# The Federal Reserve System

**Date:** October 11, 2013

**To:** Federal Open Market Committee

**From:** Bill English and Simon Potter

**Subject:** Potential Policy Responses to the Debt Ceiling

We once again face the case where the limit for the Federal debt ceiling will soon become binding and the Treasury is quickly running out of the additional borrowing capacity it can achieve under various accounting procedures. Under these circumstances, the chances for a technical default on Treasury securities through missed or delayed principal or coupon payments cannot be ruled out. The staff discussed this possibility and potential Federal Reserve policy responses in a memo to the Committee in July 2011.[1] This memo revisits the potential responses considered in 2011, considers additional options, and makes some recommendations.

As in 2011, the potential responses include decisions on how securities with delayed payments 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 delayed payments on Treasury securities or market participants' reactions to a higher probability of such an event that could have significant consequences for financial stability or the economy. Some of these policy 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 delayed payments could affect five routine policy actions that are permissible under the Federal Reserve Act and fall within the current authorization of the

[1] See Bill English and Brian Sack "Potential Policy Responses to the Debt Ceiling" memo to the FOMC, July 19, 2011.

Desk and the authority of the Reserve Banks. The transcript of the Committee discussion in 2011 suggests that there was broad support for these types of actions, should they prove necessary, without any change to the current procedures. Underlying each of these actions is the premise that the Federal Reserve would continue to accept Treasury securities with delayed payments in these transactions at their (potentially reduced) market values and on the same terms that apply to other Treasury securities.[2] This approach seems appropriate because we continue to anticipate that after a relatively short delay, all Treasury securities will be paid in full, and so the securities remain very low risk. These five actions could help the market cope with the pressures that may emerge in the event of a technical default.

1. **Outright purchases of Treasury securities.** The Desk is currently conducting outright purchases of Treasury securities as part of the open-ended purchase program. At these operations, market participants could offer the Desk securities with delayed payments, unless the Desk's procedures were explicitly changed to exclude such securities. (Only securities with delayed <u>coupon</u> payments are applicable here, as the Desk already excludes from its operations securities with short maturities, which would include securities with delayed <u>principal</u> payments.) Under existing operating procedures, securities with delayed payments could account for a large share of the accepted offers in our purchase operations, especially if they cheapen relative to other Treasury securities or if market participants want to get them off of their balance sheets. Of course, while bigger than they were in 2011 when the Desk was only reinvesting the proceeds of maturing securities, our monthly purchases would still be very small relative to the amount of affected securities in the market.[3] Additionally, since the schedule of purchases is preannounced, the timing of those purchases may not coincide with periods of heightened stress. Nonetheless, continuing to accept these securities could allow the operations to help market functioning to some extent 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 securities with delayed payments in these operations in the same manner as other Treasury securities, with the prices determined through competitive bidding.

[2] This would be consistent with the intended supervisory treatment which is to maintain the same risk weights for such assets for supervisory purposes.
[3] About $775 billion of Treasury securities have a coupon payment on October 31, and another $1.7 trillion have a coupon payment on November 15.

2. **Rollovers of maturing Treasury securities.** As a result of the Maturity Extension Program, SOMA holds only minimal amounts of securities at risk of missing a principal payment. Under current rollover guidelines, the Desk does not have any maturities over the coming weeks that are large enough to be rolled over into new securities. Unless otherwise directed by the Committee, the Desk would maintain its current policy on rollovers.

3. **Securities lending activity.** Under the current terms of the daily securities lending facility, counterparties can offer Treasury securities with two or more days of remaining maturity as collateral against a loan of other Treasury securities (without delayed payments) or agency securities.[4] In theory, in the event that securities with delayed payments are experiencing poor liquidity in cash or financing markets, or are facing higher haircuts or exclusion as collateral in other transactions, the Desk might see an increase in such activity. In practice, however, this increase in activity could be relatively muted since the maturity restriction on acceptable collateral would limit use of the facility to accept only securities with missed coupon payments. Unless the Committee directs otherwise, the Desk intends to accept Treasury securities with delayed coupon payments at their prevailing market values and with the same haircuts as other Treasury securities.

4. **Repurchase agreements.** It is possible that a 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 Treasuries with delayed payments as collateral at their prevailing market

[4] Securities with less than two days to maturity are not acceptable as collateral in these transactions under the Desk's current Master Agreement and the Desk's current settlement and booking systems. As a result, if a default event were to happen, securities with delayed principal payments would not be able to be used as collateral in this facility. Making changes to these agreements and systems is not feasible in the time available.

prices and on the same terms as other Treasury securities, unless otherwise directed by the Committee.[5]

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 Treasury securities with delayed payments as discount window collateral at their prevailing market valuations and with the same haircuts as other Treasuries.[6]

Next, we consider two potential policy actions that use traditional monetary policy tools but that could require additional authorization from the Committee to the Desk. Such operations could also be authorized by the Chairman to address "temporary disruptions of U.S. dollar funding markets" of a "highly unusual nature," although the Chairman would consult with the Committee if feasible before taking such a step.[7] These options involve using repurchase agreements or reverse repurchase agreements (RRPs) to address developments in the Treasury repo markets that are not necessarily causing the federal funds rate to move outside of its target range. They may be especially useful in scenarios where markets appear to be responding preemptively to the possibility of a technical default. For example, if the Committee came to believe that financial markets were under more pressure in advance of a potential default date than was the case in 2011, it might want to consider these additional actions. Overall, given the extraordinary circumstances that could be facing the Treasury market and the ability of the Desk

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[5] Recent market conversations about the triparty infrastructure for managing repurchase agreements have revealed what appear to be significant credit risk issues associated with repurchase agreements that are collateralized by securities which mature and are paid before the operational maturity of the repurchase agreement itself. This could be an issue in the case of RPs managed through the triparty settlement system that are collateralized with securities which have had missed principal payments. Staff is continuing to investigate this issue and to assess ways to address these risks.

[6] Because of the 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. Alternatively, 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.

[7] The Chairman's authority in such cases was added to the Authorization for Domestic Open Market Operations in January 2013.

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.** Ahead of the debt ceiling and in the event of delayed payments on Treasury securities, demand for Treasury bill and GC repo against securities which are not at risk of delayed payments could increase substantially, leading rates for these transactions to become negative. If sharp declines in these rates were seen as undesirable from a policy perspective, RRP operations could be appropriate. Such operations are already occurring on a daily basis under the ON RRP exercise authorized at the September 2013 FOMC meeting, and this program could be expanded by increasing or removing the per counterparty bid limit while leaving the rate at 1 basis point. Such a facility could be effective at raising Treasury bill and repo rates, potentially above 0 percent. The staff recommends the FOMC consider moving in this direction if negative interest rates appear to increase concerns around financial stability.[8]

7. **RPs to address pressures in the Treasury repo market.** It is possible that in a scenario where the Treasury repo rate and other money market rates come under considerable upward pressure, the federal funds rate could nonetheless remain within the stated target range. Indeed, such a scenario may be relatively likely given the limited volume in the federal funds market, the idiosyncrasies in that market, and the very high level of excess reserves. RPs against Treasury collateral could be effective at addressing this increase in rates whether it is isolated to the Treasury GC repo market or includes other money market rates. The staff recommends that such operations be considered if pressures in the RP market became substantial and were having detrimental consequences for financial stability or risked weighing on the economic recovery.

The FOMC could also consider policy responses that involve outright operations aimed specifically at Treasury securities with delayed payments.[9] These options could be warranted if

[8] 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 TSLF.

[9] The Treasury has asked the staff to prepare for the possibility of conducting buybacks of outstanding marketable Treasury securities as agent for the Treasury. If such operations were initiated by the Treasury, they could be occurring at the same time Federal Reserve purchases would occur under these options. The Desk is prepared to manage such a situation from an operational perspective.

the market was experiencing widespread "fire sales" either because of stigma associated with holding these securities or because of forced liquidations triggered by large money market fund redemptions. If these pressures were sufficiently large, the Committee might see such purchases as appropriate to support financial stability and foster its macroeconomic objectives. However, such an approach would insert the Federal Reserve into a volatile political situation and could raise questions about its independence from debt management issues faced by the Treasury. Thus, the staff assumes that the FOMC would not be interested in pursuing these options, but they are presented for completeness.

8. **Purchase operations to remove Treasury securities with delayed payments from the market (action 9 in the 2011 memo).** To limit the negative impact of securities with delayed payments on market functioning, the FOMC could decide to purchase a specified amount of these issues. These purchases would be in addition to those associated with ongoing outright purchases under the open-ended asset purchase program (the first policy action described above). This approach would help market functioning if cash market liquidity was to deteriorate sharply 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 such 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] The terms of these operations would be determined through competitive bidding.

9. **Outright CUSIP swaps to remove Treasury securities with delayed payments from the market (action 10 in the 2011 memo).** 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 would be to conduct CUSIP swaps. A CUSIP swap would be an operation in which the Desk simultaneously (or at least on the same day) bought a Treasury security with delayed payments and sold a Treasury security without delayed payments. Such an operation would

[10] If purchases were mostly concentrated in Treasury bills, such purchases would not have a significant impact on the duration risk of the SOMA portfolio and could be allowed to mature once the debt ceiling issues have been resolved.

be roughly neutral in terms of the size of the SOMA portfolio and the amount of reserves in the banking system, but could have some impact on the overall duration of the portfolio.[11] The terms of these operations would be determined through competitive bidding.

Finally, the 2011 memo considered the possibility for a new liquidity facility, specifically one targeted to provide support for money market funds (action 8 in the 2011 memo). The transcript from the August 2011 FOMC meeting suggests that such an approach had very little support. Thus, this option is not being considered by the staff at this time. Additionally, staff believes that market operations targeted at purchasing Treasury securities with delayed payments (and perhaps those seen by some market participants as at risk for delayed payments), potentially in combination with RPs, could be a more effective way to provide liquidity to money funds than a lending facility. Such actions, especially if taken before severe market dislocations had pushed prices down substantially, could stem concerns over the viability of money market funds facing large redemptions.[12]

For the time being, the staff intends to prepare for the debt ceiling contingency in a manner consistent with the recommendations listed in items 1 through 5 above. All of the options laid out in this memo will be discussed at the October 16 videoconference, and the Committee can provide additional guidance at that time.

[11] Since some of the securities that may be targeted in this operation would include short-dated securities, and since there are no holdings in the portfolio with similar duration, a program that swapped the same par amount of securities would like shorten the duration of the SOMA portfolio on the margin. If the Committee wished to keep the duration of the portfolio neutral, a smaller par amount of securities could be sold from the portfolio, but this would lead to an overall increase in the size of the portfolio.

[12] Money market mutual funds carry their assets on an amortized cost basis, so the losses they face would depend on market valuations relative to those amortized costs.