Federal Reserve System

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To: Federal Open Market Committee

From: Bill English and Brian Sack

Subject: Potential Policy Responses to the Debt Ceiling

With the federal debt ceiling binding and the Treasury running out of the additional borrowing capacity it can achieve under various accounting procedures, a technical default on Treasury securities cannot be ruled out. The staff discussed this possibility at the last FOMC meeting and highlighted some of the market pressures that could emerge in response to, or even in anticipation of, a technical default on Treasury securities. During that discussion, some FOMC participants expressed an interest in receiving additional information on how the Federal Reserve could respond in such a situation. This memo describes the potential responses by the Federal Reserve and makes some recommendations on them.

The potential responses include decisions on how defaulted securities will be handled in routine operations—including open market operations, securities lending transactions, and discount window lending—as well as actions that could be taken specifically in response to market strains resulting from a Treasury default. Some of these responses are covered in the current authorization that the FOMC has given to the Open Market Trading Desk at the Federal Reserve Bank of New York (the Desk), while others would require additional authorization. Decisions about the discount window instead reside with the Board of Governors and the individual Reserve Banks, but these decisions are included in the discussion because they serve similar purposes to some of the actions that could be taken by the Desk.

We begin by describing how defaults could affect five routine policy actions that are permissible under the Federal Reserve Act and fall within the current authorization of the Desk and the authority of the Reserve Banks. The relevant issue for these actions is the treatment of defaulted Treasury securities – that is, securities that are experiencing a delay in principal or interest payments due to the debt ceiling. The staff's recommendation is to make no changes to our current procedures, thereby treating defaulted Treasury securities in these transactions on the

same terms that apply to other (non-defaulted) Treasury securities. This approach would send a signal to the market that we continue to view principal and interest for these securities as backed by the full faith and credit of the U.S. government. Moreover, in many cases, this approach would help the market cope with the pressures that could emerge in such circumstances.

1. **Outright purchases of Treasury securities.** The Desk will be conducting outright purchases of Treasury securities as part of the ongoing reinvestment of principal payments on agency debt and agency mortgage-backed securities (MBS). At those operations, market participants could offer the Desk defaulted securities unless the Desk's procedures were explicitly changed to exclude them. (Only defaulted securities with missed coupon payments are an issue here, as the Desk already excludes from its operations securities with short maturities, which would include securities with missed principal payments.) Under existing procedures, defaulted securities could account for a large share of the accepted offers in our purchase operations, especially if they cheapen relative to non-defaulted securities or if market participants want to get them off of their balance sheets. Of course, our purchases would still be very small relative to the amount of defaulted securities in the market.[1] Nonetheless, continuing to accept these securities could allow the operations to help market functioning and would not change the characteristics of the SOMA portfolio in any meaningful way. Accordingly, unless otherwise directed by the Committee, the Desk intends to accept defaulted securities in these operations in the same manner as other Treasury securities, with the prices determined through competitive bidding.

2. **Rollovers of maturing Treasury securities.** There are some circumstances in which the Desk might not be able to roll over maturing holdings of Treasury securities into new issues at auction. For example, this issue could arise if Treasury were to delay an auction while still making principal payment on maturing securities (so that the settlement date of the auction did not coincide with the maturity date of our holdings). It is also possible that, if the sizes of Treasury auctions had to be reduced significantly to stay under the debt ceiling, the Desk could be constrained by its long-standing limit to obtain no more than 35 percent of a newly issued security at auction, or Treasury could ask the Desk to reduce SOMA's rollovers to an

[1] About $1.5 trillion of Treasury securities have a coupon payment on August 15, and another $600 billion have a coupon payment on August 31.

amount below 35 percent in order to maintain a steady size of newly auctioned securities to the private sector.[2] If the full amount of maturing holdings cannot be rolled over, the Desk intends to purchase securities in the secondary market to make up for the lost rollovers, as required under the current directive, unless otherwise directed by the Committee.

3. **Securities lending activity.** Market participants might want to offer the Desk defaulted Treasury securities in exchange for other (non-defaulted) Treasury securities in the Desk's regular securities lending operations. They may be particularly inclined to do so if defaulted securities were experiencing poor liquidity in cash or financing markets, or if such securities were facing higher haircuts or exclusion as collateral in other transactions. Allowing dealers to conduct this exchange would support their ability to maintain regular activities in the market. Unless the Committee directs otherwise, the Desk intends to accept defaulted securities in its securities lending operations, and the defaulted securities taken as collateral in these operations would continue to be assigned full market value with the same haircuts as non-defaulted securities. In addition, the Desk could consider changes to the program, such as a loosening of the per dealer limit, to allow the facility to be used more aggressively.

4. **Repurchase agreements.** It is possible that deterioration in the functioning of the Treasury repo market will create a need for funding that would put upward pressure on repo rates and other short-term interest rates. Under the current directive, the Desk would need to inject reserves through repurchase agreements (RPs) if the federal funds rate threatened to move above 25 basis points. RPs against Treasury collateral would directly address the market strains that may emerge, as it would allow dealers to fund Treasury positions that might be difficult to finance in the repo market. If such operations prove necessary, the Desk intends to accept defaulted Treasuries as collateral at market prices and on the same terms as non-defaulted securities, unless otherwise directed by the Committee.

[2] This limit could be loosened, similar to the decision to relax the 35% limit on our holdings of any given issue for the asset purchase program. However, the 35% limit at auction applies to all other market participants, and hence the Desk is not inclined to loosen it at this point. Moreover, the Treasury might have concerns with the Desk taking such sizable amounts of its auctions.

5. **Discount window lending.** Depository institutions may also face unexpected funding needs if the ability to finance Treasury collateral in the repo market were to become impaired or if broader funding market pressures emerged. The discount window could serve as an effective vehicle for providing such funding directly to these institutions. In these circumstances it would seem appropriate for the Federal Reserve to accept defaulted Treasury securities as discount window collateral with appropriate valuations and haircuts.[3]

Next, we consider two potential policy actions that use traditional monetary policy tools but that could require additional authorization from the FOMC to the Desk. These options involve using repurchase agreements or reverse repurchase agreements (RRPs) to address developments in the Treasury repo markets that are not causing the federal funds rate to move outside of its target range. Given the extraordinary circumstances that could be facing the Treasury market and the ability of the Desk to address them through its operations, the staff believes that these options should be given serious consideration if market conditions were to become impaired.

6. **RRPs to address negative Treasury bill and repo rates.** At the last FOMC meeting the staff raised the possibility that Treasury bill and GC repo rates could become negative as bill supply is squeezed ahead of the debt ceiling. It is difficult to determine whether such rates are likely to induce significant strains on market functioning, or whether the market would simply clear at these low rates and still function reasonably well. If market functioning became a concern, the Desk could likely raise Treasury bill and repo rates above 0 percent, without missing the federal funds target rate, by conducting RRPs against SOMA's Treasury holdings. The staff recommends the FOMC consider moving in this direction if negative interest rates appear to be inducing meaningful problems for market functioning.[4]

[3] Depending on the extent of market disruptions, it might be appropriate to cut the primary credit rate in order to ease pressures on banks and other financial firms that could result in adverse macroeconomic effects. Because of stigma associated with discount window borrowing, it could be helpful to issue a statement indicating that the discount window is available to address funding needs as has been done at times in the past. One could also consider setting up a separate facility to provide funding specifically against Treasury collateral at a rate below the primary credit rate.

[4] Another alternative here is to consider a securities lending facility that would take agency debt and agency MBS as collateral in exchange for Treasury collateral, as was the case for "schedule 1" transactions in the Term Securities Lending Facility.

7. **RPs to address pressures in the Treasury repo market.** It is possible that the repo rate will come under much more upward pressure than the federal funds rate, since it is the Treasury repo market that could be particularly disrupted. Thus, we cannot rule out circumstances in which the repo rate moves up meaningfully while the federal funds rate is still in its target range. Because the Desk's authorization to conduct RP agreements is tied to the directive for keeping the federal funds rate within the target range, it is not clear that the directive provides a reason to conduct RPs in such circumstances. However, RPs against Treasury collateral could be very effective at addressing some of the market strains that would be present. The staff recommends that the Committee consider such operations if pressures in the RP market became substantial and were having detrimental consequences for broader market functioning.

New liquidity facilities also could be considered if the pressures related to the debt ceiling were to persist or extend to a broader set of market participants. The staff would need to see where such pressures emerge before considering the appropriate response. One example of such a facility would be to provide support for money market funds.

8. **Support for money market funds.** It is possible that Treasury-only money market funds could experience a decline in the value of their holdings or missed principal and interest payments on those holdings. At the same time, they could face redemptions as concerned investors pull away from all investments related to Treasury securities. This combination could create a liquidity squeeze for those money market funds, potentially leading to abrupt sales of Treasuries into distressed markets at inappropriate prices. In such a situation, a facility might be developed to provide liquidity to money funds.[5]

Lastly, the FOMC could consider policy responses that involve outright operations aimed specifically at defaulted Treasury securities. These options would be warranted if the FOMC determined there was a need to escalate its support of market functioning as much as possible in response to a technical default on Treasury securities. However, such an approach would insert the Federal Reserve into a political situation and could raise questions about its independence from debt management issues faced by the Treasury. Thus, the staff assumes that

[5] Such a facility could be authorized under Section 13(3) of the Federal Reserve Act and under the provisions of the Dodd-Frank Act, would require approval by the Treasury Secretary.

the FOMC would not be interested in pursuing these options, but they are presented for completeness.

9. **Purchase operations to remove defaulted Treasury securities from the market.** To limit the negative impact of defaulted securities on market functioning, the FOMC could decide to purchase a specified amount of these issues from market participants. These purchases would be in addition to those associated with reinvestments (the first policy issue described above). This approach would help market functioning if cash market liquidity were to deteriorate and participants were otherwise unable to sell their Treasury holdings. Moreover, in contrast to the financing operations discussed above, outright purchases remove the securities from firms' balance sheets, so that the firms no longer have to deal with the operational issues associated with defaulted securities. Unless offset by other actions, such operations would increase the size of the SOMA portfolio and the amount of reserves in the banking system.

10. **Outright CUSIP swaps to remove defaulted Treasury securities from the market.** One way to avoid the effects of additional purchase operations on the size of the Federal Reserve's balance sheet and the amount of reserves is to do them as CUSIP swaps. A CUSIP swap would be an operation in which the Desk simultaneously (or at least on the same day) bought a defaulted Treasury security and sold a non-defaulted Treasury security. This operation would be roughly neutral in terms of the size of the SOMA portfolio and the amount of reserves in the banking system. It could also be designed to limit any change in the duration risk of the SOMA. This approach has similarities to securities lending operations against defaulted Treasury collateral (the third policy issue described above), only in this case the operation would remove the defaulted securities from the market permanently. The terms of these operations would be determined through competitive bidding.

The staff intends to prepare for the debt ceiling contingency in a manner consistent with the recommendations listed in items 1 through 5 above. If you have any comments, concerns, or suggestions on this approach, please send them to us by Monday, July 25. If events unfold in a manner in which a broader set of policy responses could be appropriate (including any actions

from items 6 through 10 above), a conference call will be arranged for Committee members to discuss possible options.