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ALERT MEMORANDUM

What Happens If Congress Fails to Raise Or Suspend the Debt Ceiling: How Market Participants Can Prepare for a Worst Case Scenario

January 25, 2023

On January 19, the U.S. government reached the statutory borrowing limit, otherwise known as the "debt ceiling." As the U.S. Treasury Department once again begins using "extraordinary measures" to prevent a default, financial market participants may consider taking steps now to plan for the U.S. government to delay or fail to meet its payment obligations. Although unlikely, particularly with regard to U.S. Treasury securities, such a scenario could affect a wide array of financial institution operations, including funding and collateral arrangements.

Fortunately, trade associations and financial market infrastructures have developed operational plans to address this scenario. As a result, if market participants prepare now, they may be able to mitigate a number of the most significant consequences.

This Alert Memorandum includes three parts. Part I presents an overview of how the debt ceiling works and what may happen if Congress does not raise or suspend the debt ceiling by the time the extraordinary measures are no longer sufficient. Part II sets out a high-level summary of how this scenario could affect U.S. Treasury securities from an operational perspective. Part III then lays out a number of steps market participants could consider taking over the next few weeks to mitigate the effects of this scenario.

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I. Background on the Debt Ceiling

— The debt ceiling is the statutory limit on the total amount of allowable outstanding U.S. federal debt. The United States hit the current debt ceiling on January 19, 2023.

— Generally, when the debt ceiling is reached, the Department of Treasury uses a variety of "extraordinary measures" to avoid delaying payments on the government's obligations.[1] These will likely include: (1) redeeming existing, and suspending new investments of the Civil Service Retirement and Disability Fund (CSRDF) and the Postal Service Retiree Health Benefits Fund (Postal Fund), and (2) suspending reinvestment of the Government Securities Investment Fund (G Fund) of the Federal Employees Retirement System Thrift Savings Plan.[2] However, the Department of Treasury estimates that cash and extraordinary measures may be exhausted as soon as early June, in which case the federal government will be unable to pay all of its obligations unless Congress raises or suspends the debt limit before then.[3]

— The United States has not experienced a large-scale default.[4] Thus, there is a great amount of uncertainty about the consequence of such an event. The Department of Treasury may attempt to avoid or delay default on U.S. Treasury securities by continuing to make timely principal and interest payments while delaying payments for all other obligations.[5] However, it is not clear whether such a step would be possible, palatable or legal.

II. Operational Implications of a Treasury Debt Payment Delay

— Prior debt ceiling stalemates have prompted a number of market participants, financial market infrastructures, and trade associations to prepare for a delay or failure by the U.S. government to meet its debt obligations.

— Of particular note, the Treasury Market Practices Group (the "**TMPG**") has set out how a delayed payment on U.S. Treasuries may affect the Fedwire Securities Service, which is the system through which Federal Reserve Banks effectuate transfers of U.S. Treasury securities.[6]

— In addition, the Securities Industry and Financial Markets Association (the "**SIFMA**") previously issued a number of materials outlining its playbook for a payment delay as well as an overview of potential scenarios.[7]

— We encourage market participants to review these materials with their operations colleagues. At a high level:

- ***A delay by the U.S. government to meet a coupon payment should not affect the transferability of the relevant U.S. Treasury***

1 See, e.g., Department of Treasury, Description of Extraordinary Measures, Jan. 19, 2023, at https://home.treasury.gov/system/files/136/Description_Extraordinary_Measures-2023_01_19.pdf.

2 Letter from Janet L Yellen to the Honorable Kevin McCarthy, Speaker of the U.S. House of Representatives, Jan. 13, 2023, at https://home.treasury.gov/news/press-releases/jy1188.

3 Id.; see also Remarks by Assistant Secretary for Financial Markets Joshua Frost on the Historical and Current Perspectives on the Debt Limit at the Federal Reserve Bank of New York's Annual Primary Dealers Meeting (Dec. 1, 2022), at https://home.treasury.gov/news/press-releases/jy1136 (describing the difficulty of forecasting the date at which cash and extraordinary measures will be exhausted).

4 The Treasury Department has previously failed to make timely payments to some small investors in 1979, though the incident is considered more of an inadvertent payment delay due to back-office technical and organizational problems. See D. Andrew Austin, Has the U.S. Government Ever "Defaulted"?, 12-19, CRS Report No. R44704.

5 See Wendy Edelberg and Louise Sheiner, How worried should we be if the debt ceiling isn't lifted?, Brookings, Sept. 28, 2021, at https://www.brookings.edu/blog/up-front/2021/09/28/how-worried-should-we-be-if-the-debt-ceiling-isnt-lifted/ (describing a contingency plan of the Department of Treasury from 2011); Grant A. Driessen, The Debt Limit, CRS Report No. IF10292 (describing the possible economic and fiscal consequences of the debt limit).

6 TMPG, Operational Plans for Various Contingencies for Treasury Debt Payments, December 2013, at https://www.newyorkfed.org/medialibrary/microsites/tmpg/files/Operations_Contingency_Plans.pdf (last visited Jan. 17, 2023).

7 SIFMA, Delay in Treasury Payments: Discussion of Scenarios, at https://www.sifma.org/resources/general/delay-in-treasury-payments-discussion-of-scenarios/ (last visited Jan. 17, 2023).

securities over Fedwire. Rather, the securities would remain on Fedwire. Once the debt ceiling is raised, the coupon payment would be made to the institution that was the holder of record as of the close of business on the date immediately preceding the originally scheduled coupon payment date (i.e., the person that would have received payment had there not been a payment delay).

- ***So long as the Department of Treasury provides the Federal Reserve Banks with notice that the U.S. government will miss a principal payment before Fedwire's end-of-day processing on the day before the principal payment date, the systems can be updated so that the operational maturity date of the securities can be postponed***. In such an instance, the securities would remain transferrable through Fedwire. When the Department of Treasury ultimately makes the principal payment, the payment would be made to the holder of record as of the close business on the day before the actual principal payment is made (i.e., the person who would have been entitled to the principal payment had the maturity date actually been postponed).
- However, in the unlikely event the Department of Treasury fails to provide such notice before the end-of-day process, the securities would become "frozen" and non-transferrable.

— We understand from past informal discussions that clearing banks and central counterparties have developed procedures to try to align their systems with Fedwire's procedures and facilitate the continued transferability of U.S. Treasury securities subject to a payment delay.

— ***Nearly all market participants will need to make manual interventions in order to ensure that their systems align with the Fedwire processing described above.*** Market participants should consider touching base with their service providers, including their clearing banks and central counterparties, to confirm that their operations are aligned.

III. Key Considerations for Market Participants upon a Treasury Debt Payment Delay

— Although substantial work has been done to address many of the operational challenges of a U.S. government payment delay, market participants should also consider the various legal implications. These considerations are wide-ranging, but we have sought to summarize a few critical points below. The below summary does not address additional implications if U.S. Treasury securities are "frozen" in Fedwire, as that will present additional legal and regulatory considerations and seems quite unlikely given the steps that have been taken to ensure U.S. Treasury securities remain transferable.

— ***Would U.S. Treasuries remain good collateral/margin?*** Market participants may wish to determine whether they can continue to collect or post U.S. Treasuries as collateral. In many cases, this question will have a number components:

- *Does the relevant documentation allow the posting of U.S. Treasuries following a payment delay?* The answer to this question will generally depend on the terms of particular agreement. Fortunately, many industry agreements do not require that U.S. Treasury securities be performing in order to be eligible collateral. However, it is possible that these terms could be modified in the applicable schedule or annex to the agreement.

- *Do the relevant regulations permit the posting and collection of U.S. Treasuries following a payment delay?* As a general matter, both the uncleared swaps margin rules promulgated by the Commodity Futures Trading Commission and prudential regulators and Regulation T and FINRA Rule 4210 appear to treat U.S. Treasury securities as eligible collateral, regardless of whether they are non-performing.[8] Nonetheless, firms will need to consult all margin and other regulations applicable to them, including in particular non-U.S. margin rules.

- *Are the securities appropriately valued?* Even if U.S. Treasury securities remain good collateral/margin, they will need to be marked to market in accordance with the terms of the relevant documentation and applicable regulations, which may present challenges if a payment delay results in stressed market conditions.

— ***How would U.S. Treasuries be treated for capital purpose following a payment delays?*** As a general matter, the U.S. implementation of the Basel capital and liquidity standards and the net capital rules applicable to broker-dealers, swap dealers and futures commission merchants generally do not require U.S. Treasury securities to be performing in order to receive favorable treatment. Nonetheless, there may be exceptions for firms subject to the banking regulators' advanced approaches[9] or non-U.S. regulations.

- The federal banking agencies' capital rules implementing the Basel standardized approach capital framework ("Bank Capital Rules") assign a 0% risk weight[10] to any exposure to the U.S. government, which would not change in the event of payment delay by the U.S. government.[11]
- U.S. government debt is treated as a wholesale exposure under the advanced internal models-based approach. These internal models take into account past performance of asset classes when determining total risk weighted assets. U.S. government debt has traditionally been risk weighted at 0% under this approach; however, a U.S. government payment delay could potentially impact the capital requirements generated under the advanced internal models-based approach which must take into account historical performance of an asset.[12]
- The federal banking agencies' liquidity rules regarding the liquidity coverage ratio (or "LCR") treat U.S. Treasury securities as high-quality liquid assets, even in the event of a payment delay.[13]
- The deductions from net capital applicable to U.S. Treasury securities and obligations secured by U.S. Treasury securities under the net capital rules of the Commodity Futures Trading Commission (the "**CFTC**") and Securities and Exchange Commission (the "**SEC**") do not depend on whether the securities are performing or not.[14]

— ***Following a payment delay, how would U.S. Treasuries be treated for purposes of Sections 23A and 23B of the Federal Reserve Act, the single counterparty credit limits and national bank lending limits?*** Sections 23A and 23B restrict "covered transactions" between a bank and its affiliates. As collateral for a credit exposure,

8 See 17 CFR § 23.156(a)(1)(ii); 12 CFR § 237.6; 12 CFR Part 220; FINRA Rule 4210(a)(6); 15 U.S.C. § 78c(a)(12).

9 The advanced approaches is applicable only to the nine banks designated as Category I and II under the Federal Reserve's enhanced prudential standards.

10 We note that the Bank Capital Rules treat non-U.S. sovereign debt in a different manner from U.S. sovereign debt, and a default of a non-U.S. sovereign may significantly increase the risk weight to be applied to obligations of the defaulted sovereign. If other nations have implemented similar rules, then it is possible that non-U.S. banks and other financial institutions subject to local capital rules may have to treat U.S. sovereign debt differently if the U.S. government were to delay its payments.

11 12 CFR § 217.32(a)(1) (standardized approach).

12 12 CFR § 217.131.

13 12 CFR § 249.20(a)(4); 12 CFR § 217.131.

14 17 CFR § 1.17; 17 CFR § 23.101; 17 CFR § 240.15c3-1; 17 CFR § 240.18a-1; 15 U.S.C. § 78c(a)(12).

U.S. government securities can cause an otherwise covered transaction to be exempt from the quantitative limits and collateral requirements in Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve's Regulation W, without regard to a payment delay by the U.S. government.[15]

Holdings of U.S. Treasuries are also exempt from the Federal Reserve's single counterparty credit limits on the basis of their 0% risk weight under the Bank Capital Rules, which should be unaffected by a payment delay (as discussed above).[16] The treatment of U.S. government securities with respect to national bank lending limits would similarly be unaffected by a payment delay.[17]

— ***How may a payment delay for U.S. Treasuries affect central counterparties?*** Participants in cleared transactions should proactively communicate with their clearinghouses in order to determine whether they may post, either as initial margin or as clearing fund, securities in respect of which a payment delay has occurred. In many instances, clearing organization rules provide the clearing organization with discretion to manage financial stress.

Can I continue trading with counterparties? Firms may wish to consider whether their trading counterparties, such as money market mutual funds subject to SEC Rule 2a-7[18] and pension plans, can provide funding secured by securities with respect to which a payment delay has occurred. In certain cases, the rules may not provide clear guidance on this issue.

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15 12 CFR § 223.42(c). Section 23A and Regulation W also restrict purchases of low-quality assets by a bank from its affiliates and the use of low-quality assets as eligible collateral for covered transactions subject to collateral requirements. "Low-quality assets" are defined to include assets on which the principal or interest payments are more than 30 days past due, and a payment delay by the U.S. government lasting longer than 30 days seems remote. Moreover, the Federal Reserve has discretion to interpret the scope of "low-quality assets" under Section 23A to clarify and preserve the status as U.S. government securities as cash-equivalent, high quality assets.

16 12 CFR § 252.71(e)(4). Gross credit exposure collateralized by U.S. Treasuries is also exempt through "risk-shifting" provisions in the regulation.

17 12 CFR Part 32.

18 17 CFR § 270.2a-7.