Global financial crises and the fate of community and nation:
Using Commons to illuminate the crisis of capitalism

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1. Introduction

Why have economists paid so little attention to the dramatic consequences of recent financial crises: in the United States, the huge but largely invisible foreclosure crisis that has followed the subprime crisis, and the loss of fiscal viability by cities and towns throughout the country; in Europe, the suffering of those with too little to eat, the frustrated futures of the unemployed young with no prospect of jobs? We might as well ask why economists largely ignored the "lost decade" that followed the Latin American debt crisis?

There are two defining features of these major financial catastrophes: first, they have occurred in the neoliberal era – that is, the post-1980 period in which market deregulation and reductions in "safety-net" provisions and public services have prevailed worldwide; second, their successful resolution or lack of resolution have in every case involved sovereign powers and sovereign risks. This essay uses John R. Commons' framework for understanding capitalism to understand some aspects of the consequences that have followed financial crises in the neoliberal era. While Commons did anticipated neither the neoliberal era nor the problem of sovereign debt in his writing, his structured, historically informed approach can shed much-needed light on these contemporary processes.

John R. Commons' theory of capitalism, delineated most completely in his *Legal Foundations of Capitalism* (1924), differs radically from both classical, neoclassical, and New Classical approaches. He bypasses the issue of what constitutes the substance and measure of value, and instead focuses on the historical expansion of the types of transactions that come under the oversight of a sovereign state (and its courts). He then focuses attention on the "working rules" of the "going concerns" – the households, firms, and states – that undertake the activities that result in economic transactions. He pays special attention to the rights, duties, liberties, and exposures to risk that are created in transactions, and to these transactions' hierarchical ordering – the fact that national law defines the character of the transactions that constitute the terrain of the market economy. He sets out a criterion for deciding whether economic transactions serve any given public – any nation – that relies on a collective-action notion of the state and on the idea of commonwealth.

This overlooked approach to the functioning and malfunctioning of capitalism can be used both to better understand the trajectory of events that have accompanied financial crises in the neoliberal era, and to develop an ethical perspective on the apportionment of losses in the wake of those crises. To date, most economists and policy analysts have treated financial crises in the neoliberal era as arising because of perceptual errors, sunspots, bad contract design, and/or problems of contractual compliance. It doesn't matter whether the borrowers in question are individuals, firms, or nations: crises come down to moral-hazard or adverse selection problems, or to perceptual errors. The only consequence of these crises that draws conventional analysts' attention is the problem of contagion.

These conventional approaches ignore the fact that neoliberal-era crises have occurred in a period in which the meaning of sovereignty itself has come under question. Sovereign governments are under pressures from global financial forces that are unprecedented, leaving them unable to act (and to protect the vulnerable) and/or leading to privilege the needs of globally mobile capital over the welfare of their citizens. The 1980s' "triple crisis" in Latin America and the U.S., the U.S. subprime and foreclosure crisis of the 2000s, and the subsequent crisis of the European Monetary Union have involved sequential shifts in what Commons would have identified as the rights, duties, liberties, and exposure to risk of the agents involved: the lenders and borrowers, the wealth-owners, banks, and servicers; the nation-states, and these nation-states' citizens and residents. These shifts have expanded the freedom of action – the liberties – of lenders and wealth-owners and servicers, while reducing rights and imposing more duties on vulnerable households. Shifting legal and economic practices, linked to power asymmetries, have forced sovereigns to focus on preserving orderly financial markets and on protecting the legal rights of the owners of claims on abstract cash flow. As a consequence, states that should be protecting the commonwealth of their citizens have been forced to contract it.

We proceed as follows. Section 2 summarizes some of Commons' ideas about state, market, and community, and considers how these ideas might be adapted to the peculiar circumstances of the neoliberal era. Section 3 then summarizes key aspects of the 1980s "triple crisis:" the Latin American debt crisis; the U.S. savings-and-loan crisis; and the Continental Illinois/oil-patch loan crisis, also in the U.S. These interlocked crises illustrated very clearly the threats to economic stability and national prosperity that were posed by a deregulating financial sector with global reach. The section contrasts the roles of a hegemonic, money-center sovereign (the U.S.) and of weakened (Latin American) sovereign nations exposed to International Monetary Fund (IMF) oversight. We use these two contrasting situations to adapt Commons' model of capitalism to account for the presence of globalizing financial capital. We do this by focusing on Brady bonds. These bonds illustrate how globalized financial firms have used their systematically-important status to structure transactions that undercut the key function of the sovereign as the guardian of the commonwealth. The terrain of transactions now includes elements of force, and not only liberty and duty, with encumbrances not compensated by the performance of important social functions.

Section 4 then turns to the subprime/foreclosure crisis in the United States, with special attention to California. The contractual form of the transactions that dominated in the subprime lending spree routinely violated Commons' criteria, and illustrated the implications of permitting an unregulated, hyper-competing, speculation-oriented financial sector to operate without adequate sovereign oversight. The resulting crisis was resolved, as in the 1980s, with a re-affirmation of the subjection of the nation-state's fisc and powers to its megabanking sector; consequently, the commonwealth shrank and the vulnerable suffered lost homes and broken communities. In consequence, former subprime hot-spots such as California's Central Valley and Inland Empire have been the backdrop for banks' navigation of a new set of profit-making opportunities. The loan modification "sweat box" phenomenon, the eminent domain issue, and bulk sales of REOs come to mind as examples of how the purposive lack of legal direction and banks' ability to resist fair enforcement standards have permitted them to make profit even in the chaotic environments their reckless lending has left behind. The deleterious effects of the subprime/foreclosure crisis on communities as "going concerns" has been overlooked. The fact that this extended crisis has not led to a social explosion can be laid to the fact that it played out in a context whose parameters had been established 20 years earlier, at the beginning of the neoliberal era.

Section 5 then turns briefly to the crisis of the European Monetary Union, with special attention to the case of Greece. The EMU is important because it represents a further step toward the restructuring of the role of the sovereign under neoliberalism. The inability of sovereign states in the EMU to determine their own monetary policies, and to set their own fiscal policies, removes them even further from Commons' ideal of the sovereign as protector of a public commonwealth. To the contrary: some nation-states are unable to protect their public's commonwealth, while other nation-states are insisting that these losses be borne for the good of the whole. Here the contradictions between political coherence and political economic necessity can be seen very starkly through the lens of Commons' historical conception of capitalism. Section 6 then summarizes the argument and reflects on its policy implications.

2. Commons on the economy, commonwealth, and finance

Commons begins his analysis in *Legal Foundations of Capitalism* by making a distinction that is of central importance in our critical discussion of global finance: between real economic activity and the reduction of that activity to an abstraction. One of his examples is between the sum of value of a business's assets and its status as a 'going concern'.[1] The classical and neoclassical approaches to economics are concerned with the former problem; Commons focuses on the tension between the two. As he succinctly puts it, "Economic theory began with a Commodity as its ultimate scientific unit, then shifted to a Feeling, in order to explain a Transaction which is its practical problem." (Commons 1924, p. 5)

His rationale stems from his historically-informed institutionalist approach:

> "Starting … with individuals rather than the working rules of going concerns, [reversed] the historical and the causal sequence" … "the inference is that the working rules were designed by a rational being for the protection of the preexisting rights and liberties of individuals. But, as a matter of fact, the notion of individual rights is historically many thousands of years subsequent to the full development of working rules … [which] are designed primarily to keep the peace and promote collective action and only secondarily to protect rights and liberties." (*ibid*., p. 137)

Commons' interest rests on societies in which virtually all wealth takes the form of privately-owned or state-managed property. He asserts that transactions define economic behavior in any epoch: all activity of any going concern begins and ends with the purchase or sale of goods or services; and this concern's working rules must conform to the rules, obligations, and rights arising from the transactions it undertakes. Transactions are shaped by systems of law. The Anglo-American countries use the "common-law method of making law by the decision of disputes" (Commons 1931, p. 651). If disputes arise, parties that cannot agree will turn to the courts to organize sanctions. The U.S. Supreme Court thus sits at the apex of the economy, in that it declares constitutional what it finds to be reasonable. Commons derives his theory of institutional economics from the decisions of the Supreme Court: "the economists went off on theories of happiness, but

[1] This insight anticipates Jensen and Meckling (1976) by 52 years. However, whereas Jensen and Meckling view ends in the conclusion that business structures should be manipulated so as to maximize the flow of monetary value to owners, Commons centers his view on the firm as a a "going concern."

courts and lawyers continued on the theory of the common law of England and America" (Commons 1936, p. 237). For Commons, then, economic theory has to be based on the relationship of "man to man," not "man to nature." But it is 'reasonable value,' not 'labor value' or 'utility' that can ground institutional economics as the field of "measurable rights, duties, liberties, and exposures to the liberties of others". (*ibid*., p. 242)

"Reasonable value" is not any individual's measure of what is reasonable. It is "the Court's decision of what is reasonable as between plaintiff and defendant. It is objective, measurable in money, and compulsory" (*ibid*., p. 244) "Hence it is not theories that must be obeyed; it is decisions … the decision is a fiat of sovereignty." (*ibid*., p. 245) The court decisions of this sovereign, then, define what is fair, and generate space in which willing buyers and willing sellers can find one another. These decisions also structure rules of four kinds, which delimit the actions of individuals and of going concerns: "a rule of compulsion, or *duty* … [then one that defines] what the individual *can* do … it is a rule of authorization, or *right* ... [a third defining] what he *cannot* do .. [it leaves him] in a condition of *exposure* or danger … [and lastly a rule that] tells what he *may* do … it is a rule of permission, that is, *liberty* …" (Commons 1924, pp. 147-148)

Commons sees "three types of persons, the citizen, the private concern, and the state…" (*ibid*., p. 150).[2] Each, as a going concern, "is more than an entity, it is collective action… it is the working rules that decide the disputes and keep the mass together in support of the rules" (*ibid*., p. 152). So institutional economics is a "nationalist theory of value". (Commons 1936: 246) … "collective action in control of individual action." The nation is defined as a public, which collectively possesses and nurtures the nation's wealth:

> "The public is not any particular individual, it is a classification of activities in the body politic deemed to be of value to the rest of the public, rather than a classification of individuals. Anyone who comes along 'indifferently,' and gets himself into a position where he might perform that class of activity, is the public. His private interests, when he gets in that position, are deemed identical with the public interest." (Commons 1924, p. 329)

It is apparent that Commons views the economy neither through the lens of class conflict or owner-manager conflict; his hope, embedded in his analytics, is that every member of the public can add to the value of goods and services exchanged, thus earning their just desserts and contributing to "the mass together in support of the rules." He introduces the distinction between wealth and commonwealth; the latter term represents the sum of the citizens', private concerns', and state's wealth. It is the nation's asset, to which all should contribute: "The basic principle of the commonwealth … [was] Let any person get rich in so far as he enriches the commonwealth, but not insofar as he merely extracts private wealth from the commonwealth." (Commons, 1924, p. 227)

What can disturb this harmony of interests is the exercise of power; the "power to withhold opportunities is economic power, and associated power is government" (*ibid.*, p. 320)
In an extended discussion (Chapter II in Commons 1924), Commons contrasts power and opportunity, and argues that when economic power is used to extract an extra margin from others,

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[2] He also distinguishes between the state and government: "The state is but one of many going concerns … The 'government' .. is the series of transactions going on between officials and the citizens …" (Commons 1924, pp. 149-50)

then the income earned does not expand the commonwealth. Such power must be restrained by the Courts (the "associated power"), even though it reduces the liberty of those firms or individuals, so as to maximize opportunity. In effect, those who have positional power, in Commons' view, must be induced to focus on activities that increase the commonwealth instead of on activities that restrict the opportunities of less advantageously placed agents.

Commons on the regulation of banking and finance

Commons does not directly discuss the problem of power in finance in *Legal Foundations*, owing largely to his chosen analytical schema. He argues that Western economies have passed sequentially through three stages: an agricultural stage, based on landlord and tenant relations; a commercial stage, based on the creditor and debtor; and an industrial stage, based on employer and employee. He does analyze credit in a 1937 essay that intervenes in a debate about aspects of Keynes' *General Theory.* Commons critiques an economist called Moulton who follows Pigou in arguing that the economic system can achieve reequilibration through downward-flexible prices, via a passive set of adjustments, with the banking system doing its part. This idea of the economy as a self-adjusting machine contrasts with Commons' insistence on viewing the economy as a nexus of contracts. He attacks the passive role that Moulton (and other economists) assign to credit in economic analysis. He observes that credit is not a "flow": "it is an active joint creation by contracts of credits and debits to be liquidated by payments." (Commons 1937, p. 685)

Commons approvingly cites Keynes' remark that it is an "optical illusion" (Keynes 1936, p. 81) that the two acts of saving and credit are one. He writes, "This is a two sided transaction of buyer and seller, made possible by the legal invention of negotiability of debts" ... these are "active" elements of the economy, for which "[f]orecasts of time are of their essence" (Commons 1937, pp. 685-6). Commons comments that the active view he shares with Keynes has rightfully led to strict regulation of finance:

> "Credit regulation in America has already reached into almost every detail of the private banking business. No other business man is entitled to complain more strenuously than the banker against government interference. This public control is coming to be more or less guided with reference to its effects on the general levels of securities and commodity prices." (*ibid*., pp. 689-90)

Taking a "laissez-faire" approach will end, he writes, in "a rather pathetic appeal to big business voluntarily to reduce prices. The pure logic of the argument is inescapable. … Apparently in all fields the business men must actively be taught their own business by government through compulsory school attendance. This education includes the field of credit regulation." (*ibid.*, p. 692) Here we see Commons clearly applying the institutionalist logic of *Legal Foundations*: economic theory that ignores the core characteristics of the really-existing economy leads to self-deception and public policies destructive of the commonwealth. Writing three years after the Roosevelt's 100-day New Deal reforms, Commons' description of "public control" of banking implies that this comes in the wake of an abuse of economic power; but he does not elaborate.

National power, supranational power, community, household

Commons' analysis allows us to analyze finance and crises rooted in credit-market breakdowns from the perspective of the interest of the nation in building its commonwealth and in suppressing excessive economic power through the power of its courts. To adapt his argument for our purpose we must extend his arguments in two directions.

First, Commons leaves untouched is the problem of supranational economic power. He argues in *Legal Foundations* that sovereign powers, once they have established rights in property in a nation, can expand either by "conquest or purchase"… "By international treaties it opens up opportunities and enforces the bargains of its citizens in all parts of the world. By military preparedness and defense it perpetuates these conquests, purchases, and penetrations." (Commons 1924, p. 386) He terms the latter, "political expansion," in contrast to "political economy" – the economic relations of the nation as it is. In effect, he doesn't anticipate any power superior to the nation-state in the realm of law: any set of transactions that the state will not be fully able to regulate as necessary to protect the commonwealth. The issue here is the global expansion of financial relations across borders, by firms that resist national control – and yet that have the capacity to reap great losses on the nations that charter them.

That the world-wide spread of contractual claims on securitized loans and on contingent claims in spot, futures, and derivatives markets could expose nations and their commonwealths to great risk would not surprise Commons; what would alarm him is the view that the nation must admit to a superior legal power in using its courts to protect its citizens' interests.

The second extension we require is to extend the notion of "going concern" to two economic units that escaped Commons' attention: the community and the household. Commons' list of "persons" includes the individual, the firm, and the (national) state. This reflects, perhaps, the great historical sweep of *Legal Foundations*, as well as the profound events of the day in which he wrote. However, it is logical to apply the idea of "going concern" to cities, towns, and neighborhoods, as these are structured entities that support the nexus of wealth generation on which Commons' attention was focused. The shift from "individual" to "household" is a move in line with our time, in which gender and the social relations that sustain everyday life have become visible. Insofar as financial crises can, by undercutting social coherence and everyday lives, affect economic resilience, these additions to the roster of "going concern" are crucial for our purpose.

3. The "triple financial crisis" of the 1980s

Economists tend to focus on the causes of financial crises; and as Reinhart and Rogoff (2013) recently observed, on sovereign debt crises that involve borrowing in foreign currency. When they do, they tend to focus on faulty market mechanisms that could lead arms-length contracts to fail. Further, economists who write about financial crises generally pay little attention to consequences. This section will not review the agency-theoretic literature on the causes of financial crises in the neoliberal era; for that, see Dymski (2011). Here we focus on the consequences of these crises, emphasizing the institutional developments as these unfolded after the outbreak of crisis.[3]

[3] Most conventional economists' accounts of the consequences of debt crises, in any event, pay scant attention to the impact of institutions. For example, in the Reinhart-Rogoff article just cited, the authors calculate that domestic holders of a defaulting government's debt are not necessarily junior to foreign debt holders; they produce a long time series (1800 to 2010) and show that "residents do better" from 1830 to 1900 and then "residents do worse" from 1950 to 2005. This

The U.S. banking system in the post-war period was, through the 1970s, both tightly-controlled (as per Commons' 1937 comment in the previous section) and economically functional. That is, most financial transactions were undertaken by insured depository institutions, and they largely provided credit that supported business activity and home purchases without excessive losses. One area in which the banking system did fall short in meeting financial needs of the commonwealth (as Commons would have put it) was in the widespread use of racial covenants and discriminatory practices, which left residents in minority communities with restricted access to working capital loans, capital, and homeownership (Chiong 2013, Hernandez 2009, Dymski 2006). The passage of the Civil Rights Act in 1964 and the passage of two federal acts mandating community reinvestment in the 1970s led to some progress in opening up access to credit in these excluded communities.

However, before the benefits of this controlled system of finance could be spread to all members of the U.S. commonwealth, several factors combined to throw it into a triple crisis in the early 1980s.[4] High rates of price inflation, combined with two successive recessions and with unprecedentedly high interest rates led, first of all, to a crisis in the housing-finance system. The U.S. system for the provision of home-purchase loans, and for home-loan refinancing, relied on a nation-wide system of savings and loan associations and savings banks (thrifts). These institutions' business model consisted of making and holding long-term mortgages that were supported by local savings deposits. As interest rates spiked, households pulled their savings into money-market funds; thrifts had to borrow funds in the money markets to cover mortgage loan portfolios locked into much lower interest rates. The thrifts were either insolvent or illiquid or both. Hasty deregulation at the federal and state levels led to speculative lending in some states and to bank runs on thrifts in two states (Ohio and Maryland) in 1985.

The second two elements of the triple crisis were intertwined. Money-center banks had been seeking to expand their market share since the 1960s; but these banks had by the late 1970s lost many of their larger borrowers to direct credit markets. The dramatic rise of oil prices in that decade pointed to the rosy prospects of developing-market economies with substantial resources. Most of the money-center banks led lending consortia that competed to expand lending in Latin America. One – Continental Illinois of Chicago – focused its attention on Penn Square Bank in Oklahoma, with over $1 billion loan participations in the U.S. "oil patch" states of Oklahoma, Louisiana, and Texas. The collapse of oil prices in 1982, combined with spiking interest rates, collapsed the "oil patch" states' bubbles, and led first to the July 1982 failure of Penn Square Bank and then to Mexico's default in August. By the end of 1982, a sovereign-debt crisis had spread to six Latin American nations.

The resolution of this triple crisis involved two deviations from Commons' vision of the governance of the national commonwealth. The first was triggered when Continental Illinois was hit by an electronic bank run in May 1984. Temporary assistance was provided by the Federal Deposit Insurance Corporation (FDIC), operating under an "Open Bank Assistance" (OBA) provision that permitted it to assist insolvent banks whose continued existence was "essential" to maintaining adequate banking services in the community. In the 1970s, this mechanism was used for the first

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ignores the fact the literature reviewed here which has focused precisely on the question of how sovereign default costs should be apportioned.

[4] For more detailed accounts of the events summarized here, see Dymski (2011 and 2012).

time, rendering assistance to banks in inner-city communities. As such, the OBA provision can be understood in Commons' terminology as a mechanism for actively intervening in the credit market to insure that all individuals have full access to the opportunities that will permit them to add to the commonwealth. In 1980, this provision was used to assist the 23rd largest bank in the U.S., First Pennsylvania Bank. Given the strict prohibition against inter-state bank acquisitions and the fact that no other Pennsylvania bank was large enough to acquire it, OBA intervention was justified on the basis that it would prevent disruptions in the regional and national banking market. The OBA provision was then used 14 times in the 1981-83 period, and a further 98 times in the 1987-88 period (the peak years of insolvency problems for commercial banks). The key point for our purpose is that this stretching of the OBA provision to include its use against banking market disruptions suggested a broader principle: that government powers could be used to maintain the systemic integrity of the financial system.

On May 11, 1984, two days after the Continental Illinois bank run, Continental borrowed $3.6 billion line at the reserve window of the Federal Reserve Bank of Chicago; this was supplemented on May 14 by a $5 billion line of credit provided by 16 large banks (led by Morgan Guaranty). Several days later, an interim solution involving equity injections by large banks and additional lines of credit was worked out. A buyer was sought; but none was found. The obvious solution was to liquidate the institution. But because it operated in Illinois, a "one-branch" state, Continental was heavily dependent on borrowed funds, provided largely by foreign wealth-holders and large domestic banks. Liquidation would cause losses for liability-holders across the globe. So doing would threaten the access of other large U.S. banks (already weakened by the Latin American debt crisis) to borrowed funds markets. On September 19, 1984, Comptroller of the Currency C.T. Conover testified before Congress that some banks – he mentioned the number "eleven" – had become a new category of bank – it was "too big to fail." He explained: "Had Continental failed and been treated in a way in which depositors and creditors were not made whole, we could very well have seen a national, if not an international, financial crisis, the dimensions of which were difficult to imagine. None of us wanted to find out" (Conover, 1984, page 288). The next day, a *Wall Street Journal* article (Carrington 1984) named the eleven names shown in Table 1. Six days later, on September 26, 1984, the resolution for Continental was announced.

The creation of a "too big to fail" category of large banks imposed a restriction on the capacity of the United States government to regulate the behavior of the corporate persons whose purpose was to enhance the national commonwealth. These entities would be protected even when their precipitous actions – undertaken in part because of their excessive power – subtracted wealth from the commonwealth. This protection began to recognize a power "higher" than that of the nation – that of global financial markets. This led in 1989 to a second contravention of Commons' vision: the creation of Brady bonds with fiscal supports organized by the United States government.

After the 1982 Latin American defaults, several rounds of rolling over the unpaid debt had come to little or nothing. Since the large U.S. banks involved had outstanding unpaid loans that were more than double their capital levels, this constituted a sword hanging over the heart of the U.S. banking system. By 1986, some 15 countries had debt problems. The Baker plan, named after then-Treasury Secretary James Baker, proposed new rounds of bank and international financial institution (IFI) lending to these countries. This plan was not effective, largely because of collective action problems that emerged among creditors: while it was in the interest of all creditors to resolve the debt non-payment problems, any particular resolution might not be in any individual bank's interest. Given the diversity of the characteristics of the creditors involved, and of the contracts they had signed, problems in negotiating as a group and of 'free riding' blocked any progress in finding a universally acceptable solution (Spiegel 1996).

Several analysts, notably Lee Buchheit, explored these problems in depth and shaped the terrain of globalized lending for the next three decades.[5] The point of departure was that the long-held belief that there was a "community of interest among bankers" in what was then called bank "loan sub-participations" had been badly shaken; in the wake of "the Penn Square Bank failure, bankers seem less eager to presume a level of competence and straightforwardness on the part of their fellow bankers" (Buchheit 1986, p. 150), a situation only exacerbated by the recent round of sovereign debt restructurings:

> These worries were present even in 'innocent' days of this market. In practice, these traditional problems recur with a frequency that is sufficient to make their oversight by lawyers hazardous (*ibid*., p. 151)

What blocked Commons' preferred solution was the murky terrain of "conflict-of-laws" (Gruson 1988). Avoiding it requires a finding by one nation's court that the interests of the parties over which it has coverage are more vitally at stake than those of other parties, with the concurrence of all the other national courts involved. This would be unlikely in any one case; and if achieved, unlikely to block future conflicts, given the diversity of contracts and parties involved. This is problematic, in that:

> "Certainty and predictability in contract law and satisfying the reasonable and legitimate expectations of the parties as reflected in their agreement are the primary desires of parties entering into commercial agreements" (*ibid*., p. 561).

Buchheit observed, "if ever there was a time for ingenuity and creativity in managing the so-called 'debt crisis,' now is the time. The conventional remedy … has already been exhausted for many debtor countries. Absent sensible alternative remedies, the possibility of outright default or debt repudiation increases dramatically" (Buchheit1988a) p. 399) He suggests that while events may generate conditions for a "global solution;" here, we "deliberate limit [discussion] to the tactical, rather than the strategic, aspects of the problem." (*ibid*., p. 371)

Buchheit and Reisner (1988) describe as a "fairy tale" a situation before a judicial tribunal where an advocate for a party involved in a sovereign debt restructuring addresses their remarks, "To the International Banking Community":

> "For example, the hundreds or thousands of credits that purport to be covered by a restructuring request will have been separately negotiated between borrowers (both public and private sector) and individual banks or, in some cases, 'syndicates' of banks lending pursuant to a single loan agreement. These banks, located in countries all over the world, are subject to differing regulatory and disclosure regimes, and have distinct lending and credit review policies and widely divergent practices in important areas such as loan loss reserve

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[5] Buchheit, a partner at Cleary Gottleib, remains a key litigator and negotiator in the Eurozone crisis (Moulds 2013).

> provisioning." (*ibid.*, p. 493)

So the international banking community has been forced into "a rather uneasy confederation:"

> "The enormity and complexity of sovereign debt problems preclude individual banks from negotiating adjustments to their own credit exposure in isolation from fellow lenders. Unanimous participation by the banking community in these affairs, however, was thought achievable only if very strict assurances could be given that all similarly situated lenders would be treated equally. The banking community pursued the goal of equal treatment by incorporating into restructuring agreements certain contractual provisions that, in their original form, were designed to regulate the behavior and status of various lenders to a particular borrower. In the restructuring context, however, these provisions are significantly expanded in an effort to regulate the behavior and status of all commercial bank lenders to all borrowers in a debtor country.
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> "The authors emphasize that "patterns of accepted inter-creditor behavior in these circumstances have evolved without any statutory or regulatory guidelines for reorganizing the financial affairs of a sovereign borrower comparable to domestic bankruptcy or insolvency laws.' What has happened, therefore, has happened only through a consensus among the participants, without the benefit of any outside policy-making authority or enforcement mechanism." (*ibid.*, p. 494)

In conclusion, "The effect of the sovereign debt crisis on inter-creditor relationships has been dramatic and rapid. The international banking community has learned to act as a more or less unitary creditor group. The international banking community has also devised methods to suppress anxieties regarding preferential treatment of certain individual banks, encourage unanimous participation in exercises that are by their nature unanimously unpopular, and discipline those members of the community who may show tendencies toward unacceptably unilateral behavior." (*ibid.*, p. 516) It remains to be seen whether "a residual tendency toward collective behavior" (*ibid.*, p. 517) will persist after the current problems are resolved. What is crucial to maintain traction is that "credit agreements should reflect the banks' entitlement to regard themselves as lenders to the country as a whole, not just separate borrowers within the country" (*ibid.*, p. 517)[6]

In March 1989, Brady bonds were created for 13 sovereign nations as a means of resolving the 1980s sovereign-debt crisis, with due consideration to the points made by Buchheit *et al*. Banks were able to unload their sovereign loans, converting them into bonds they continued to hold or selling them off to other investors (in which case some discount was included). Individual contracts were then structured for those carrying on as creditors of existing claims; the U.S. Treasury provided 30-year zero-coupon bonds as collateral in many cases, with borrower countries purchasing these bonds with IMF and World Bank financing or with their own reserves. Payment was in some cases guaranteed by double-AA securities held at the Federal Reserve Bank of New York. Clearly, the diverse resolutions available eliminated the "holdout" problem. While the formal

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[6] Buchheit (1988b) writes skeptically about the potential of debt-to-equity conversions in the same special law review: on one hand, nations will be unwilling to go forward once they perceive the cost of such arrangements; on the other, lenders who convert to equity will lose the protection of the "unitary creditor group" that Buchheit sees as crucial in creating coherent negotiations.

Brady process ended in the 1990s, the mechanisms and conventions created for this program have been carried on after the Brady program officially was terminated.[7]

It is immediately clear that while Brady bonds solved an otherwise unresolvable collective-action problem thrown up by conflicts-of-law, the price of this resolution was to further dilute the place of the nation-state in Commons' vision of the commonwealth. While Brady contracts were agreed separately, they were feasible because of the validation of the power over global finance – and hence over the legal authority of the nation-state – of what Buchheit called a "unitary creditor group." Further, the U.S. banks most involved in this workout were precisely those defined as "too big to fail" in 1984.

The recruitment of the Federal Reserve to the cause of underwriting banks' strategic needs was not restricted to the Brady bond incident. In 1998, the Federal Reserve pre-approved the impending merger of Citibank and Travelers Group, giving the parties an 18-month-window within which the passage of a law removing the Glass-Steagall prohibition of the intermixing of commercial and investment banking would be required. The Gramm-Bliley-Leach (or Financial Services Modernization) Act of 1999 provided the necessary legal change. Insofar as financial deregulation and consolidation had been on the national policy agenda since 1980, the Federal Reserve's action is understandable, if not admirable.

The thrift crisis led to further financial deregulation and to the construction of an almost fully securitization-based system of housing finance. Mortgage companies took the lead; initially, the focused on packaging "plain vanilla" loan offers that FNMA and FHLMC were willing to underwrite and sell off on the mortgage-backed securities market.[8] Deregulation permitted the creation of new savings vehicles, such as private equity and hedge funds, many of them focused on high-return investments. The growth of private-market underwriting and the 1994 invention of credit-default swaps permitted mortgage companies to offer riskier mortgages, with higher rates, trigger clauses, and higher fees and penalties than "plain vanilla" instruments. The market centralized; and the volume of subprime loans and of other forms of predatory lending exploded as the financial markets – at the hub of which were the surviving too-big-to-fail megabanks – expanded the scope and depth of the markets for mortgage (and non-mortgage) securitization. The plentiful liquidity available to Wall Street encouraged megabanks to increase their leverage and off-balance sheet positions: a range of new derivatives markets based on real or synthetic securities provided expanded opportunities for zero-sum speculation.

This brings us to a third development that eroded Commons' nation-state-as-protector-of-the-commonwealth framework in this period. As described in detail elsewhere (Hernandez 2009, Dymski 2006), it was no secret that the subprime and predatory lending emerging in the 1990s was

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[7] According to EMTA (2014), Brady bonds accounted for 61% of all emerging-market debt trading in 1994, though only 2% in 2005. Mexico retired its Brady bonds in 2003,

[8] A mortgage loan is "plain vanilla" when it is adequately collateralized (so that the loan on the property financed does not exceed 80% of that property's market value), when loan-servicing takes a modest share of residents' income (usually a third or less), and when there are no other encumbrances on the property. FNMA (Federal National Mortgage Association, or Fannie Mae) and FHLMC (the Federal Home Loan Mortgage Association, or Freddie Mac) also had maximum loan amounts which varied over time.

often corrosive of the welfare of individuals and households, especially in lower-income and minority communities. A number of initiatives at the state level aimed at blocking the worst lending-market abuses were unsuccessful, as they contravened the U.S. Constitution's interstate commerce clause. The U.S. Congress remedied this by passing the Home Ownership and Equity Protection Act of 1994. However, the Federal Reserve under Alan Greenspan refused to promulgate regulations implementing this act until 2005 – 11 years later – on the basis that the purposes of this Act were not clear (Dymski 2012). By that time, the subprime crisis was just around the corner.

But however unclear may be legislative intent to penalize or reduce predatory lending, Chairman Greenspan need only have looked more carefully at the implications of continuing developments in overseas borrowing markets. The sovereign-debt market continued to grow explosively, even though – as Buchheit (1999) pointed out – the rights and duties of creditors and debtors remain undefined, and bond-buyers tend to be even less well-informed than bankers about underlying risks. All this suggested that a "new financial architecture" for global finance was needed; Buchheit observed that while this had been "talked about at extraordinary length for the last two years, argued "it is not yet clear how many concrete changes the official sector will insist upon and the private sector will accept." (*ibid*., p. 229).[9]

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[9] Aizenman (2002) also warned of the dangers of a hasty plunge into financial opening, especially for emerging-market countries.

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