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WASHINGTON POLICY STRATEGY

Potomac Perspective

As the Memorial Day weekend approaches, a debt ceiling deal might be announced in the next 48 hours. The announcement could have a positive impact on financial markets but given the muted response so far to negative debt ceiling headlines, any rally would probably be similarly muted. If Washington fails to reach a deal in the next few days, policymakers have some contingency plans – especially for the banking system. We take a look at a few of these plans.

Ahead of the Memorial Day holiday, profound thanks to all who have made the ultimate sacrifice in defense of freedom and liberty.

What if There is No Deal: Contingency Plans for a Possible Default – Although the chance of a default on U.S. Treasuries is remote even if the government reaches the X-date (the date when the Treasury Department exhausts its extraordinary measures to manage the debt ceiling and might lack enough cash to pay all its obligations), the possibility cannot be totally dismissed. Prioritizing thousands of payments is a monumental task and government IT systems are not state of the art. A recent glitch with Federal Aviation Administration computers that caused a ground stop of U.S. commercial flights and the crash of the Obamacare website when it was rolled out in 2013 are but two examples of government computer systems failing to operate at optimum levels. So, a computer error, which leads to a default, is possible. That raises the question of what happens next.

It is nearly impossible to look at all the implications of a default, but we attempt to look at what could happen to banks that hold U.S. Treasuries on their balance sheet and what might happen in situations where Treasuries are loan collateral.

According to the transcript of an October 2013 Federal Open Market Committee (FOMC) conference call, the Federal Reserve and other banking regulators had prepared guidance prior to the 2011 and 2013 debt ceiling standoffs, but that guidance was never issued. **Banks and investors could expect to see a press release from the regulators which will state that if Treasury misses a bond payment, the supervisory and regulatory treatment of Treasury securities and other securities issued or guaranteed by the U.S. government or its agencies (i.e., government sponsored enterprises) and held in investment portfolios will not change the asset's risk-based capital treatment. According to the 2013 transcript, bank examiners would not criticize or adversely reclassify U.S. Treasuries owned by banks.**

While banking regulators cannot make a similar statement regarding Treasuries that are utilized as collateral, the regulators' guidance could be a powerful message to counterparties to continue to accept U.S. Treasuries as collateral even in the unlikely event there is a default on one or more issues.

The timing of when the regulators would issue such guidance is unclear. The banking regulators might not release it until after an actual default on a U.S. Treasury security or until after a missed payment for another obligation. However, based on the 2013 FOMC transcript, banks and bank investors should expect regulatory guidance if the government misses a payment of some type.

Potential Timing of a Deal – *Punchbowl News* reported that House Republicans seem confident that the Biden administration will reach a debt ceiling agreement with House Republicans in the next few days. If true, this could set up a vote sometime next week. If a deal is announced today, Congress could vote as soon as Tuesday (the House is out of session next week but could be called back). If an agreement is not reached until the weekend, a vote would not occur until the following weekend (June 3-4).

There is a degree of urgency to reach an agreement, but it seems to be less than what pushed Washington to a deal in 2011. This diminished anxiety could further delay the completion of negotiations. There are several reasons that the environment seems less anxious than in 2011.

First, there has been little pressure from the financial markets. Equity markets have sold off the past two days but the roughly 1.4% decline in the S&P 500 on Tuesday and Wednesday pales in comparison to the approximately 18% selloff in the index that occurred in July of 2011. Markets could sell off further, especially if Washington fails to raise the debt ceiling by the X-date and Treasury misses a payment on some obligation. For now, the markets believe Washington will reach a deal and this faith has actually reduced pressure on lawmakers to reach the anticipated agreement.

There have also been questions among some lawmakers about when the X-date will actually occur and what the ramifications of reaching the X-date without a deal would mean. One possible result of failing to raise the debt limit before the X-date could be a downgrade of the credit rating of the U.S. government. However, the prospect of a downgrade raises the question of how a downgrade would impact interest rates and markets. Despite warnings in 2011 that a downgrade would lead to higher interest rates, the bond market rallied and rates fell following S&P's downgrade. That was due, in part, to a sovereign debt crisis in some Eurozone countries which led to a flight to perceived safety and a rally in U.S. Treasuries, but even after the European situation stabilized, the U.S. remained in a low interest rate environment. This time could be different as rates are now higher and the U.S. is in an inflationary environment, but there is a legitimate question about whether a downgrade of the U.S. government's credit rating would impact interest rates. This uncertainty could be contributing to the muted market response which, up to this point, has reduced pressure on Washington to reach a deal.

Finally, public polling has delivered mixed message and does not seem to be increasing pressure to reach a deal. A CNN poll found that 60% of voters said that spending cuts should be part of an increase in the debt ceiling. This contrasts with an NPR/NBC/Marist poll in which 52% of voters said Washington should raise the debt ceiling first and cut spending later (42% said cut spending along with a debt ceiling hike). The NPR poll showed that the public would blame both sides roughly equally if an agreement was not reached. House Republicans have seen the CNN poll as validation for their position. They view the split decision on who voters would blame as evidence that the White House and Democrats are not in as strong a position politically as they typically are in debt ceiling showdowns. This has emboldened congressional Republicans to not capitulate.

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