

US Debt Ceiling and Probability of Default. Almost Never.

Oct 17 is D Day. If the debt ceiling is not raised, there is the possibility of a US default. The consequences are quite catastrophic, to such an extent that it is almost inconceivable that the US treasury will allow it to happen, despite the combined efforts of the Democrats and Republicans. Why is it so inconceivable?

US treasuries are the most common form of collateral for most collateralized lending and derivatives. The ETF market would be at risk since a significant proportion of ETF's are synthetic, meaning that their portfolios consist of a large dollop of US treasuries collateralizing total return swaps. Guess what the investment banks and structurers who are given that collateral do with it? They rehypothecate it, using it as collateral for their own swaps and borrowing.

The elephant behind the drapes is the repo market. Domestic repo is some 4.6 trillion USD in size. And collateral can be rehypothecated, meaning it can do several turns and thus securitize a multiple of the initial notional exposure. In Europe the repo market is some 6 trillion USD in size. That's a combined 10 trillion USD of collateral. Not all, but a majority of it is US treasuries. But the impact is massive because this collateral gets turned over almost daily. Repo is mostly an overnight market. Longer dated repo exists but is small in comparison. Ex the US and Europe, repo market sizes are hard to come by because the deals are bilateral, off exchange agreements. Given that US treasuries are rehypothecated, the damage is not limited to the stock of

collateral. A default by the US government would trigger margin calls or asset sales. There is no other market sufficiently large and liquid to replace US treasuries as collateral. There might be an exodus to bunds and gilts but there are limits to what those markets could absorb. Agency mortgages are sovereign risk by construction and would also lose their status as good collateral. This would additionally hurt the US domestic funding market but cause less international damage.

But by then all this would be academic. Global finance would grind to a halt as the collateralized lending market seized up. This is the scenario that is so catastrophic that it makes it inconceivable that the US treasury would allow a few fisticuffs between Congress and the White House to cause a default. The question, therefore is, how can it avoid default in the event that the debt ceiling is not raised.

How do you raise cash without creating a liability? This lies in the realm of the financial engineers. Perhaps future cash flows cannot be pledged in return for cash, but they might be sold, for cash. Thinking out loud, and out on a limb, it is possible that a legal route can be found so that future cash flows of the government could be cash trapped in an SPV and the equity of that SPV, can be sold. Such equity would be valued using a DCF methodology with an appropriate discount rate. It smacks of debt issuance, but it isn't. Not really.