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Treasury Market and the Debt Ceiling

Treasury expects to reach the limit of its current "extraordinary measures" for funding by October 17. If the debt ceiling were not raised and Treasury reaches its limit for "extraordinary measures", Treasury will only be able to fund government operations through: 1. cash on hand (estimated by Treasury to be about $30 billion at October 17); and 2. revenues (tax receipts etc.).

Timing: A number of factors influence the timing of Treasury's inability to fund government operations and to make payments. Both revenues and expenditures are difficult to predict and the precise date remains unclear. Most expect that Treasury will be unable to meet its obligations some time during the last two weeks of October and the first week of November if the debt ceiling is not raised.

Prioritizing Payments: It is not expected that Treasury could, in order to avoid default on outstanding securities, prioritize payments because of both legal and operational constraints. Treasury processes nearly 100 million payments monthly and has asserted that it will be impossible to make the necessary changes to implement a priority payment system. Treasury, in a prioritization scenario, would need to asses day-to-day who/what programs would be funded sowing both confusion and an inability to plan. It is also unclear if Treasury would have the legal authority to make these choices. In addition, "fire sales" of assets (ie, gold) would disrupt markets and further erode market confidence.

Increase in borrowing costs: If the U.S. were to default on its obligations, the Treasury's cost of funding will rise as investors will require a default premium that will result in Treasury paying higher rates at auctions for Treasury securities to compensate for additional risk. This cost increase could become a permanent cost to taxpayers were investors to view the risk of future defaults differently after a default or extended failure to pay. If Treasury's cost of borrowing were to rise by 50 basis points on a continuous basis, the annual ongoing cost to taxpayers could top $75 billion.

These are not hypothetical concerns: in 2012 the Government Accountability Office (GAO) reviewed the 2011 debt ceiling raise and noted:

"Delays in raising the debt limit can create uncertainty in the Treasury market and lead to higher Treasury borrowing costs. GAO estimated that delays in raising the debt limit in 2011 led to an increase in Treasury's borrowing costs of about $1.3 billion in fiscal year 2011. However, this does not account for the multiyear effects on increased costs for Treasury securities that will remain outstanding after fiscal year 2011. Further, according to Treasury officials, the increased focus on debt limit-related operations as such delays occurred required more time and Treasury resources and diverted Treasury's staff away from other important cash and debt management responsibilities."

Extrapolating from the work of the GAO, the Bipartisan Policy Council found that 10-year costs to the taxpayer of waiting until the deadline in 2011 were estimated to be $19 billion.

Treasury has approximately $370 billion in debt coming due during late October to November 15. Normal procedure would be to rollover this debt but, as noted above, debt ceiling risks include higher interest rates and limited auction participation in rollover auctions.

Possible Downgrades: If the uncertainty continues for long or if the Treasury were to default, further possible downgrades to the U.S. sovereign bond rating could occur. While there was not a clear negative impact from the 2011 S&P downgrade investors may be more likely to pull back this time as concerns about solutions for the long-term fiscal picture would continue. Also, uncertainty remains as to the behavior of some classes of investors as many funds cannot invest in non-AAA rated securities.

Foreign Investors: Default, delays in payments, weakening in prices for Treasury securities and a perception that the U.S. government is unable to deal with either short or long-term fiscal issues, could result in a reduction in foreign purchases of Treasury securities, or sell offs of existing foreign holdings. Foreign investors, most notably foreign official institutions such as governments and central banks, hold 40% of outstanding Treasury debt or about $5.6 trillion of the currently outstanding debt. Foreign investors would be less likely to participate aggressively at auction and may sell current holdings to reduce exposure. This would be consistent with behavior of the foreign investment community noted when the GSEs fell into conservatorship in 2008. Debt ceiling uncertainty may also exacerbate volatility and asset repricing that may be occurring as rates rise due to Federal Reserve tapering.

Financing Market: Disruptions in the $4 trillion Treasury financing would further raise borrowing costs. Treasuries are the world's safest asset and are widely used as collateral for both risk mitigation and financing. Shrinkage in the financing market would further pressure rates as haircuts on Treasuries would increase—thus reducing financing capability—and disrupt the collateral market because of margin calls throughout the financial system that would reflect the repricing of Treasury collateral.

Operational Disruptions: While the current operational infrastructure in the Treasury market provides challenges with respect to Treasury delays in payments/defaults, SIFMA has reviewed a number of default scenarios from an operational perspective and based on our work, we believe that market participants are operationally prepared to deal with the scenarios that a Treasury failure to pay would present. In order to reduce operational risk as much as possible, advance notice of a failure to pay on Treasury securities would be beneficial. Howver, market participants continue to pursue additional solutions to reduce any operational risks and understand that the triparty repo market will be able to continue to support securities with extended payments regardless of the timing of notice..

Economic Impact: Rising rates caused by all the factors above would have damaging consequences on the fragile economic recovery. Treasury security rates are the benchmark through which all other credit throughout the economy is priced. As rates in the Treasury space increase, interest rates across the economy would rise, including rates for home mortgages and small business loans, with many losing access to credit altogether. The impact of the reduction of credit availability could be severe, particularly during an economic expansion that is both weak and fragile.