters into IRSAs to reduce the risk associated with interest-rate volatility and is able to achieve more effectively its objective of providing consumers with government-backed student loans.

contracts assure consumers that if they buy a house within the 60- or 90-day period before the contract expires, they will be entitled to borrow mortgage money at interest rates no higher than those in effect at the time their contract was signed. If interest rates fall during that period, they are guaranteed the new, lower rates, and if they choose not to buy a house, they can walk away without paying a penny. Those features may seem simple but, in fact, they transfer the buyers' risk that interest rates will go up while they are house hunting to the bank. And for a bank that might have millions of dollars worth of pre-approved mortgages outstanding at any time, a hike in interest rates could be costly. However, by using [IRSAs] banks can hedge that risk.


86. Id.
87. Id. at F2.
88. Id.
89. Id.
90. Id.
91. Id. at F1.
92. Id.
93. Id.
94. Id. at F2.
95. Id.
Sears, Roebuck and Co. has also used IRSAs successfully to better manage its assets and liabilities.\textsuperscript{96} Sears began entering into IRSAs in 1983.\textsuperscript{97} By late 1984, Sears had executed $2.5 billion in IRSAs.\textsuperscript{98} Sears' primary objective was to restructure its debt so that there would be a fifty-fifty split between debt owed at a variable rate of interest and debt owed at a fixed rate.\textsuperscript{99} Sears accomplished its goal by 1984 by entering into thirty-six IRSAs with fifteen different counterparties, among them "foreign and domestic banks, investment bankers, and merchant banks."\textsuperscript{100} By entering into these IRSAs, Sears exchanged a portion of "its short-term and variable-rate debt for fixed, long-term debt of other issuers, providing itself with protection against interest-rate rises."\textsuperscript{101}

While IRSAs have been successfully implemented by an overwhelming majority of the most active swaps dealers,\textsuperscript{102} there is nothing inherently good or bad about IRSAs. If IRSAs are structured improperly, poorly monitored or used as a speculative tool with the hope that interest rates will move in one's favor, they can result in increased costs and risks.\textsuperscript{103} Losses associated with IRSAs "have tended to arise less from anything inherent in the derivatives themselves and more from basic failures of management. Firms that have got into derivatives trouble have done so by letting individual employees trade or invest without proper analysis or supervision."\textsuperscript{104}

Procter & Gamble, for example, blamed IRSAs for losses of $102 million in 1994.\textsuperscript{105} P&G criticized its IRSA counterparty, Bankers Trust, for P&G's losses, asserting that Bankers Trust had sold P&G IRSAs that "were inappropriate for managing [the] firm's interest-rate risk."\textsuperscript{106} Yet, P&G also replaced its own treasurer.\textsuperscript{107} P&G's chief financial officer explained that those involved did not understand the IRSAs' risks.\textsuperscript{108} P&G had entered into "diff" IRSAs.\textsuperscript{109}

\textsuperscript{97} Id. at 28.
\textsuperscript{98} Id.
\textsuperscript{99} Id.
\textsuperscript{100} Id. at 3.
\textsuperscript{101} Id.
\textsuperscript{102} See infra notes 113-21.
\textsuperscript{103} See, e.g., supra note 73 (discussing losses resulting from an IRSA entered into by a Pennsylvania governmental unit).
\textsuperscript{104} \textit{The Beauty in the Beast}, supra note 8, at 22.
\textsuperscript{105} Corporate Hedging: Hard Soap, Economist, Apr. 16, 1994, at 82.
\textsuperscript{106} Id.
\textsuperscript{107} Id.
The "diff" IRSAs were gambles on the way that German and American interest rates would move in relation to each other; however, the rates moved contrary to expectations, and because P&G had heavily leveraged its gamble, it suffered large losses in a relatively short period of time.110

The foregoing is just one of the more recent incidents in which private institutions have suffered losses in connection with IRSAs.111 Yet, a study conducted by the International Swaps and Derivatives Association, Inc.112 indicated that through the end of 1991, cumulative losses associated with IRSAs, as well as with several types of similar transactions,113 were relatively small.114 The survey results were based upon the experiences of a "diverse group of established swap dealers, representing over 70% of the $4.34 trillion volume of swaps" and related transactions.115 The survey revealed that out of a total of $3.105 trillion in transactions, the total notional value of defaulted swaps was $12.8 billion.116 The marked-to-market value117 of the losses was $358.36 million,118 just 0.0115% of the total notional value of the outstanding contracts.119 Furthermore, nearly one-half of the losses were attributable to losses in connection with hundreds of IR-
SAs entered into by a borough in Great Britain that had acted ultra vires of its statutory powers by entering into the IRSAs.\textsuperscript{120} In addition, the survey results indicated that losses from swap transactions were significantly lower than losses resulting from other traditional financial transactions in a single year.\textsuperscript{121} As one observer noted:

[If derivatives offered no more than a sort of dangerous sport for corporate treasurers, they would not have acquired their present size. Huge, global markets have grown up in them because they make good financial sense to a large and diverse group of users. By "hedging" tomorrow's transactions at today's prices, a company may not increase the profit it makes but it can certainly eliminate much of the risk involved in making it.\textsuperscript{122}]

Because IRSAs are typically customized agreements,\textsuperscript{123} they can be relatively straightforward or can combine risk in a variety of ways.\textsuperscript{124} If counterparties enter into IRSAs without adequate expertise and technological resources, as well as systems for oversight and review, they may incur significantly increased, rather than decreased, risks and costs.\textsuperscript{125} When IRSAs are used and monitored properly, however, they can provide significant benefits to the institutions that use them.

C. Governmental Units' Use of IRSAs

Governmental units' use of IRSAs has increased for the same reasons that the use of IRSAs has increased in the private sector.\textsuperscript{126} Many state and local governmental units, like institutions in the private sector, are exposed to risks resulting from interest-rate fluctua-

\textsuperscript{120} Id. at 3.
\textsuperscript{121} Key results of the survey included findings that
The ratio of notional principal of defaulting transactions (life-to-date) divided by swap transactions outstanding (as of December 31, 1991) [were] only 0.41%. Even relative to other types of credit losses experienced in a single year, swap losses compare favorably. For example, according to the FDIC Quarterly Banking Profile for the period ending December 31, 1991, 5.3% of loans at FDIC insured banks were categorized as non-performing. Also according to the FDIC, 1.6% of all loans at FDIC insured banks were charged off during 1991.
Id. at 4 ("Analysis of the Results of the ISDA Default Survey").

\textsuperscript{122} The Beauty in the Beast, supra note 8, at 22.

\textsuperscript{123} Dalglish, supra note 84, at 21.

\textsuperscript{124} Group of Thirty, supra note 15, at 3.

\textsuperscript{125} Id.

tions on a daily basis.\textsuperscript{127} In fact, state and local governmental units "probably have more exposure to changing interest rates, given the much narrower universe of alternate ways to manage this risk."\textsuperscript{128} When one considers that the volume of state and local governmental debt outstanding rose from $365 billion in 1980 to $1.2 trillion in 1993,\textsuperscript{129} it appears likely that governmental units' interest in using IR-SAs or other derivatives to generate savings and reduce risk will increase significantly in the future.\textsuperscript{130}

1. Generating Savings

The most common reason that governmental units enter into IRSAs is to reduce the cost of borrowing money.\textsuperscript{131} It has been "estimated that a typical floating-to-fixed-rate [IRSA] saves a municipal issuer about 10 to 20 basis points\textsuperscript{132} on its cost of funds, compared with a conventional fixed-rate structure."\textsuperscript{133} Yet, entering into IRSAs is not necessarily or automatically beneficial. Governmental units, like their private sector counterparts, must carefully assess their needs, objectives and resources before entering into IRSAs. They should use an IRSA only when they are satisfied that the benefits, when weighed against the risks, make entering into an IRSA an appropriate choice.

For example, in 1990, the State of Connecticut considered, but ultimately rejected, using an IRSA in connection with the sale of a variable-rate general obligation bond issue of approximately $300 million to convert the variable rate to a fixed rate.\textsuperscript{134} Connecticut officials decided that "the timing and the size of the issue [were] not optimum."\textsuperscript{135} Connecticut expressed an interest in entering into an IRSA on a future, somewhat smaller, bond issue of about $200 mil-

\begin{thebibliography}{99}
\bibitem{127} Bashawaty, \textit{supra} note 23, at 5.
\bibitem{128} Id.
\bibitem{131} See, \textit{e.g.}, \textit{Joint Surveys, supra} note 24, at 15 (noting that 56\% of respondents to the Joint Surveys reported that they used derivative products to reduce borrowing costs); McGavin, \textit{supra} note 9, at 219 (noting that most often the reason for entering into IRSAs "is to convert the effective cost of a borrowing"); \textit{Swaps' Popularity Increasing in the Municipal Market}, Global Guaranty (Am. Banker-Bond Buyer Newsl. on Credit Enhancement), Sept. 14, 1992, at 7 (noting that IRSAs are popular in the public sector because of the "need to cut financing costs and the ongoing decline of federal assistance for municipal capital programs").
\bibitem{132} A basis point is .01\%.
\bibitem{133} \textit{Swaps' Popularity Increasing In the Municipal Market, supra} note 131, at 7.
\bibitem{135} Id. (quoting Assistant Treasurer Benson R. Cohn).
\end{thebibliography}
Similarly, in 1993, The City of New York decided to cancel a complex bond refunding transaction that included an IRSA component because "slack demand" and unusually volatile interest-rate movements at the time complicated the pricing of the transaction.  

Other governmental units have decided that entering into IRSAs would help to lower their cost of raising capital. For example, in 1990, the Dallas/Fort Worth Airport Authority used a "forward commitment" IRSA in connection with the future refunding of $243.65 million in outstanding bonds. That transaction, estimated to generate savings of approximately $2.6 million a year, permitted the airport "to reduce landing fees . . . by approximately six cents per thousand pounds of landed weight." In 1992, the Rhode Island Convention Center Authority used an IRSA in connection with a $225 million fixed-rate bond sale to convert synthetically the bond's fixed-rate obligations into floating-rate obligations. This transaction will save the convention center an estimated $11 million over a five-year period. In 1994, The City of New York's $2.2 billion bond sale included an IRSA for a $500 million floating-rate portion of the issue, effectively converting the floating-rate portion to a fixed-rate obligation, saving the city approximately $440,000.

Some governmental units, after assessing their needs and an IRSA's benefits and risks, may prudently determine not to use an IRSA at a given point in time. When used and monitored appropriately, however, IRSAs have generated significant savings for some governmental units; these savings can directly benefit taxpayers and consumers in their jurisdictions.

2. Minimizing Risk

By entering into an IRSA, governmental units also may be able to minimize risks associated with adverse changes in interest rates. For example, many governmental units raise funds by issuing bonds that...

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138. In a typical forward-commitment IRSA, the governmental unit contracts now for an IRSA to take effect in the future when outstanding debt is redeemed. In this particular transaction, the arrangement allowed "all or a portion of the savings to be realized before the redemption of the outstanding bonds." D/FW Debt Refinancing to Save $2.6 Million a Year, Airports, Oct. 23, 1990, at 443.
139. Id.
140. Id.
142. Id.
pay a fixed rate of interest but earn interest on their investments at a floating rate. In such cases, governmental units might better synchronize their assets and liabilities by entering into IRSAs that will allow them to convert synthetically their fixed-rate obligations into floating-rate obligations that more closely match the floating rate of interest they earn on assets. If such governmental units did not enter into IRSAs and the floating rate of interest earned fell below their fixed-rate obligations, the governmental units would have to draw on or generate other revenue to meet their fixed-rate obligations. Conversely, if the floating rate of interest rose above the fixed-interest rate, such governmental units would realize a net benefit from their income and liabilities. Entering into an IRSA to protect against the risk that interest rates will fall in this relatively simple scenario, however, also means that if interest rates rise, such governmental units will not realize the benefit of the spread between their fixed-rate liabilities and their variable-rate income.

In this scenario, a decision not to enter into an IRSA to hedge against a drop in interest rates is a decision to take a gamble that the rate of interest earned on investments will rise. Yet, a decision to enter into an IRSA to hedge against adverse changes in interest rates can be a responsible management policy that seeks to match assets and liabilities in a way that locks in the spread between a portion of a governmental unit's debts and a corresponding amount of its investments.

Managing assets and liabilities in this manner has two effects. First, it quantifies the unit's financial exposure thereby better enabling the governmental unit to budget for its operations. Second, it protects against an increase in the spread if the investment returns decrease. On the other hand, if investment returns increase, the governmental unit would forgo the benefits that higher investment returns would have reaped had the governmental unit not entered into the IRSA. Because the main purpose of using an IRSA for asset/liability management is to quantify and limit interest-rate risk, the objective of such a policy is achieved regardless of how interest rates move. Not entering into an IRSA, or entering into one in the hope that rates move favorably, increases the governmental unit's exposure to risk.

This point is highlighted by Wall Street's reaction to the Federal Home Loan Bank Board's 1987 finding that "[o]nly 150 of the 3,536 thrifts insured by the Federal Savings and Loan Insurance Corp.

145. See, e.g., Aaron Pressman, Besides Bringing Additional Savings, Some Swaps Lower Issuers' Risk Profile, Bond Buyer, Dec. 22, 1993, at 6 (discussing some of the benefits of entering into IRSAs); Dickson, supra note 20, at 20 (discussing the expansion of the municipal swaps market and the benefits of swaps).
[were] hedging their assets against interest-rate fluctuations.” Wall Street finance specialists expressed the view that “[s]upervisory staff at the Bank Board [were] ‘not doing their jobs’ if thrifts have failed to hedge fixed-rate portfolios.”

Unlike most thrift institutions back in 1987, the Louisiana Public Facilities Authority used an IRSA in 1988 to improve management of its assets and liabilities. LPFA “issued bonds on a seven-day floater basis” to purchase debt from local school boards. The purchased debt earned interest at a fixed rate. LPFA then entered into an IRSA that synthetically converted fixed-rate school board debt to a floating rate that better matched LPFA’s floating-rate bond obligations.

D. The Lack of Express Statutory Authority

There are several reasons why more governmental units do not use IRSAs. Many of the nation’s smaller governmental units have relatively small amounts of debt and assets to manage; therefore, they may have no need to enter into IRSAs. Governmental units that do not issue debt often or regularly may find that, relative to the size of their investment portfolios, it does not make sense to invest significant amounts of time and effort to become sufficiently knowledgeable about the use of IRSAs because they will never or only rarely be beneficial in their cases. On the other hand, some governmental units that could benefit from the use of IRSAs may not understand enough about IRSAs and their potential benefits.

147. Id. (quoting Eric Hemel, then a vice president of mortgage finance at First Boston Corp.).
148. Dickson, supra note 20, at 20.
149. Id.
150. Id.
151. Id.
152. “[Eighty-seven] percent of those using derivative products are from jurisdictions serving populations of more than 100,000” and 53% “issue more than $50 million in municipal debt annually.” Joint Surveys, supra note 24, at 15; see also Godfrey, supra note 78, at 29 ([M]ore than half of those who answered [the G.A.O. Survey, supra note 13] said they were not convinced that derivative products could benefit their jurisdiction.”).
153. While the G.A.O. Survey, supra note 13, found that only six percent of respondents were using derivatives, the 6 percent usage rate probably understates the role that derivatives play in debt issuance. The use of derivatives tends to come from the ranks of larger tax-exempt issuers, and the country’s largest 300 issuers represent more than 60 percent of the new-issue tax-exempt debt annually. More than 53 percent of the respondents reporting usage of derivatives said their annual issuance was more than $50 million.
units believe that derivatives are excessively risky or too complex. Yet, as Heather Ruth, former president of the Public Securities Association, stressed, deciding not to use derivatives when it is appropriate to use them may unnecessarily expose governmental units to increased risk and costs. There are, however, many large, sophisticated governmental units that do not have statutory authority to enter into IRSAs.

Before governmental units can enter into IRSAs, they must address a legal issue unique to governmental entities, that is, whether they have the statutory authority necessary to execute IRSAs. Standard & Poor's, a credit rating agency, has stressed to governmental units the importance of legal authority, warning governmental units that if they lack statutory authority to enter into an IRSA, the IRSA may terminate for illegality, exposing the governmental unit to "a potentially large termination payment" and/or floating-rate exposure." S&P recommends that if a governmental unit's statutory authority to enter into IRSAs is ambiguous, the governmental unit should make absolutely certain that the authority on which it relies warrants such reliance. As discussed in part II, entering into IRSAs without express or clear statutory authority may have potentially serious consequences. For example, although lawyers and regulatory bodies advised a London borough that the borough was legally authorized to

155. Thirty-six percent of the respondents to the Joint Surveys who are not considering the use of derivative products said the risks were excessive, while 38% said they were too complex. Joint Surveys supra note 24, at 15.
156. "[[P]ublic reaction to derivatives may have gone too far . . . . [A]voiding the use of financial products can also be a risk to issuers and investors . . . .] [M]unicipalities should not overreact to recent reports of losses and increased attention given to derivatives in the media." Morrison, PSA's President, supra note 22, at 3.
157. "Twenty-five percent [of the respondents to the G.A.O. Survey, supra note 13] said their jurisdiction did not allow the use of derivatives." Godfrey, supra note 78, at 29; see also infra notes 261-65 and accompanying text (discussing that such governmental units may be reluctant to enter into IRSAs even when the use of IRSAs is financially prudent).
158. McGavin, supra note 9, at 220-21; see also Morrison, PSA's President, supra note 22, at 3 (reporting that Heather Ruth, former president of the Public Securities Association, warned state and local governmental units "to make sure they are authorized to make certain investments. 'This is fundamentally your responsibility—not the responsibility of people who come to you with investment ideas.'").
159. Rao & Hassan, supra note 21, at 94-95. A termination payment is the payment that may be owed to or received by a counterparty upon the IRSA's involuntary termination caused by events such as counterparty payment default, bankruptcy, liquidation or a downgrade in the counterparty's credit rating. Id.
160. Id. at 94.
161. "[W]hile many states have statutes that give the issuers' [sic] the authority to enter into swap agreements[, b]y contrast, there are states that prohibit the use of swaps or have legislation that is ambiguous. If the law is ambiguous, S&P suggests that an issuer verify its legal authority." Id. at 94-95.
enter into IRSAs, Great Britain’s highest court found that the borough had acted ultra vires of its statutory authority by entering into hundreds of IRSA transactions.162

Furthermore, although a growing number of state legislatures have enacted legislation expressly authorizing governmental units in their jurisdictions to enter into IRSAs, the authorizing legislation often does not provide adequate, comprehensive reporting systems and controls that are regarded in this industry as integral components of a financial strategy that uses IRSAs to hedge risk and reduce costs.163 In other words, a bald authorization to enter into IRSAs or other forms of derivatives—without provisions for adequate guidelines, oversight and review—also can result in increased exposure to risks and losses as well as other undesirable consequences.

II. UNDESIRABLE CONSEQUENCES

Several undesirable consequences result from governmental units’ lack of express statutory authority to enter into IRSAs or from a bald authorization to enter into IRSAs without adequate guidelines, oversight and review.164 First, a court may decide that a governmental unit acted ultra vires of its statutory powers by entering into IRSAs; second, governmental units that do not enter into IRSAs when appropriate because they lack express authority, lose significant opportunities to improve management of their assets and liabilities and to reduce their cost of capital; and third, governmental units that enter into IRSAs without adequate oversight and review may use IRSAs for speculative purposes or may enter into poorly structured IRSAs.

A. The Ultra Vires Threat

An IRSA is an executory contract.165 It requires an offer, acceptance, consideration from both counterparties and performance, including the payment of money in the future according to the IRSA’s terms and conditions.166 A standard condition contained in IRSAs is that illegality will cause the IRSA to be void.167 Thus, a fundamental problem between IRSA counterparties arises when one of the counterparties is not legally authorized to enter into the IRSA.168 In the case of an IRSA with a governmental unit, the IRSA may terminate prematurely if the governmental unit lacks the statutory author-

162. See infra notes 173-207 and accompanying text.
164. See supra notes 152-63 and accompanying text.
165. McGavin, supra note 9, at 221.
166. Id.
167. The Effect of Interest Rate Swaps on the Evaluation of Municipal Credit, supra note 21, at 6.
168. Id.
ity to enter into an IRSA in the first place.\textsuperscript{169} Termination of an IRSA for illegality can expose a governmental unit to added costs.\textsuperscript{170} It can also expose the governmental unit’s counterparty to losses. Therefore, it is imperative that each governmental unit and its putative counterparty properly assess whether the governmental unit is legally authorized to enter into the IRSA.\textsuperscript{171}

Because IRSAs involving governmental units are a fairly recent development, “little jurisprudence can be found that addresses the legality of swaps or any of the other matters relevant to the enforcement of swaps.”\textsuperscript{172} Thus, for the time being, the leading jurisprudential answer

\textsuperscript{169} Hu, \textit{supra} note 5, at 1487.

\textsuperscript{170} Rao & Hassan, \textit{supra} note 21, at 94-95.

\textsuperscript{171} Clear legislative authorization to enter into swap contracts is only part of the ultra vires avoidance story for municipal players. Investment banks and their governmental counterparties also must review carefully each governmental unit’s statutory limitations on the amount of debt the governmental unit can incur. See Webster & Sheffield Pub. Fin. Newsl., Interest Rate Swap Agreements in the Municipal Market 1, 4 (Nov. 1990). For example, in some jurisdictions, a governmental unit’s IRSAs may be treated as long-term contractual obligations that are subject to debt limitations. \textit{Id.} at 4. However, some other jurisdictions may allow governmental units to avoid these debt limitations if the IRSA-related obligations are paid from special funds or current general revenues. \textit{Id.} Thus, there are different legal issues depending upon whether the IRSA represents a general obligation contract or whether the IRSA payments are “secured by a specific stream of revenues.” \textit{Id.}

Investors and their governmental partners should also be aware that state procurement statutes may be broad and ambiguous enough to encompass IRSAs. See McGavin, \textit{supra} note 9, at 228. These procurement statutes may require governmental units to publish notices of their intent to enter into particular IRSAs, to publicly bid IRSAs prior to award or to make an effort to award IRSAs to disadvantaged or minority businesses. \textit{Id.} If the debt restrictions are exceeded or if the required procurement procedures are not followed, an IRSA may be also repudiated as procedurally ultra vires. \textit{Id.}


“[N]o United States court has yet determined whether a party’s lack of authority can be used to shield that party from its obligations [with respect to derivative transactions].” Joanne Medero et al., \textit{Investing in Derivatives: Current Litigation Issues}, Insights, Nov. 1994, at 4, 8. Recently, however, a community college district in Illinois commenced an action in federal court to rescind certain investments it had entered into, asserting, among other things, that its treasurer had acted ultra vires of his authority by entering into an agreement to purchase the securities at issue. \textit{Id.} at 7. In September of 1994, however, the district court granted defendant Westcap Securities’ motion to compel arbitration of the dispute concerning whether Westcap Securities sold investments to the college district that the college district was unauthorized to purchase. Community College Dist. No. 508 v. Westcap Gov’t Sec., Inc., 1994 WL 530849, at *6, 7 (N.D. Ill. Sept. 29, 1994). Addressing the college district’s assertion that the purchases should be rescinded because the treasurer was not legally authorized to invest in the securities at issue, the court concluded that this argument “focus[ed] incorrectly on the end result of [the treasurer’s] actions as opposed to” whether the treasurer was authorized to enter into an agreement with Westcap Securities to purchase securities generally. \textit{Id.} at *6. The court held that the treasurer had authority to enter into the agreement with Westcap Securities to purchase securities in general and that the issue of “[w]hether Westcap fraudulently induced [the treasurer] into investing in securities which were not safe investments for the type of institution
to questions concerning legal authority to enter into IRSAs lies in the 1991 decision of the United Kingdom’s highest court, the House of Lords, in *Hazell v. Hammersmith and Fulham London Borough Council*. The issue in *Hammersmith* was whether a municipality had the requisite legal authority to engage in IRSAs. Although the counterparties to the municipality’s IRSAs had “engaged in comprehensive cross-checks with lawyers and other responsible authorities to confirm that the swap dealings were lawful,” the House of Lords held that they were not.

The Council of the London Borough of Hammersmith and Fulham began entering into IRSAs in December of 1983. By February of 1989, the council had entered into 592 swaps, 297 of which were outstanding at the time of appeal. The notional value of all 592 swap contracts was approximately $10.2 billion. The notional value of the 297 outstanding transactions was approximately $5 billion. The council’s actual borrowings, as of March 1989, were approximately $660 million. “Arguably,” one commentator has stated, “The [c]ouncil only needed to enter into swap contracts equal to, at most, the amount of their borrowings . . . in order to protect themselves against adverse interest rate movements.” But, the council had entered into IRSAs that, in total, were fifteen times greater than the amount necessary to hedge its debt.

In comparison to other authorities, the number of IRSAs entered into by the council was thought to be excessive. The House of Lords noted that only ten of the 450 other United Kingdom authori-

[the treasurer] represented is a question for the arbitrator,” not the court. *Id.* A similar action has been filed by the County Commissioners of Charles County, Maryland, in September of 1994 against various broker-dealers. County Commissioners of Charles County, Maryland v. Liberty Capital Markets, Inc., No. DKC 94-CV-2188 (D. Md. filed Sept. 2, 1994). Medero, *supra*, at 7, 8 n.24. In this action, the plaintiffs assert that the county treasurer, who had “invested 98 percent of the county’s investments in volatile derivatives” (Aaron Pressman, *Can it Happen Here?*, Empire St. Rep., Apr. 1995, at 44, 47), lacked the legal authority to enter into the various derivatives at issue and that the “transactions were *ultra vires* and void *a[b] initio*.” Medro, *supra*, at 8. A decision has not yet been rendered in this case.

174. *Id.* at 377.
177. *Id.* at 377.
178. *Id.* at 380-381.
180. *Id.* at 526.
181. *Id.*
182. *Id.* at 526 n.69.
183. *Id.*
184. *Hammersmith*, 2 W.L.R. at 381.
ties had entered into more than ten swaps during the period from 1987 to 1989, and only eighteen had entered into more than five.\textsuperscript{185} It was apparent that the council, in contrast to most other authorities, had engaged in financial transactions "well beyond normal debt-management procedures."\textsuperscript{186} The House of Lords apparently adduced that the council had not engaged in the IRSAs to reduce the costs of borrowing or to hedge against changing interest rates.\textsuperscript{187} Rather, the Law Lords believed the council participated in the IRSAs for purely speculative purposes—the hope of realizing financial gains by accurately forecasting changes in interest rates and using those profits to decrease debt-service costs.\textsuperscript{188}

The House of Lords had to determine whether the council was empowered to enter into any type of swap agreement.\textsuperscript{189} To resolve this issue, the Law Lords reviewed the council's source of power, the Local Government Act of 1972.\textsuperscript{190} Under the 1972 Act, the council was expressly authorized to engage in "‘borrowing or lending of money or the acquisition or disposal of any property or rights[ ] which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.'"\textsuperscript{191} The House of Lords opined that local authorities subject to the provisions of the 1972 Act have only those powers enumerated in the 1972 Act or otherwise granted by Parliament.\textsuperscript{192} The Law Lords unanimously concluded that "a local authority [subject to the provisions of the 1972 Act] has no [express] power to enter into a swap transaction."\textsuperscript{193}

While the council's counterparties conceded that the council had "no express power" to enter into swap transactions, they argued that the council possessed such "implied power."\textsuperscript{194} The House of Lords, then, had to determine whether the IRSAs were "‘calculated to facilitate, or [were] conducive or incidental to,’ the discharge” of the coun-

\textsuperscript{185} Id. at 380.
\textsuperscript{187} Hammersmith, 2 W.L.R. at 383.
\textsuperscript{188} Id. at 380.
\textsuperscript{189} Id. at 377.
\textsuperscript{190} Id. at 373, 382-83.
\textsuperscript{191} Id. at 383 (quoting § 111(1) of the 1972 Act).
\textsuperscript{192} Id. at 383; see also Guindi, supra note 172 (discussing whether Hammersmith was correctly decided and identifying factors that may have influenced the Law Lords in their decision, including the notion that the House of Lords may have wanted to defer to Parliament on whether local boroughs should be empowered to enter into IRSAs, noting that Parliament had granted certain other governmental entities express authority to enter into IRSAs); Hammersmith, 2 W.L.R. at 389 ("It is for Parliament and not the courts to decide whether there should be conferred on local authorities unlimited power to hedge or a power limited for the protection of the taxpayers and ratepayers.").
\textsuperscript{193} Hammersmith at 390.
\textsuperscript{194} Id. at 382.
council’s authorized power and function of borrowing. The Law Lords held that the IRSAs neither “facilitate[d]” nor were “conducive” to borrowing because the council’s strategy—entering into swaps with the hope of financial profit—impermissibly contravened the council’s “duty to act prudently in the interests of the ratepayers.”

The Law Lords then considered whether IRSAs might be “incidental to” borrowing in spite of the fact that an IRSA could be entered into years after a borrowing transaction. “[A] power,” the House of Lords held, however, “is not incidental merely because it is convenient or desirable or profitable.” The House of Lords also rejected the banks’ argument that IRSAs were “incidental to the function of debt management.” “Debt management,” the Law Lords found, “describes prudent and lawful activities, not unlawful ones. If entering into the transactions was unlawful, then doing so could not be characterized as debt management.” Thus, all 592 IRSAs that the council had entered into were ultra vires of the powers of the council and therefore illegal.

The decision did not address how the ultra vires finding would impact the parties in the case. The House of Lords merely observed that its ultra vires finding did not necessarily mean that the banks would be unable to recover against the borough. Rather, the consequences of each transaction would have to be reviewed on a case-by-case basis.

Thus, in Hammersmith, the House of Lords, in a strict interpretation of the laws applicable to the council, written well before IRSAs were ever conceived, concluded that the council lacked either express or implied power to enter into IRSAs and left open the question of the impact of its ultra vires finding on the parties. The legal battle over who will absorb the losses between the council and its IRSA counterparties is trudging on in British courts.

195. Id. at 383 (quoting § 111(1) of the 1972 Act).
196. See id. at 383-84.
197. Id. at 383.
198. Id. at 384.
199. Id. at 385.
200. Id. at 388.
201. Id.
202. Id.
203. Id. at 390, 392.
204. Id. at 389-90.
205. Id. at 390.
206. “The counterparties can claim restitutionary remedies, but these are uncertain in their scope.” Canby, supra note 66, at 421.
207. Credit Commercial de France “is the latest to seek damages from the government of Hammersmith and Fulham.” French Bank Sues British City for Fraud, Am. Banker, Jan. 13, 1994, at 6. “Chemical Banking Corp., for example, sued the city in 1992.” Id. Credit Commercial de France said that it is “seeking restitution of sums paid to Hammersmith and Fulham” as well as “the recognition of the fraud commit-
SWAP AGREEMENTS

Given the absence of case law on this issue in the United States, it is possible that a court may look to Hammersmith for guidance if it must decide whether a governmental unit in the United States acted ultra vires of its statutory authority by entering into IRSAs. In the United States, the ultra vires doctrine, as it relates to state and local governmental units, is the "well-established" principle that dictates that as "creatures of the State," state and local governmental units can exercise only that power which the legislature has conferred upon them. The authority of municipalities has been described as:

(1) the powers granted in express terms; (2) those necessarily or fairly implied in or incident to the powers expressly granted; and (3) those essential to the accomplishment of the declared objects of the corporation—not simply convenient, but only those which are indispensable, to the accomplishment of the declared objects of the corporation.  

Thus, acts of state and local governmental units are ultra vires when they are beyond the express, incidental or implied powers conferred upon them by the state or are not essential to the fulfillment of their legislatively declared objectives.

These principles were at issue in a highly publicized case involving the "largest municipal bond default in history." At issue in Chemical Bank v. Washington Public Power Supply System was whether the holders of $2.25 billion worth of revenue bonds issued by the Washington Public Power Supply System between 1977 and 1981 would be repaid, with interest, for a total of $7.2 billion. The WPPSS court, in a narrow construction of applicable Washington statutes, held that the bondholders were not entitled to restitution because WPPSS had neither express nor implied statutory authority to enter into the agreements by which the bonds were issued. WPPSS, a joint operating agency and municipal corporation comprised of nineteen public utility districts and nine cities, was empowered, among other things, to acquire, construct, operate and own

- Hammersmith and Fulham, which made false statements to CCF with regard to its ability to perform such swaps.
- Id.
- Fischer, supra note 179, at 513.
- The results of a default are different depending on the type of bond issued:
  - When the source of repayment of a bond is limited to a specified fund, the bond is a revenue bond. The "special fund" is defined by the revenues set aside for the repayment of the indebtedness. A toll bridge, for example, is likely to be financed with revenue bonds repayable solely from the tolls collected at the bridge. In the event toll revenues are insufficient to pay debt service, bondholders have no recourse against the general assets of the political subdivision in which the toll bridge is situated.

- Fischer, supra note 179, at 514-18.
- See WPPSS, 691 P.2d at 536.
plants and related facilities for the purpose of generating or transmitting electrical power.\textsuperscript{214} In 1976, WPPSS and eighty-eight other governmental units signed participation agreements to obtain financing to construct two nuclear power plants.\textsuperscript{215} The participation agreements conferred upon the participants various rights, interests and obligations in the power plants to be constructed.\textsuperscript{216} In accordance with the participation agreements, WPPSS issued $2.25 billion in bonds.\textsuperscript{217} When enormous cost overruns occurred, WPPSS terminated the two construction projects prior to completion.\textsuperscript{218} Many of the participants repudiated their obligations under the participation agreements.\textsuperscript{219} The bondholders' trustee then sought a declaratory judgment that WPPSS was obligated to make payments to the bondholders and that the participants were bound under the agreements to make payments to WPPSS for their respective shares of the debt service owed on the bonds.\textsuperscript{220}

The WPPSS court, however, found that the twenty-eight governmental units comprising WPPSS exceeded their statutory authority to purchase electricity or own power plants because the participation agreements, among other things, required the participants to guarantee bond payments "irrespective of whether any electric current [was] delivered\textsuperscript{150} and to surrender ownership interest and considerable control to WPPSS.\textsuperscript{222} As to the remaining sixty governmental participants, the court held that they were released from their obligations under the agreements in accordance with the doctrines of mutual mistake and commercial frustration.\textsuperscript{223}

In WPPSS, the court also discussed the distinction between substantive ultra vires acts and procedural ultra vires acts. The general rule, the court noted, is that

\begin{quote}
a private party, acting in good faith, may recover from a governmental agency if the agency "had the power it sought to exercise but merely ... exercised it in an irregular manner or by unauthorized procedural means", and the action was not \textit{malum in se, malum prohibitum} or manifestly against public policy.\textsuperscript{224}
\end{quote}

The WPPSS court found that because the contracts were not for the purpose of purchasing electricity or power plants, it was substantively...

\begin{footnotesize}
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\item[214.] \textit{Id.} at 529 & n.1.
\item[215.] \textit{Id.} at 529.
\item[216.] \textit{Id.}
\item[217.] \textit{Id.} at 530.
\item[218.] \textit{Id.}
\item[219.] \textit{Id.}
\item[220.] \textit{Id.}
\item[221.] \textit{Id.} at 535.
\item[222.] \textit{Id.}
\item[223.] \textit{Id.} at 537.
\item[224.] \textit{Id.} at 545 (quoting Noel v. Cole, 655 P.2d 245, 250 (Wash. 1982)).
\end{itemize}
\end{footnotesize}
ultra vires for WPPSS to enter into them. The court concluded that neither WPPSS, which had acted ultra vires of its statutory authority, nor the sixty participants were under any obligation to make payments to the bondholders. In reaching its holding, the court referred to its previous decision in this case where it had noted that the ultra vires doctrine "applies to government action to 'protect the citizens and taxpayers . . . from unjust, ill-considered, or extortionate contracts, or those showing favoritism.'" The participation agreements, the court noted in its earlier decision, did not adequately protect the ratepayers whom the governmental participants were supposed to represent. By relying on the participation agreement scheme instead of on the legislative scheme that incorporated protections for the ratepayers, the governmental units acted ultra vires of their statutory authority, thus rendering the bondholder contracts void.

Given the holdings in Hammersmith and WPPSS, a putative counterparty to an IRSA with a governmental unit should insure that the governmental unit: (1) has statutory authority to enter into the IRSA; (2) wants to enter into the IRSA for debt management and not speculative purposes; and (3) where authority to enter into IRSAs is arguably ambiguous, provides legal opinions that demonstrate that reliance on other statutory powers is clearly warranted.

B. The Implicit "Gamble"

Governmental units that lack express statutory authority to engage in IRSAs or whose authority is ambiguous also may be less likely to learn how IRSAs work and to investigate whether they could benefit their jurisdictions. Other governmental units that do possess the expertise required to structure and use IRSAs effectively may be reluctant to enter into them absent express statutory authority. In either event, the result can be lost opportunities to minimize risk and reduce costs. Furthermore, when governmental units could derive benefits from entering into IRSAs but are precluded from doing so because they lack statutory authority to use IRSAs, state legislatures effec-

225. Id. The trustee asserted that WPPSS possessed broad statutory power to contract for the purchase of electric and power plants and that its only error WPPSS made was failing to specify clearly in the participation agreements "sufficient ownership interest to protect ratepayers." Id.
226. Id.
228. Id. at 342 (quoting 10 E. McQuillin, Mun. Corp. § 29.02, at 200 (3d ed. 1981)).
229. Id.
230. Id.
tively force governmental units to "gamble" unnecessarily with public resources. Such governmental units also may be needlessly exposed to increased interest-rate risk and costs.

The Joint Surveys revealed that thirty-six percent of the respondents believe derivative products are too risky, and thirty-eight percent said they are too complex.232 Only four percent of the respondents identified themselves as "being very knowledgeable about derivative products," and only twenty percent said they "knew the basics."233 The Joint Surveys also found that "even though derivative products were used by issuers in twenty-five states, more than one-third of the users were in California and Florida."234 In 1987, these two states granted governmental units within their jurisdictions express statutory authority to enter into IRSAs and other types of derivative transactions.235 Based on the Joint Surveys results, it appears that there may be a positive correlation between the existence of express statutory authorization to engage in IRSAs and the use of IRSAs by governmental units. If this correlation is established, it may also suggest that when governmental units have express authority to engage in IRSAs, they are more motivated to learn about how IRSAs work and to investigate whether the use of IRSAs might benefit their jurisdictions.

The general lack of knowledge relating to IRSAs also may be the result of an aversion to derivatives among government fiscal officers. Such aversion likely is exacerbated by the recent plethora of bad press about derivatives generally. Headlines such as "Auburn, Maine, Announces Losses From Derivatives,"236 "Greenwood County, S.C., Treasurer Quits After Fund Suffers Derivatives Losses,"237 and a popular business magazine's cover story on derivatives titled, "The Risk That Won't Go Away"238 do little to inform and much to intimidate, as do comments by legislators such as, "You can call it whatever you
want, but in my book it's gambling." 239 Upon closer examination, however, it is clear that fiscal mismanagement, exacerbated by the absence of proper oversight and control, rather than IRSAs, or derivatives per se, is the root cause of most of the losses that have received widespread negative media attention. 240

"[In the current environment,]" noted one government official, "there is a risk that the pendulum is swinging too far toward a kind of false fiscal conservatism." 241 In other words, a risk exists that public finance officials, acting under the guise of responsible fiscal management, will elect not to enter into IRSAs, even when it is fiscally prudent.

Other governmental units that possess the required expertise and resources to enter into IRSAs may be reluctant to engage in these transactions without express statutory authority. The State of New York Metropolitan Transportation Authority, 242 for example, has never executed an IRSA. The MTA, however, tried, unsuccessfully, for the last several years to convince the New York State Legislature to enact legislation expressly authorizing it to enter into IRSAs as well as various other types of derivative contracts. 243 One of the MTA's more immediate objectives has been to use IRSAs to help "eliminate

RIVATIVES are tightening their grip on the world economy. And nobody knows how to control them").

239. Silber, supra note 84, at 12 (comment by Henry B. Gonzalez, then-chairman of the House Banking Committee, made at a hearing on derivatives trading held in October 1994.)


241. Morrison, PSA's President, supra note 22, at 3 (quoting Heather Ruth, former President of the Public Securities Association).

242. The MTA is responsible, among other things, for securing funding for bridge and tunnel, subway, bus and commuter rail operations in the New York metropolitan region provided by the Triborough Bridge and Tunnel Authority, the New York City Transit Authority, the Staten Island Rapid Transit Operating Authority, The Long Island Rail Road Company, the Metro-North Commuter Railroad Company and the Metropolitan Suburban Bus Authority. See Metropolitan Transportation Authority, 1993 Annual Report 33, 56 (1994).

243. Hume, supra note 40, at 2A, 6A. The City of New York as well as the MTA have been unable to convince state legislators that IRSAs' benefits can be substantial. Id. In 1991, for example, the MTA was unable even to obtain approval from the New York governor's counsel to go to the Legislature with proposals to allow it to enter into interest rate and commodity swaps. "What probably killed us was that we tried to go for the kitchen sink," said Edward Armendariz, [former] director of finance for the MTA. He said the authority will try again but will limit its legislative proposals to interest rate swaps, which got a better reception than commodity swaps from the lawyers. Id. In 1995, the MTA again sought statutory approval to enter into fixed-to-floating-rate IRSAs to help close an annual drain on its budget of $26 million, informing state legislators that the "[M]TA is interested in pursuing the use of derivatives as a means of reducing our exposure, not increasing our risk." Michael Moss & David Henry, MTA Seeks OK for Derivatives Deal, N.Y. Newsday, Jan. 25, 1995, at A33 (quoting
a $26 million average annual drain caused by a mismatch in the $1 billion the MTA borrows at higher long-term rates but invests at lower short-term rates for just a few months, until it is spent." Had the MTA possessed express statutory authority to enter into IRSAs over the last two years, it could have realized savings of approximately $52 million. The MTA has estimated that the cost of a subway ride could decrease by five cents for every $55 million that the MTA saves.

As indicated by this example, state legislators impose on the public definite, measurable costs when they fail to ensure that the use of public funds is maximized and protected against unnecessary risks and costs. Rather than permitting governmental units to have access to more financial tools, tools that the private sector uses regularly, state legislators have made a decision to continue to allow governmental units to take implicit gambles with public resources. The implicit gamble, in the case of the MTA, for example, is a decision to allow the MTA's investment portfolio to go unhedged in the hope that short-term interest rates will rise and not decline. In the MTA's case, this gamble has not paid off. New York State's legislators' failure to give the MTA express statutory authority to enter into IRSAs has cost taxpayers and consumers tens of millions of dollars in the last few years alone.

C. Increased Exposure to Operational Risk

In addition to expressly authorizing governmental units to enter into IRSAs, as several states have already done, state legislatures must establish a comprehensive system of oversight and control of governmental units' use of IRSAs. As one commentator has observed, many of the problems involving governmental units' derivative investments largely stem from the fact that legislation governing governmental units has "lagged behind the rapid development of the derivatives market."

Thus, even if a governmental unit's IRSA were to survive an ultra vires challenge, there is a risk that reliance on existing statutes could result in increased operational risks. A number of existing statutes, for example, authorize governmental units to incur debt, enter into contracts and generally do what is necessary to achieve their respec-

MTA Executive Director Jay Walder. The New York State Legislature has not yet acted on the MTA's proposed legislation.

244. Moss & Henry, supra note 243, at A33.

245. Id.


247. Canby, supra note 66, at 421.

248. See supra notes 73-75 and accompanying text.
But, many of these statutes were enacted long before any legislator could have contemplated their use by governmental units in connection with the contemporary array of complex financial vehicles. Such statutes, therefore, are not likely to require the types of reporting, oversight and review necessary to manage successfully today's complex transactions. Even more recently enacted statutes expressly authorizing governmental units to enter into IRSAs and similar transactions often fail adequate reporting, oversight and review.

In either case, the result, as appears to be the case in Orange County, California, could be increased operational risks and significant financial losses.

On December 6, 1994, Orange County, California, and the Orange County Investment Pool filed for bankruptcy protection under Chapter 9 of the United States Bankruptcy Code, governing municipal bankruptcies. With these filings, it was reported that Orange County, the fifth-largest county in the United States in population, "became the largest municipality ever to file for Federal bankruptcy protection." The bankruptcy filings were precipitated by a liquidity crisis resulting from the inability of the pool's treasurer to renew a $2 billion loan made to the pool by CS First Boston and from CS First Boston's decision to sell $2.1 billion it held as collateral. The pool, with assets estimated at $7.5 billion, suffered paper losses of $2 billion in 1994. Although county officials initially blamed rising interest rates and derivatives for the pool's troubles, it appears that an overly aggressive investment strategy, coupled with a lack of oversight and controls, were at the root of the pool's problems.

Details concerning causes and ramifications of the Orange County bankruptcies are still unfolding. Based on extant press reports, it ap-

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249. McGavin, supra note 9, at 220-23.
251. See infra notes 298-301, 337-47, and accompanying text.
252. See David L. Dubrow, Five Aspects of Municipal Bankruptcy That Will Be Crucial to Orange County, Bond Buyer, Dec. 12, 1994, at 9; Yacoe, supra note 237, at 19.
255. Sallie Hofmeister, A Default By Orange County: Firms Face Lawsuits over Collateral Sales, N.Y. Times, Dec. 9, 1994, at D1, D5.
257. A "paper" loss is an "unrealized [loss] on a security or other investment still held." Black's Law Dictionary 1111 (6th ed. 1990). A loss is "realized . . . only upon the sale of the security." Id.
pears that the pool’s losses were the result of a variety of factors, including: (1) the treasurer’s strategy of using certain investment vehicles to speculate with the hope of financial gain and borrowing heavily to make additional investments;261 (2) the county supervisors’ apparent failure to inform themselves of the treasurer’s investments and strategy;262 and (3) the flaws in the state’s laws that expressly authorize certain investments in derivatives but lack appropriate oversight mechanisms and controls.263 This toxic combination created a situation that permitted “‘a public official [to] gamble a government into bankruptcy.’ ”264

The Orange County Investment Pool is managed by five elected officials who comprise the Board of Supervisors, the entity responsible for overseeing the activities of the county treasurer.265 In addition to the county itself, investors in the pool include 186 cities, school districts and transportation and sanitation agencies both in Orange County and elsewhere in the state.266 Orange County, the largest investor in the pool, held about one-third of the pool’s assets.267 The majority of the remaining two-thirds came from funds invested by other governmental units that were required to invest their extra revenues in the pool.268

With respect to the county’s investment strategy, the treasurer appears to have made two serious mistakes. First, the treasurer invested sixty percent of the pool’s assets in derivatives known as “structured notes, consisting primarily of inverse floaters”269 issued by the Federal National Mortgage Association (known as “Fannie Mae”) and the Federal Home Loan Mortgage Corporation (known as “Freddie Mac”).270 An inverse floater “combine[s] the features of an ordinary

261. The pool, for example, had borrowings of approximately $13 billion, well in excess of state law limiting borrowings to the size of the pool’s annual revenues of $1.5 billion. Leslie Wayne, Orange County in Suit Against Merrill Lynch, N.Y. Times, Jan. 13, 1995, at D2. Furthermore, the borrowings that the treasurer used to leverage the pool’s size, “were used for speculation and not simply to ‘supplement income,’ which is the only use permitted by California law.” Id. (quoting James W. Mercer, a lawyer representing Orange County, California).


263. See infra notes 298-301 and accompanying text.


265. Weikel & Lait, supra note 262, at A46.


267. Wayne, supra note 253, at D11.

268. Leslie Wayne, $1.5 Billion Loss Seen for Orange County; Orange, Calif., Hurt as Derivatives Drop, N.Y. Times, Dec. 2, 1994, at D1, D16.


270. Search Warrants are Issued in the Orange County Fiasco, N.Y. Times, Dec. 20, 1994, at D8.
fixed-rate bond with an interest-rate swap." The interest paid on these structured notes moves inversely to market rates; as interest rates fall, they pay more interest, and as interest rates rise, they pay less. These investments are considered risky because as interest rates rise, their value falls and the interest they earn also drops. According to S&P, governmental units should limit their exposure to derivatives to no more than fifteen percent to twenty percent of their portfolios. Most of the governmental units that have experienced significant losses from derivative investments were the ones that did not invest wisely in derivatives and "based as much as 90% of their portfolio on derivatives."

The treasurer's decision to invest sixty percent of the pool's assets in inverse floaters put the portfolio in a position well in excess of the recommended exposure to derivatives. Furthermore, these investments fared poorly in two ways in a rising interest-rate environment: (1) their value declined and (2) the interest the pool earned on these investments also fell.

Second, it appears that losses tied to the inverse floaters were exacerbated by the treasurer's decision to borrow heavily through the use of reverse repurchase agreements ("reverse repos") to make additional investments. In 1979, the county treasurer, who was then the head of the California association of county treasurers, drafted a change to state law that permitted county treasurers to borrow money through the use of reverse repos. In a reverse repo, a borrower gives a lender assets, such as United States government securities, in return for a loan. The borrower then agrees to repurchase the assets pledged as collateral on a preset date at an agreed price. If the value of the collateral falls, the borrower must post additional collateral to cover the amount of the outstanding loan balance. The county treasurer used these agreements to borrow approximately $13 billion. The proceeds were used to purchase about $13.5 billion of investments for the pool. Then, investments held by the pool were
used to collateralize the reverse repos. While this strategy performed well when interest rates were falling, as interest rates began to rise in 1993, and the market value of the collateral fell, the pool had to use cash reserves to post additional collateral for the balance of the reverse repos' terms. Eventually, the pool became insolvent, and the lenders began to sell the collateral they held to recover the outstanding loan balances.

Merrill Lynch & Company, one of the investment banks that had entered into reverse repos with the pool, asserts that in 1992, it warned the treasurer about the increased risks in the pool and even "offered to buy back at a profit to the fund all the derivative securities that Merrill had sold to it." The treasurer, Merrill Lynch alleges, "declined Merrill's offer, saying that he was aware of the volatile nature of the fund's investments."

Acting Treasury Secretary Frank N. Newman summed up the Orange County situation by noting that the pool's financial troubles were caused by an improper investment strategy, not by its investment in derivatives per se. The pool, Mr. Newman observed, "purchased long-term securities with short-term loans," and when short-term interest rates climbed, the pool assets declined. The levels and types of investments, as well as the level of borrowing involved, strongly suggest that the pool did not use derivatives as a tool for hedging against the risks associated with changes in interest rates, but rather as a means of speculating with the hope of realizing gains. By borrowing heavily through the use of reverse repos, and continuing to do so in a rising interest-rate environment, the pool became locked in a cash-draining, downward spiral which left it with no other option but to file for federal bankruptcy protection.


The official statement for a $64 million tax-exempt note issue sold [by the county] last August . . . contain[ed] a section on the county's investment pool that said the pool contained derivatives as well as fixed- and floating-rate securities, a "significant portion" of which "are pledged with respect to re-purchase agreements."


283. During the county fiscal year ending June 30, 1993, the pool earned 8.52% on its investments, compared to earnings of 4.71% in the State of California Treasury investment pool during the same period. Garvey & Fairclough, supra note 277, at 6.


285. Garvey & Fairclough, supra note 277, at 8. In addition, as Jon Lukomnik, Deputy Comptroller for Pensions for New York City, observed, the pool "had both operating cash and pension funds mixed together, though the investment strategies for each should be completely different." Hevesi, supra note 40, at 2.


287. Id. at D7.

In addition, the Orange County Board of Supervisors were apparently unaware of the magnitude of the pool’s problems. The members of the Board of Supervisors were far from knowledgeable about reverse repos and inverse floaters. The Chairman of the Board of Supervisors “admitt[ed] that much of the county’s economic problems are beyond his comprehension.” A local political activist stated: “It would be incredible malfeasance if the board didn’t make themselves aware of the investments [the treasurer] was making because they have a central role to make sure the money was invested properly.” Surprisingly, however, “the supervisors contend that they should not be held responsible for the crisis because the public should not expect elected officials to be knowledgeable about these types of investments. Another Orange County activist summed up the attitude of the Board of Supervisors by commenting: “They have plenty of arrogance and no accountability.” The Board of Supervisors also has been criticized by some for failing to take corrective action earlier after “watchdog agencies” repeatedly noted problems. Had the Board of Supervisors appropriately monitored the treasurer’s activities, it is possible that it would have discovered that the treasurer’s investment strategy was improper, and resulting losses may have been minimized.

Further compounding the risks inherent in the treasurer’s investment strategy are the flaws in relevant California law. The law seeks to ensure that treasurers’ day-to-day investment decisions are free from interference by locally elected officials; however, the law also permits treasurers to act with virtually no supervision. The law’s oversight requirement is that the governmental unit’s supervising body approve the use of reverse repos. More significantly, the law does not require the treasurer to mark periodically the pool’s investments to market and to report the results to the Board of Supervisors, legislators or regulatory bodies.

289. Flanigan, supra note 129, at D3.
290. A child-care expert, a former Marine, a former college professor, a former police officer and a former mayoral aide comprised the five-person Board of Supervisors at the time of the bankruptcy filings. Weikel & Lait, supra note 262, at A1, A46.
291. Id. at A1.
292. Id.
293. Id. at A46 (quoting Christopher Meara, Irvine, California, attorney).
294. Id.
295. Id.
296. Id. (quoting Tom Rogers, an activist in southern California).
297. Id.
298. Hofmeister, supra note 276, at D17.
299. Id.
300. Id.; see also Cal. Gov’t Code §§ 53601(i), 53635(i) (West 1983 & Supp. 1995) (requiring that “[i]nvestment in a reverse repurchase agreement shall be made only upon prior approval of the legislative body of the local agency”).
301. Flanigan, supra note 129, at D3.
While it is far too early to identify what all of the ramifications of the Orange County bankruptcies will be, they are bound to include actions such as those taken by the Saddleback Valley Unified School District. The district had to lay off forty-seven employees to lower costs because most of its operating funds are tied up in the Orange County Investment Pool bankruptcy.\(^{302}\) Other bankruptcies may also result.\(^{303}\) Furthermore, many of the pool’s investors, following Orange County’s lead, plan to commence lawsuits against the investment banks that sold investment vehicles to the pool.\(^{304}\) It probably will be years before many of the pool’s and county’s troubles are sorted out among all the participants.\(^{305}\)

Although the Orange County investment strategy yielded investment income for several years,\(^{306}\) it is, nevertheless, a strategy fraught with excessive risks and an improper scheme for managing public resources. Because the Orange County Investment Pool bankruptcy highlights the fact that an overly speculative investment policy and inadequate oversight—not derivatives per se—are at the root of the problem, governments can begin to formulate legislation that addresses these issues.

Since the Orange County bankruptcy filings, some legislators have rushed to draft legislation that would significantly curb or even ban the use of derivatives by governmental units,\(^{307}\) noting that other similar, but relatively smaller scale, examples have occurred.\(^{308}\) Many


303. For example, early in December of 1994, “the small city of Montebello in Los Angeles County disclos[ed] that it might have to file for bankruptcy because it has more than 60 percent of its $777.2 million investment portfolio frozen in the Orange County pool.” Hofmeister, supra note 282, at 39. Montebello has, however, been able to avoid bankruptcy for the time being. In late December, Montebello “received a $14-million infusion from the investment pool, a key part of [its] plan to avoid defaulting on a $25.6-million note payment due [December 30, 1994].” Mark Platte et al., O.C. Deficit Could Triple to $120 Million by June, L.A. Times, Dec. 29, 1994, A1, A18.

304. Id.


306. In the 22-year period from July 1972, through June 1994, the Orange County Investment Pool outperformed California’s Local Agency Investment Fund in 17 of those years. Jeff Brazil et al., Citron’s Track Record Falls Short of Reputation, L.A. Times, Jan. 8, 1995, at A1. During the four-year period from 1991 through 1994, the pool “enjoyed some of the best above-market returns, but [it was also the period when the pool] took [the] greatest risks.” Id.


308. For example, in 1994, Rep. Henry Gonzalez, then-Chairman of the House Banking Committee, noted that the credit rating of the Odessa Junior College District in Texas was lowered after it was discovered that the district “had lost millions” from its investments in derivatives. Texas Governor Urged to Sound Alarm on Derivatives Risk, Bond Buyer, Sept. 14, 1994, at 2. Later in 1994, officials of the City of Auburn, Maine, reported that the city “lost more than 40% of [its] funds that were invested in derivatives and other securities.” Fitzgibbon, supra note 236, at 1.
others, however, urge caution, expressing concern that such legislation "may go too far." While it may take less effort on the part of legislators simply to prohibit governmental units from using derivatives such as IRSAs, that clearly is not the most prudent alternative given that IRSAs, when used and monitored properly, can save taxpayers millions of dollars. Rather, state legislatures, in addition to expressly authorizing certain governmental units to enter into IRSAs, should enact a legislative scheme requiring governmental units to report adequately on their use of IRSAs and establishing clear oversight functions and responsibilities as well as guidelines on the appropriate structure and use of IRSAs.

III. IN SEARCH OF . . . STATUTORY AUTHORITY

Most governmental units in the United States do not have express statutory authority to enter into IRSAs. Despite this lack of express statutory authority, some of these same governmental units enter into IRSAs regularly. Many do so by relying on their existing powers, such as their authority to contract, manage their investments, issue debt and generally do those things necessary to achieve their statutory purposes. Since 1985, a growing number of states, including California, Florida, Nevada, New York and Utah, have given a few or all of the governmental units in their jurisdictions express statutory authority to engage in IRSAs as well as other derivative products. While there are numerous variations between and within these two groups—those that have express statutory authority and those that do not—in many cases the legislation upon which they rely share a common defect: a lack of an adequate, comprehensive program for oversight and control of governmental units' use of derivatives.

A. Reliance on Other Grants of Power

An absence of express statutory authority does not necessarily mean that a governmental unit is prevented from entering into IRSAs. While specific authorization is desirable, implied authority to

310. See supra note 27 and accompanying text.
311. For example, "for several years the Port Authority of New York and New Jersey has been swapping its fixed rates into variable rates and vice versa." Moss & Henry, supra note 243, at A33. Yet, "[i]t remain[s] unclear who authorized the Port Authority to engage in swaps, since the bi-state agency often skirts state regulations." Id. See also infra note 329 and accompanying text (discussing The City of New York's derivative investment activities and disagreements among market participants regarding the status of its legal authority to engage in derivative transactions).
312. McGavin, supra note 9, at 220-23.
313. See infra notes 334-47 and accompanying text.
314. McGavin, supra note 231, at 6. For a detailed review of the variety of ways in which some governmental entities may find implied authority to enter into IRSAs based on their existing statutory powers, see McGavin, supra note 9, at 220-23.
enter into IRSAs may be found in state constitutions, governmental units' charters and enabling legislation, as well as in court decisions and rulings and regulations interpreting these laws.315

Most state and local governmental units have the power to execute contracts and can exercise this power in furtherance of other governmental powers and duties, such as the powers to borrow, invest and otherwise manage their affairs.316 As a general rule, a governmental entity possesses those powers that are expressly granted, as well as those that are necessarily implied, but not powers that are "merely convenient."317 Where a governmental unit is specifically empowered to "'do all things necessary or convenient' for the exercise of the powers granted," however, the rule that implied powers must be necessary and not simply convenient is not applicable.318 Thus, the power to enter into IRSAs in certain instances may be implied from a governmental unit's express power to enter into contracts, in conjunction with a general power to do whatever is necessary or convenient to carry out the governmental unit's purposes.319

The Metropolitan Transportation Authority, as noted earlier, does not have express statutory authority to enter into IRSAs.320 Nevertheless, it would appear that, under its existing powers, the MTA could execute an IRSA in certain instances in furtherance of its express purposes. Pursuant to the New York Public Authorities Law, the MTA has the power "[t]o enter into contracts and leases and to execute all instruments necessary or convenient."321 The MTA also has the power "[t]o borrow money and issue negotiable notes, bonds or other obligations,"322 as well as the power "[t]o do all things necessary, convenient or desirable to carry out its purposes and for the exercise of" its express powers.323 Based on the foregoing express

316. Id. at 221.
317. Polk County Bd. of Supervisors v. Polk Commonwealth Charter Comm'n, 522 N.W.2d 783, 790-91 (Iowa 1994) (citing Merriam v. Moody's Executors, 25 Iowa 163, 170 (1868), and Gritton v. City of Des Moines, 73 N.W.2d 813, 815 (Iowa 1955)). The "Dillon Rule" provides that municipal entities can only possess and exercise powers that are "expressly granted by the legislature," necessary, "fairly implied" or incidental to express powers, and those that are "indispensably essential—not merely convenient—to the declared objects and purposes of the municipality." Id. See also 3 Sutherland, Stat. Const., § 64.02, at 260-62 (5th ed. 1992) (discussing limitations on municipalities' powers); 2 McQuillin, Mun. Corp., § 10.21, at 1057 (3d ed. 1988) (discussing rules of construction with respect to the powers of municipal corporations).
319. See McGavin, supra note 9 at 221.
320. See supra notes 242-46 and accompanying text.
322. Id. § 1265(3).
323. Id. § 1265(14).
powers, the MTA may have the implied power to enter into IRSAs in particular cases.

On the other hand, a general rule of statutory construction provides that a legislative body is presumptively aware of existing statutes involving similar matters. Thus, when the New York State Legislature created the New York Local Government Assistance Corporation in 1990 and expressly authorized it to engage in IRSAs, the Legislature, presumably, was aware that other governmental units in New York State did not have this express power. Arguably, had the Legislature wanted the MTA or other governmental units to have the authority to enter into IRSAs, it would have amended the appropriate statutes to effect this intent.

In some states, municipalities' "home rule" power may further support a conclusion that such municipalities have the power to enter into IRSAs. Home rule powers generally authorize local municipalities to act subject only to express statutory limitations on their authority. In Texas, for example, courts have consistently held that municipalities with home rule powers need not look to legislative grants of authority to exercise powers; rather, they need only determine that no legislative limitation exists on their constitutional powers. Thus, where municipalities have broad home rule powers in addition to the power to contract, manage their finances and do all things necessary or convenient in the furtherance of their express powers, these municipalities arguably also have the authority to enter into IRSAs under certain circumstances.

Yet, absent express statutory authority, there may still be disagreements as to whether a governmental entity may legally enter into IRSAs. The City of New York, for example, has entered into IRSAs although it lacks express authority, and some market participants have questioned the city's authority to enter into these types of transac-

324. See, e.g., Colonial Springs Club v. Westchester County, 840 F. Supp. 19, 20 (S.D.N.Y. 1993) (in resolving a dispute over whether a statute referring to those who "own residential property" could be read to exclude "renters," noted that the difference in terms was meaningful and that "courts generally assume that rule-making and legislative bodies are 'knowledgeable about existing law pertinent' to the subject.") Id. (quoting Goodyear Atomic Corp. v. Miller, 486 U.S. 174, 184-85 (1988))).
326. McGavin, supra note 9, at 222-23.
327. "In contrast to a general-law city, a home-rule city has authority to do whatever is not specifically prohibited by the State." City of Lockhart v. United States, 460 U.S. 125, 127 (1983).
328. McGavin, supra note 9, at 223 & n.11 (citing State v. City of La Porte, 386 S.W.2d 782, 785 (Tex. 1965); Royal Crest, Inc. v. City of San Antonio, 520 S.W.2d 858, 865 (Tex. Civ. App. 1975); cf. Chemical Bank v. Washington Pub. Power Supply Sys., 666 P.2d 329, 340 (Wash. 1983) ("In some states, the home rule powers of municipalities result in considerable autonomy from state control. In Washington, the courts have interpreted home rule powers of first class cities more narrowly.").
This type of ambiguity makes the market inefficient because each IRSA must be analyzed under the laws of the applicable jurisdiction.

Still other undesirable consequences flow from uncertain authority to enter into IRSAs, such as "the distortion of competition in the market, the creation of uncertainty in the market generally as to whether transactions entered into in good faith will be upheld, etc." Furthermore, even if a governmental unit's reliance on other express grants of power to enter into IRSAs survives an ultra vires challenge, this ambiguity does nothing to ensure that a governmental unit's use of IRSAs or other investment tools is prudent and undertaken only to improve debt and asset management or reduce costs. Most states' existing legislation was not designed to deal with these relatively modern and complex financial transactions and is unlikely to contain the type of oversight and guidelines necessary to ensure that IRSAs are not misused.

B. Express Statutory Authorization

While many governmental units, in reliance upon their existing statutory powers, have entered into IRSAs without legal challenge to date, a growing number of states have given governmental units within their jurisdictions express authorization to enter into IRSAs. Great variety exists, however, in the scope of and limitations on existing express authority.

329. Sean Monsarrat, Munis Tumble, Hit by Supply; New York City Priced at 7.15%, Bond Buyer, Oct. 21, 1992, at 1, 30. In October of 1992, "market players questioned how the city could execute a swap without expressed legal authority" even though the city's bond counsel had issued an opinion that the city had the power to enter into the particular IRSA. Id. The transaction, involving a $50 million indexed inverse floater, included an IRSA. Id. at 30. An indexed inverse floater is a variable rate security that moves "inversely to market interest rates and [is] pegged to an index." Id. Indexed inverse floaters expose issuers to a variable-rate liability. Id. IRSAs are typically used in conjunction with this product to offset their variable rate risk. Id. The city's bond counsel issued an opinion that the city is legally authorized to execute this particular transaction because the city is expressly authorized to "execute contracts that facilitate the issuance of variable-rate debt." Id. Yet, bond counsel also stated that this does not mean that the city can legally execute IRSAs generally. Id. Some of the participants in the transaction hesitated to even call the transaction an IRSA, referring to it instead as a "'bond issuance accommodation agreement.'" Id. The city stated that the transaction would save half a million dollars over the term of the bonds. Id.

330. See, e.g., Das, supra note 46, at 70 ("An efficient market by definition is one in which prices are set at levels whereby the resources traded in the market are allocated equitably or efficiently among the participants." Id. This economic theory requires "satisfaction of a wide range of conditions." Id. Among the necessary conditions are the participants in the market agree on the implications of various information and its effect on the value of the resources being traded. Id.)

331. See Canby, supra note 66, at 421-22.

332. Id.

333. McGavin, supra note 9, at 223.
Some states have given very broad express authority to virtually all governmental units within their jurisdictions.\(^\text{334}\) In California, for example, every governmental entity in the state has express statutory authority to enter into IRSAs, as well as various other types of derivatives, in connection with new or existing bond issues, purchasing or holding investments or in connection with any investment program.\(^\text{335}\) Similarly, in Florida, any governmental unit that issues taxable bonds may enter into IRSAs and other types of derivatives.\(^\text{336}\) In Nevada, in contrast, only a municipality that has issued or plans to issue securities in the amount of $10 million or more may enter into IRSAs if such agreements are “in the best interests of the municipality.”\(^\text{337}\) Nevada also requires, among other things, that the IRSA counterparty be highly rated by a “nationally recognized rating agency,” and either guarantee the IRSA or put up 100% of the IRSA’s notional value as collateral at the time the agreement is made.\(^\text{338}\) The New York Legislature has granted only one governmental unit express authority to enter into IRSAs. The New York Local Government Assistance Corporation may “enter into interest rate exchange or similar arrangements with any person under such terms and conditions as the corporation may determine.”\(^\text{339}\) The power of the New York State Thruway Authority to enter into IRSAs, while not express, is inferred from its obligation to report annually to the state comptroller and budget director its expenses, including fees paid to “providers of interest rate exchange agreements.”\(^\text{340}\)

In Utah, all public treasurers are expressly authorized to enter into IRSAs provided that their governing board or the issuing authority makes a determination that entering into IRSAs is “necessary, convenient, or appropriate for the control or management of debt or for the cost of servicing debt.”\(^\text{341}\) Unlike many other states, however, Utah

\(^{334}\) See, e.g., supra notes 29-31 and accompanying text (discussing California’s legislation granting virtually all governmental units in California express authority to engage in IRSAs and other derivative products).

\(^{335}\) See supra note 31.

\(^{336}\) Fla. Stat. Ann. § 159.823(5) (West 1990) sets forth the governmental units that are authorized to enter into IRSAs and other types of derivative products. These include

- the state, any department, board, commission, or other agency of the state,
- or any county, municipality, special district, or other political subdivision of the state, heretofore or hereafter created, or any board, commission, authority, or other public agency or instrumentality which is now or hereafter authorized by law to issue bonds.

\(^{337}\) Nev. Rev. Stat. § 350.820(1) (1994) (permitting only those municipalities that have “issued or propose[ ] to issue municipal securities in the amount of $10,000,000” to enter into IRSAs).

\(^{338}\) Id. § 350.820(2).


has provided, together with this express statutory authority, clear statutory and regulatory guidance for public treasurers and oversight bodies. Utah’s regulatory guidelines include limitations on the purposes for which IRSAs may be used, criteria concerning the quality of IRSA counterparties and requirements concerning semi-annual reporting on outstanding IRSAs. Utah also imposes criminal penalties upon “[a]ny public entity that wilfully violates” regulations governing IRSAs or that “knowingly makes or causes to be made a false statement or report to the [Utah money management] council."

While statutes expressly authorizing governmental units to enter into IRSAs vary widely, many share a common omission—a lack of a comprehensive program providing for guidelines, oversight and control of governmental units’ use of IRSAs. Even Utah’s statutes and regulations, while going much further than most states’ statutes in providing necessary guidelines and reporting requirements for public finance officials, fall short of guidelines and procedures generally recommended in this industry. For example, Utah does not appear to require public treasurers to mark IRSAs to market, a procedure that industry participants regard as fundamental to managing a portfolio containing derivatives.

C. Benefits of Express Statutory Authority

Under certain circumstances, entering into an IRSA may be the most fiscally prudent action a governmental unit can take. Why, then, would state legislatures fail to enact legislation expressly permitting certain governmental units to enter into IRSAs? Some observers suggest that when regulators have difficulty understanding the risks involved in derivative transactions, they cannot be expected to draft

342. Id. § 51-7-3, 51-7-18.
344. Id. at R. 614-18-4 (The governmental unit’s governing board can only approve an IRSA if it “is designed to reduce the amount or duration of payment, rate, spread or similar risk, or . . . is reasonably anticipated to result in a lower cost of borrowing.” Furthermore, the regulation specifically provides that IRSAs can only be used “for the control or management of debt or the cost of servicing debt and not for speculation.”).
345. Id. at R. 614-18-5 (requiring that a counterparty be rated “in one of the highest three rating categories by at least two Nationally Recognized Statistical Rating Organizations as defined in [the regulations]”).
346. Id. at R. 614-18-8(1) (requiring public treasurers to report to the Utah Money Management Council a listing of all outstanding contracts, their notional value, “the underlying debt to which each [contract relates],” the type of contract and a description of the governmental unit’s payment obligations under each contract).
347. Id. at R. 614-18-8(2), (3).
348. Group of Thirty, supra note 15, at 9 (recommending that derivatives dealers, for risk management purposes, should “mark their derivatives positions to market” daily).
effective regulations. While understanding the risks and benefits of IRSAs may be difficult, legislators have an obligation to the public to educate themselves on this subject.

States should enact legislation expressly permitting certain governmental units within their jurisdictions to enter into IRSAs and establish adequate systems of oversight and control for three primary reasons. First, express authorization will eliminate the risk that a governmental unit could be found to have acted ultra vires of its statutory authority by entering into an IRSA. This, in turn, will enhance the attractiveness of governmental units as swap counterparties, enabling them to obtain a better execution price for swaps and improving the efficiency of the market.

Second, express authorization, together with appropriate oversight and controls, may encourage more government financial managers to become knowledgeable in the way IRSAs work and to investigate whether the prudent use of IRSAs may benefit their jurisdictions. In addition, those governmental units that already possess the expertise and resources to execute and manage IRSAs properly can begin to use this investment tool, secure in the knowledge that their actions, procedures and investment strategies are clearly sanctioned by their legislatures. Governmental units will be able to use this tool, when appropriate, to hedge against risks associated with interest-rate volatility, thereby helping to eliminate the implicit "gamble" that may be in their existing portfolios. They also will be able to assist more actively other governmental units and local officials in understanding this product and in developing guidelines for other governmental units' financial programs.

Third, by establishing and enforcing a clear and comprehensive system of oversight and controls, state legislatures will significantly minimize the danger that public funds will be needlessly lost due to operational risk—the risk of losses resulting from "inadequate systems and control, human error, or management failure."

D. Recommendations

To avoid or minimize risks and increased costs, state legislative leaders, like their counterparts in the private sector, must ensure that "[f]inancial decisions . . . [are] monitored more closely from the very

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349. Hu, supra note 5, at 1463.
350. See, e.g., Bashawaty, supra note 23, at 10, 12 (arguing that the derivatives market should become more standardized, thereby increasing activity in and access to this market for a larger number of dealers and users and providing a widening range of products).
351. See supra notes 232-35 and accompanying text.
352. Group of Thirty, supra note 15, at 50.
The recommendations in this part offer the elements of a statutory framework wherein IRSAs can be used responsibly and in concert with clearly stated legislative objectives. These recommendations are intentionally general in nature so that they can be modified to apply to different types of governmental units in different jurisdictions. Modifications, of course, will be appropriate in certain circumstances, and some existing statutes already contain elements of these recommendations. Furthermore, these recommendations are not intended to impede governmental units or to impose excessive regulations. Rather, they are intended to ensure that governmental units' use of IRSAs is prudent. As governmental units' use of IRSAs increases and financial managers' knowledge and sophistication about IRSAs and their applications expand, some of these requirements may be appropriately reduced or eliminated.

1. Only Large Governmental Units Should be Authorized to Enter into IRSAs

State legislators should assess the governmental entities in their jurisdictions and clearly distinguish, by dollar volume of debt outstanding, between those entities that should be authorized to enter into IRSAs and those that should not. Not every one of the nation's 50,000 state and local governmental entities should be authorized to enter into IRSAs. Many of these governmental entities do not issue debt or issue relatively small amounts of debt infrequently. State legislators should ensure that those governmental units that have little or no need to use IRSAs are expressly prohibited from entering into IRSAs. Conversely, there are many larger governmental entities that issue significant amounts of debt on a regular basis, managing billions of dollars in assets. Such governmental units could benefit from entering into IRSAs and should be expressly authorized to do so.

2. Legislative and Regulatory Bodies Should Approve Governmental Units' IRSA Guidelines

The governing body of each governmental entity expressly authorized to enter into IRSAs should develop guidelines that must be submitted to designated state legislative and regulatory bodies for approval prior to the entity's use of IRSAs. The guidelines should clearly set forth in detail the governmental unit's purposes and objectives for the use of IRSAs. The guidelines should include, but not be limited to, the following:

a. standards and procedures for the qualification of IRSA counterparties and standards for determining the financial

benefit to be obtained through the use of such agreements. Such standards should address the following:

1. the form of IRSA contracts;
2. interest rate exposure;
3. credit ratings of counterparties;
4. collateralization;
5. exposure limits;
6. the index or indices used to determine the value of the IRSAs;
7. capitalization of counterparties;
8. the procurement process to be used; and
9. the terms for whether IRSAs should be negotiated or competitively bid;

b. requirements that IRSAs be in writing and contain provisions covering payments, security, default and remedies;

c. requirements for periodic internal and independent audits of governmental units' IRSAs;

d. adoption of standards that demonstrate that governmental units utilize managers and financial professionals with appropriate expertise and technical resources in the development and negotiation of IRSAs;

e. limitations on the amount of IRSAs, in terms of notional value, and on the relationship of such amounts to outstanding indebtedness;

f. provisions addressing the roll-over risk and the risk of early termination of IRSAs and provisions for mitigating the governmental entity's exposure thereto;

g. provisions for reporting on IRSAs; and

h. provisions for notice to legislative and regulatory bodies of the proposed authorization of an IRSA, including the proposed terms and conditions thereof.

3. Responsibilities of Governing Boards of Governmental Units

Each IRSA to be entered into by a governmental unit should be authorized in advance by its governing body based upon a written analysis and determination of the following:

a. the necessity or appropriateness of such contract and that the proposed IRSA complies with the governmental entity's guidelines;

b. the benefits expected to be realized through the use of the IRSA and that such expectation is reasonable;

c. the risks presented by the use of the IRSA and the measures to be taken to manage such risks; and

d. that the use of the IRSA is related to the present or future issuance or carrying of its bonds, notes or other obligations or the acquisition or carrying of a program of investment and is not being entered into for speculative purposes.
4. Human Resources, Systems, Monitoring and Reporting Requirements

Each governmental unit expressly authorized to enter into IRSAs should demonstrate to its governing, legislative and regulatory bodies that its IRSAs are structured and monitored by well-trained, responsible persons and that it has adequate resources and systems for monitoring its IRSAs. Each governmental entity should mark its IRSAs to market daily and file at least quarterly with its governing, legislative and regulatory bodies a report regarding the use, status and actual performance of each IRSA relative to its goals.

5. Internal and Independent Audits, Accounting and Disclosure Practices

Each governmental entity expressly authorized to enter into IRSAs should report annually to its governing, legislative and regulatory bodies its practices and procedures for internally auditing its IRSAs for compliance with the governmental entity's guidelines, how and when independent audits are conducted and its accounting procedures, as well as disclosure practices applicable to IRSAs. These governmental entities should develop principles relating to the disclosure standards applicable to IRSAs in connection with their debt offerings and financial reports and statements. Furthermore, such governmental entities should provide the results of each audit, internal and independent, to their governing, legislative and regulatory bodies.

Conclusion

Much of the states' existing legislation governing financial activities of governmental units is in need of revision to reflect current financial developments and economic realities. Even many of the relatively recently enacted statutes expressly authorizing governmental units to enter into IRSAs do not adequately address operational risks that can result from largely unsupervised, unmonitored IRSA activities. State legislatures must meet their responsibility of safeguarding the public fisc by educating themselves in the use of IRSAs, enacting legislation expressly authorizing governmental units to enter into IRSAs and monitoring their use of IRSAs. Until legislatures take these actions, many of the nation's state and local governmental units will continue to operate—significantly less efficiently than necessary or desirable—in search of statutory authority to enter into IRSAs.