S. HRG. 113–193

IMPACT OF A DEFAULT ON FINANCIAL STABILITY AND ECONOMIC GROWTH

HEARING

BEFORE THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED THIRTEENTH CONGRESS

FIRST SESSION

ON

DISCUSSING THE FINANCIAL MARKETS AND POTENTIAL ECONOMIC IMPACTS OF A DEFAULT IF THE STATUTORY DEBT LIMIT IS NOT RAISED AND THE TREASURY IS UNABLE TO FULFILL THE FINANCIAL OBLIGATIONS OF THE UNITED STATES

OCTOBER 10, 2013

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C O N T E N T S

THURSDAY, OCTOBER 10, 2013

WITNESSES

IMPACT OF A DEFAULT ON FINANCIAL STABILITY AND ECONOMIC GROWTH

THURSDAY, OCTOBER 10, 2013

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
Washington, DC.

The Committee met at 10:02 a.m. in room SD–538, Dirksen Senate Office Building, Hon. Tim Johnson, Chairman of the Committee, presiding.

OPENING STATEMENT OF CHAIRMAN TIM JOHNSON

Chairman JOHNSON. Good morning. I call this hearing to order.

This Committee has many important issues to consider and plenty of challenges our constituents want us to solve together on a bipartisan basis. However, we find ourselves on Day 10 of a Government shutdown that is costing taxpayers money. In addition, the shutdown drags down our economic recovery with each passing day. This unnecessary shutdown does nothing to address our long-term fiscal challenges and is certainly not promoting job creation in the short term.

If that were not bad enough, we have only 1 week left before we reach our Nation's debt limit. If Congress does not act soon, the United States will fail to pay its bills in full and on time by choice for the first time in history. I do not favor making the United States into a deadbeat Nation, which would be the consequence if we do not raise the debt ceiling. While we must work to address our long-term fiscal issues, a default on our debt will not reduce our deficit. And there is little to nothing Congress could do after the fact to repair the damage that would be felt for generations.

It is important to remember the mere threat of a default can have significant costs. During the last major debate on the debt limit in 2011, the uncertainty and delays in raising the debt ceiling cost taxpayers about $1.3 billion for that fiscal year, according to GAO. Over a 10-year window, the taxpayer cost could be as high as $18.9 billion.

So today, before it is too late, we will hear from our witnesses about the kind of impacts we should expect if the United States defaults. We will hear what this could mean not only for the financial system, but also for American families' ability to pay their bills, small businesses' ability to create jobs, and current, as well as future, retirees' ability to protect their life savings.

It is time to stop playing this foolish game of chicken with our economic recovery, and it is time for Congress to focus on addressing the real problems our constituents sent us to Washington to solve. To do that, we must first raise the debt limit.

With that, I recognize Ranking Member Crapo for his opening statement.

STATEMENT OF SENATOR MIKE CRAPO

Senator CRAPO. Thank you, Mr. Chairman, and thank you to our witnesses for appearing today to present your thoughts on this important topic.

While there has been a lot of recent attention on what happens if the debt limit is not increased, there has been less attention on our larger, wider, real debt crisis. The statutory debt limit is currently $16.7 trillion. Since 2009, the debt limit has been increased by $5.4 trillion. CBO projects that debt subject to the debt limit will reach $25 trillion within 10 years. The statutory debt limit is a symptom of our fiscal problems and must be addressed.

Since we have already focused on the impact of failing to lift the debt ceiling, I would like to focus on the debt itself. According to recent Treasury figures, the gross debt has increased $6.1 trillion since 2009. Deficits are projected to be the norm as our aging population and rising health care costs push spending higher. Unless we make significant reforms to entitlement programs, they will crowd out all other Government spending from infrastructure to defense. Failure to improve these programs also threatens them with insolvency, which will happen within a generation if we do not act now.

In recent years, we have made important progress in some areas of fiscal policy. For example, we have begun to actually make Federal agencies go through their budgets to identify and eliminate waste and to identify fraud and abuse and set priorities and learn to do more with less. But the mid- and long-term projections from CBO show that our debt crisis is only going to get worse if we do not substantively deal with the fiscal policies that we have, thus far, far failed to address, namely, entitlement reform and pro-growth tax reform.

The Committee for a Responsible Federal Budget recently noted that most of the deficit reduction agreements made since 1980 have been accompanied by a debt ceiling increase. I joined fellow members of the Finance Committee recently in sending a letter to Secretary Lew suggesting that we again use the debt limit as an opportunity to bring lasting reforms and debt reduction to our Nation.

As a member of the Bowles-Simpson Fiscal Commission and the Gang of Six, I know there has been a lot of work done on this issue and that both sides can find common ground. Tax reform is an equally important component in getting the debt under control. The current Tax Code is inefficient and burdensome. We need to dramatically simplify our Tax Code, reducing rates for all taxpayers so that we can create economic growth.

I am interested in the thoughts of our panel on how the current Tax Code affects investment. The debt ceiling debate creates an opening for real progress in these areas. Now is the time to work together on solutions that reduce our deficits and move our economy forward. It is time to make these hard decisions.

Thank you, Mr. Chairman.

Chairman JOHNSON. Thank you, Senator Crapo.

Are there any other Members who would like to give brief opening statements? Senator Reed.

STATEMENT OF SENATOR JACK REED

Senator REED. Well, thank you very much, Mr. Chairman. I think this is a very important hearing. We are on the verge of doing something that I think is not only unwise policy but flies in the face of the Constitution. The Fourteenth Amendment particularly says:

> The validity of the public debt of the United States, authorized by law, including debts incurred for payment of pensions and bounties for services in suppressing insurrection or rebellion, shall not be questioned.

We are certainly questioning that as we lead up to this crisis.

And so this is not a trivial matter. Our forefathers, our predecessors, recognized the importance of paying the debt on time every time and enshrined it in the Constitution, and we are on the verge of breaching that sacred commitment that we have all taken. That is the oath we take. And I think everyone is in favor of long-term, wise policies, *et cetera,* but we are talking about within a few days breaching and defaulting on the debt.

I could not agree more with Governor Keating's comments in the Washington Post, and thank you for being here, Governor Keating. In his words:

> Using the debt ceiling as leverage in the deficit debate is unwise and dangerous. Citizens nationwide are frustrated with the political stalemate in Washington, but our Nation's financial integrity should not be used as a bargaining chip.

I absolutely agree, and thank you for that statement, Governor.

What we potentially could do is set off a financial chain reaction that would go from market to market to market with unknown and perhaps catastrophic consequences. And anyone who was here in 2007, 2008, and 2009 and saw the collapse of Lehman and the bankruptcy, which everyone assumed, at least in the Treasury, could be self-contained, could be worked out, was a minor sort of blip on the scene, understands the potential consequences in multiple markets—overnight Treasury markets, mutual fund markets, *et cetera.*

Already we are seeing credit default swaps increase, European banks reporting they have jumped to 150 million euros from about 1.6 million euros in recent months. A huge spike. Rates are going up on short-term Treasury bills. I just saw today that the Hong Kong Stock Exchange has basically downgraded already Treasuries as collateral, at least the short-term Treasuries as collateral. So you can see the ripple effect as this goes out. We have to raise the debt ceiling to avoid default, and we have to do it promptly.

Thank you.

Chairman JOHNSON. Anybody else? Senator Menendez.

STATEMENT OF SENATOR ROBERT MENENDEZ

Senator MENENDEZ. Thank you, Mr. Chairman.

Mr. Chairman, first of all, I appreciate your leadership in having this extraordinarily timely hearing, and I think the question of default is a question of both what happens at home and abroad for us as America. And I hope my colleagues across the aisle, and particularly in the House of Representatives, would agree that defaulting on the Nation's debt would cause tremendous harm to American families, businesses, and to the global economy and would, in my view, dramatically weaken America's standing in the world, not just in its respect and stature but in ways that have consequential economic significance to us here at home. And I would also hope that they agree that these are outcomes no one wants to see.

I would say to our friends particularly in the House of Representatives, who are threatening default, let us stop lurching from one manufactured crisis to another manufactured crisis and stop threatening to default on the Nation's obligations. And I understand they have policy priorities, although I am never quite sure which one it is that we are talking about. First it was about ending Obamacare, which was passed by the Congress, signed by the President, affirmed by the Supreme Court, which is the final voice of what is the law of the land, and then reaffirmed by the American people in the reelection of the President, where there were two clear choices.

Then it was about the medical device tax. Now I hear about debt. And in that respect, I know that this debt ceiling was raised by President Reagan 18 times, by President Bush 9 times, and the second President Bush 7 times. So evidently, you know, during those periods of time, there were 34 times in which the debt ceiling was raised.

So I know there are other policy priorities people want to achieve. I want to achieve comprehensive immigration reform. It does not mean I am willing to shut down the Government until the House of Representatives does what I want. I mean, it just does not make sense to the American people as a way of doing business.

You know, we ask countries around the world to actually pursue fiscal structural reforms because we think it is in our interest at the end of the day. And then we ultimately look at the costs of a default, and I say to myself, 'How do we have standing in the world to be able to pursue those policies that promote economic opportunity here at home?'

And I think the harm from default would take not just a short term to recover from, but I think it could take a decade to recover from. I think it sees an immediate drop in economic growth, an increase in the amount of our Federal budget spent on paying interest, money that comes directly out of the taxpayers' pockets. Mortgage interest would rise; home values could very well plummet at a time in which we are finally getting recovery in the housing market. Student loans and credit cards would become more expensive. Companies around the country would see the cost of borrowing spike, seriously harming their ability to invest and create jobs. Millions of American families would see their savings for retirement or a home or their children's college education decimated. And the U.S. dollar, which is the final point I will make—and I think about this in my other role as the Chairman of the Senate Foreign Relations Committee—the U.S. dollar is the world's most important reserve currency. And U.S. Treasuries are a safe haven where investors know they can put their money in times of crisis and uncertainty.

And this value to the world strengthens our economy and lowers interest rates for American consumers, businesses, and governments at every level. Why is that something we are willing to risk over a political tactic? I cannot understand it, and I hope that better senses will come shortly to the Congress.

Thank you, Mr. Chairman.

Chairman JOHNSON. Anyone? Senator Toomey.

STATEMENT OF SENATOR PATRICK J. TOOMEY

Senator TOOMEY. Thank you, Mr. Chairman. I just want to make a brief point in response to my colleagues from Rhode Island and New Jersey.

I could not agree more with the sentiment about the importance of the fact that the U.S. dollar is the world's reserve currency. The importance of the U.S. Treasury securities simply cannot be overstated as an investment vehicle, as a benchmark for credit markets around the world, as a source of safe and secure investment.

I hope as we have this discussion we can be honest and candid about what we are really talking about here. As we all know, if we do not raise the debt ceiling sometime soon, then at some point we are going to have disruptive consequences because tax revenue is only 85 percent of all the money that we are planning to spend. It is not 100 percent. And that means the other 15 percent has got to be borrowed. And if it is not, then you have to make sudden and very, very unfortunate decisions about which things get cut. That is very disruptive. It is not where we want to go. And so I hope the President will agree to actually address the underlying problems that got us here so that we can avoid this.

Having said that, there is absolutely no circumstances under which we should ever tolerate choosing willfully to make sure that a missed payment would include a missed payment on a Treasury security precisely because of the uniquely important role that Treasury securities play.

And so I was disappointed that the Treasury Secretary at a recent hearing refused to acknowledge the obvious—it is obvious to me; maybe I should not consider it so obvious—that he would not choose to default on a U.S. Treasury security precisely because of the unique role that these instruments play. But I hope we would agree that that would be the most disruptive of the very unfortunate and disruptive options that would be available.

So that is the context in which we are having this discussion. I thoroughly agree with the comments of the Ranking Member that at some point it is just irresponsible to not deal with the underlying problem that gives rise to the need for all of this debt. And, frankly, it is not clear to me why this Administration should be the first Administration in modern history to simply refuse to have a discussion about how we got here at a moment like this.

Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to remind my colleagues that the record will be open for the next 7 days for additional statements and other materials.

Senator BROWN. Mr. Chairman?

Chairman JOHNSON. Yes.

STATEMENT OF SENATOR SHERROD BROWN

Senator BROWN. Thank you, Mr. Chairman. My guess is that what you just said was a suggestion that we not do opening statements, but I will—that really just went over my head, Mr. Chairman. I did not notice.

Thank you. I have a few comments, and I will not talk for more than 2 or 3 minutes. Five years ago, we were dealing with the financial crisis. We could be on the brink of another one, this one self-inflicted, as Governor Keating mentioned in his comments that Senator Reed mentioned.

In 2008, banks' funding dried up in the overnight repo market because of worries about their collateral and their creditworthiness. In 2010, we did not enact reforms that perhaps we should have to the repo markets. Regulators are working on it, but they are still vulnerable.

I sent letters yesterday to the two triparty repo clearing banks—Bank of New York Mellon and JPMorgan—that were in the middle of the short-term funding problems for Bear Stearns, Lehman Brothers, and AIG. I asked them what effect a default would have on the triparty repo market where 85 percent of the market is backed by U.S. Treasuries or U.S. agencies' securities. We are already seeing issues in the financial market.

The Wall Street Journal reported that the cost of using short-term Treasuries as collateral has already increased. The world's largest money manager, as we all know, reportedly sold off its Treasury holdings and maturity in late October. Treasury Secretary Lew testified in front of Senator Menendez and Senator Toomey and me and others that yields on short-term Treasuries at Tuesday's auction nearly tripled from the week before.

We also saw in that hearing where some are setting up a construct where Government, Treasury, the President has to choose between paying off bond holders, paying off Chinese investors and Wall Street investors, choosing between that and Medicare, veterans' benefits, funding everyday government in this country—a choice that no one, absolutely no one should inflict upon our Government. It has never been done before.

This week, I spent a lot of time this week calling community bankers and business people and hospital administrators and people running major research institutions in my State, mostly, I assume, Republicans, although I do not know their political affiliation. Most of them were incredulous that we would even be thinking of this prioritization of—if we reach the debt limit that we would prioritize even thinking about making these choices between paying Wall Street and paying Main Street, if you will. They cannot believe we are in a position that some are saying we should not raise the debt limit and inflict a crisis on themselves. I think Governor Keating's comments say exactly that. It would be unwise and dangerous to do this. We have no business moving our country in this direction.

Mr. Chairman, thank you.

Chairman JOHNSON. Are there any other—I would like to—Senator Warner.

STATEMENT OF SENATOR MARK R. WARNER

Senator WARNER. Less than a minute. I just have to say that this notion of prioritization, we are in uncharted territory. We do not know what would happen. Why would we take that risk? Again, respectfully, any list of prioritization which has Social Security or Medicare and the military may or may not work. But the thing that I find stunning is—and when I get to our questions, I will ask Governor Keating this. As a former Governor—and there are other Governors here—none of those prioritization lists include the pass-throughs that help fund State budgets, local budgets, hospitals. So you could potentially have a circumstance where perhaps America does not default, but every State and every locality either is in an immediate budget crisis or they would have to default, and the ripple effect is, again, unprecedented.

Thank you, Mr. Chairman.

Chairman JOHNSON. I would like to now introduce our witnesses that are here with us today.

Mr. Frank Keating is the President and CEO of the American Bankers Association. Previously he served as Governor of Oklahoma.

Mr. Ken Bentsen is the president of the Securities Industry and Financial Markets Association. He previously served as a Congressman for the 25th District of Texas.

Mr. Gary Thomas is the President of the National Association of Realtors®. He has been in the real estate business for more than 35 years.

And, finally, Mr. Paul Schott Stevens is the President and CEO of the Investment Company Institute. Previously he served as Special Assistant for National Security Affairs to President Reagan.

Mr. Keating, you may proceed.

STATEMENT OF FRANK KEATING, PRESIDENT AND CHIEF EXECUTIVE OFFICER, AMERICAN BANKERS ASSOCIATION

Mr. KEATING. Chairman Johnson and Ranking Member Crapo, I am Frank Keating, President and CEO of the American Bankers Association. As noted, I previously served two terms as Governor of the State of Oklahoma and recently was a member of the Bipartisan Policy Center's Debt Reduction Task Force.

I appreciate the opportunity to be here to discuss the need to raise the debt ceiling and the consequences of failing to do so.

Let me be very clear: We need to meet our obligations and not create any uncertainty that we will do so—on time, every time. In this country, our word is our bond. The respect and admiration that the United States and its institutions inspire around the world are based on the certainty that when our Nation makes a promise, we keep it.

Ordinary Americans will bear the brunt of the damage if our leaders do not prevent the United States from defaulting on its debt for the first, the very first time in its history. We are much closer to disaster this year than we were 2 years ago when the debt ceiling standoff caused economic uncertainty to spike, consumer confidence to plummet, and stock prices to spiral downward—all because of the perceived risk of the United States defaulting on its domestic and international debt obligations. The 2011 debt standoff cost taxpayers close to $20 billion as nervous investors demanded higher interest on U.S. Treasury bonds to account for the risk of a Government default. If our Nation defaults on its nearly $17 trillion in debt, the harm is likely to be measured in hundreds of billions of dollars.

Even the slightest uptick in Treasury interest rates would cascade throughout the economy. It would raise the costs for taxpayers to service our country's debt and would raise the borrowing cost for businesses, meaning job losses and price increases. Default would be a blow to retirement funds, leaving fewer resources available for our retirees. For banks, which hold $3 trillion in Treasury, agency, and mortgage-backed securities, the sharp decline in value of those securities would translate into fewer resources available for mortgages, business, auto, credit card, and student loans.

If Congress fails to act and we hit the debt ceiling, we will set off a chain of events that will impact all Americans. The consequences would not be easily reversed, and the repercussions could linger for years, providing a constant drag on our economy.

Default would also put the United States in the category of reckless debtor nations that have broken their word in the markets, which include Argentina, Venezuela, and Cameroon. Defaults left those countries financial pariahs and debilitated their economies.

The answer to managing our debt is not to simply stop making our payments on money already spent. We should never inject uncertainty into the markets that we as a country will not keep our word and pay the debts that we owe. We must pay our bills on time and in full; then we must carefully manage our future spending and bring down our debt to a sustainable level.

No one takes our national debt more seriously than I do. As a Republican Governor, working with my entire 8 years a Democrat House and a Democrat Senate, I balance my State's budget 8 years running and worked with colleagues from both sides of the aisle to ensure that our State honored its debts and expanded its economy.

Later, I joined the Bipartisan Policy Center's Debt Reduction Task Force, which endorsed in a bipartisan way painful but necessary measures to put the country's fiscal house in order. I urge Members of this Committee and the full Senate and House to engage in a bipartisan way to find long-term solutions to our growing debt levels.

If confidence is lost in our country's willingness to pay its bills on time, we will have lost something that may be impossible to regain: the world's trust.

Thank you. I would be happy to answer any questions you might have.

Chairman JOHNSON. Thank you.

Mr. Bentsen, you may proceed.

STATEMENT OF KENNETH E. BENTSEN, JR., PRESIDENT, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

Mr. BENTSEN. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is Ken Bentsen, and I am the president of the Securities Industry and Financial Markets Association. Thank you for the invitation to testify today regarding the risks associated with a default on the Nation's public debt. Given the important role U.S. Treasury debt plays as a world currency and store of value, any such default would negatively impact the economy and certainly disrupt the operations of our financial markets. Indeed, the market has already signaled increasing concerns regarding the public debt limit, resulting in dramatic pricing effects on the short end of the Treasury market and repurchase agreements, or repos. Investors are voting with their wallets and their feet.

While we firmly believe that the time is long overdue for the Administration and Congress to come together and develop long-term solutions to our very real fiscal challenges, voluntarily defaulting on the Nation's debt obligations should not be an option for policymakers to consider.

Should Congress fail to raise the debt limit and the Treasury is unable to meet interest and principal payments coming due, it would trigger a series of events which inevitably would lead to American taxpayers paying more to finance our debt. Even a short-term failure to fulfill our obligations would seriously impair market operations and could have significant consequences to our fragile economic recovery.

Since the threat of default first arose in the summer of 2011, SIFMA has been engaged with its members in developing scenarios to better understand the consequences of a failure to pay on Treasury securities. Based on our work, we do, in fact, believe that market participants are operationally prepared to deal with the scenarios that a Treasury failure to pay would present. However, as you know, a default by the U.S. Government would be unprecedented and the consequences for the market and the economy would be dangerously unpredictable, so no amount of planning can identify and mitigate all of the potential short- and long-term consequences of a default.

While we assume that any missed payments will eventually be made, the impact of missed payments on the broader market for Treasury securities may impact the price of Treasury securities, which could impact the value of collateral held at clearinghouses and central counterparties. Further, it is entirely possible that for purposes of any escrow, collateral, or margin agreements involving such securities, the defaulted securities could be deemed non-eligible and subject to replacement, resulting in a drain of liquidity.

Since filing our written testimony just yesterday, market participants have continued to meet and review enhancements that could mitigate operational risks that have been identified, particularly in the repo market. It is important to avoid disruptions in the Treasury repo market, and market participants continue to review ways to improve overall resiliency.

Treasuries are the world's safest asset and the most widely used collateral for both risk mitigation and financing. Shrinkage in the financing market would further pressure rates as haircuts or discounts on Treasuries would increase—raising costs, reducing the financing capability, and disrupting collateral markets because of margin calls throughout the financial system that would reflect the overall repricing of Treasury collateral.

Given the significant uncertainty surrounding a failure to pay, market participants and SIFMA have developed a playbook this is intended to provide key market participants and service providers a forum to share information about the latest developments including decisions from the Treasury, the Administration, and Congress and the status of the infrastructure and settlement providers. Of particular concern to market participants is an early indication from Treasury that securities will be extended and whether processes are being—or can be—delayed. It is important for the market to know as early as possible if Treasury intends to extend the payment date of any due interest and principal. Treasury securities are traded in a global market with the global trading day beginning in Asia at 8 p.m. Eastern Standard Time. Market participants normally run their own internal processes prior to the Asia open in order to provide a clear cutoff to reflect positions on their books and records. Failure to provide early indications of intention could further obfuscate positions and could cause trading confusion in the Asian markets. The disruption to pricing and trading behavior is impossible to predict.

U.S. debt obligations are the currency of the global financial markets and the real economy, and their soundness should not be questioned. No amount of planning can anticipate all the potential consequences of a default. Short- and long-term consequences to the taxpayer can be anticipated, but the further limits on the ability to transfer, sell, finance, and post as collateral defaulted securities would only serve to undermine investor confidence and hurt our fragile economic recovery. SIFMA and its member firms have frequently called on Congress and the Administration to work together to put our fiscal house in order, but unnecessarily triggering a voluntary default will result in dramatic, and possibly permanent, damage to our economy and markets in ways both anticipated and unanticipated and must be avoided.

Again, SIFMA appreciates the opportunity to testify today, and I look forward to answering your questions.

Chairman JOHNSON. Thank you.

Mr. Thomas, you may proceed.

STATEMENT OF GARY THOMAS, 2013 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

Mr. THOMAS. Thank you. Chairman Johnson, Ranking Member Crapo, and Members of the Committee, on behalf of the 1 million members of the National Association of Realtors®, whose members practice in all areas of residential and commercial real estate, thank you for the opportunity to share our concerns about the potential economic consequences of not raising the statutory limit on our Nation's debt before the limit is breached.

I am Gary Thomas, President of the National Association of Realtors®. I have more than 35 years of experience in the real estate business, and I am the broker-owner of Evergreen Realty in Villa Park, California.

It is no secret that real estate is a cornerstone of our Nation's economy, representing roughly 18 percent of our Nation's gross domestic policy. As the housing market has recovered from the Great Recession, it has substantially contributed to our Nation's economic growth, especially since 2011. Home sales, housing prices, and residential construction are all on the upswing.

For example, home sales were 13.2 percent higher in August 2013 than a year earlier, with 5.48 million homes sold. Home prices have increased 15 percent, pushing up the value of household real estate to $18.6 trillion at the end of the second quarter of this year. These key housing indicators have been supported by low mortgage rates and improved consumer confidence.

With that being said, the housing market has not fully recovered. Maintaining momentum in the housing market is particularly crucial right now. The housing recovery could stall if the debt limit is not addressed. A default or even the perceived threat of a default could undermine the distinct economic advantage that has taken us centuries to build, undermining our financial stability and raising costs today and for generations of Americans to come. It is impossible to predict the exact economic impact in the event our Nation is unable to pay its creditors. However, the significant economic disruptions that resulted from the 2011 debt ceiling impasse provide a useful guide. Financial market disruption, reduced consumer and business confidence, and slower job growth all happened when the debt limit was not increased until the very last minute.

In the event of a default, a series of events would occur, causing a domino effect, resulting in higher mortgage rates and increasing the cost of buying a home. Historically, an increase in the mortgage rates of 1 percentage point reduces home sales by roughly 350,000 to 450,000. This would wipe out any increase in home sales predicted in 2014. A decline in home sales would also have a broader impact on our national economy. Roughly 700,000 to 900,000 fewer jobs would be created as a result of a 1-percentage-point increase in the mortgage rates.

As a selling broker, I want to bring this down to a personal level to highlight the impact on my clients. For a borrower earning $60,000 a year and taking out a $200,000 mortgage, that 1-percent increase would raise the monthly principal and interest payment by nearly 10 percent. Any decrease in a consumer's disposable income has broad economic ripple effects. Higher mortgage rates and lower consumer confidence are both likely to follow in the event of a default.

Again, if we look back to the debt ceiling debate of 2011, consumer confidence plummeted 22 percent following the impasse. Thankfully, our economy has been able to bounce back from the 2011 debt ceiling debate. But the impasse prolonged the housing downturn. The result is the real estate market did not begin to turn around in earnest until 2012.

As the housing market heals, mortgage rates have increased from historically unprecedented lows. Moreover, meager increases in family income have squeezed the affordability of homes. Affordability has plunged 18 percent to the lowest level since 2006. With consumer sentiment already facing headwinds from rising interest rates, the recent Government shutdown will likely be an additional blow to consumer confidence and our economic recovery. U.S. economic expansion will be even more susceptible to the adverse effects from a debt ceiling impasse.

We have already experienced the negative economic consequences from even the prospect of a default during the debt ceiling impasse of 2011. Let us not repeat this mistake again. More importantly, let us not allow a debt limit impasse lead to the United States defaulting on its debt.

Thank you for the opportunity to share our thoughts, and we look forward to working with Congress and the Administration on efforts to address the challenges still facing this Nation's housing market and overall economy.

Chairman JOHNSON. Thank you.

Mr. Stevens, you may proceed.

STATEMENT OF PAUL SCHOTT STEVENS, PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE

Mr. STEVENS. Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to appear before you once again.

I am pleased to have the opportunity to testify on behalf of the Investment Company Institute, its member funds, and the 90 million American investors that they serve. Today members of ICI manage in excess of $15 trillion in total assets.

Funds and their investors have a very significant stake in the stability and predictability of the market for U.S. Treasury securities. The most recent ICI data show that, as of June 30, registered funds held more than $1.7 trillion in securities issued by the Treasury and by U.S. Government agencies. That accounts for more than 10 percent of fund assets.

Now, U.S. Treasuries, as the Committee knows, trade in the deepest, most liquid market in the world. Treasury securities have always been regarded as providing the "risk-free rate of return," a key factor in pricing other assets, including corporate and municipal bonds, stocks, and real estate.

But today that notion of the risk-free rate is in serious jeopardy. Today Washington, the Federal Government, is itself the single greatest source of risk to the global financial system.

The immediate threat to financial stability is, of course, the looming stalemate over the Federal debt ceiling, but we must not lose sight of the longer-term hazards our Nation faces if we fail to take decisive action to contain the growth of our national debt. After all, there are two things that individuals, households, businesses, or nations must do to maintain a high level of creditworthiness: they must pay their bills on time when they come due, and they must avoid taking on more debt than they can reasonably afford to service and to repay.

For our Nation, ignoring either of these principles will be ruinous. A Treasury default likely precipitates a sudden crisis and a degradation of the United States' financial and economic standing. But failure to bring our debt under control will be equally destructive and on current trends is even more likely.

What makes the Treasury market so deep and so liquid is the certainty of investors that the U.S. Treasury will pay its obligations, on time and in full, when interest or principal comes due. One Treasury misses or delays a payment, investors will learn a lesson that cannot be unlearned: Treasury securities are no longer as good as cash.

The future risk of missed payments will be priced into the interest rates that investors demand. We already can see early signs of these concerns developing in the market as the October 17th deadline approaches. And should the Treasury default, the effects would quickly spill beyond the Treasury markets and into the broader economy. Multiple shocks—cash shortfalls for holders of defaulted Treasuries, higher interest rates, diminished confidence, and pressure on the dollar—would be likely to undermine economic activity. The impact would persist well beyond any resolution of the debt ceiling and repair of the default.

Now, let me stress that default is by no means uniquely a problem for mutual funds or other registered investment companies. Nothing about their structure makes them any more vulnerable than any other investment vehicle. Because the health of the Treasury market underpins virtually all financial markets, the damage of a default—or even of a second near miss in a little over 2 years' time—will be visited upon every American who saves, invests, borrows, or has any stake in the economy.

Now, with our focus on the debt ceiling, it is easy to lose sight of the other looming risk: the unsustainable long-term growth in our national debt. The tax and spending bargains reached so painfully in the last 3 years have slowed the growth of debt for the short term. But the Congressional Budget Office's latest projections show that that progress will be short-lived. By 2018, the debt held by the public will be rising as a share of GDP. By 2038, under current law and budgetary policies, Federal debt held by the public will reach 108 percent of GDP.

Now, these scenarios and our long-term debt trends do not promise a bright future for the economy or the Nation. So I have two unequivocal messages today.

First, no one should take lightly the prospect of a default on United States debt obligations. The credit of the United States emphatically must not be put into question.

Second, those who dismiss or minimize our current budget problems are also playing with fire. The risks they are taking may be less immediate, but they are no less consequential; and the longer the Nation delays action, the larger and more difficult the necessary corrective measures become.

Thank you, Mr. Chairman. I look forward to your questions.

Chairman JOHNSON. Thank you all for your testimony.

We will now begin asking questions of our witnesses. Will the clerk please put 5 minutes on the clock for each Member?

This question is for the full panel. No matter where you stand on fiscal issues or even health care, should Congress seriously entertain a default on our debt? And what do you believe is the most troubling long-term impact if the United States does not pay its bills on time? Mr. Keating, let us start with you.

Mr. KEATING. Well, as noted by my fellow panelists, if the United States defaults on its debts, a little bit or a lot is calamitous. And we have to think in perspective what has occurred over the course of the last number of years. From 1789, when George Washington became President and our Republic was established, to the year 2000, the national debt was $5 trillion. According to the Bipartisan Policy Center, our Rivlin-Domenici panel, between 2000 and 2009, that national debt roughly doubled, a little bit less than doubled. Now it is going to double again.

So the figures are scalding, and I am sure that the congressional panel as well as Simpson-Bowles—and I know Rivlin-Domenici found the same thing. In the year 2020, it will be $1 trillion a year just to pay the interest on the debt. By the year 2025, every cent of Federal tax revenue will go to Social Security, Medicare, Medicaid, and interest on the debt.

What is required, as noted, is to get through the default period because it will obviously dramatically raise interest rates and create real havoc in the community bank environment, most particularly, the ability to borrow money and to lend money, and then sit down aggressively and in a bipartisan fashion to focus on this runaway train.

In 1950, the average person retired at 62 and died at 69, or 65 and 69. Today the average person retires at 62 and dies at 80. So all the actuarial tables are off. We are, mercifully, living a lot longer, which is causing huge stresses in our ability to provide for the elderly in the United States, and it will continue to deepen and darken over the course of the next 20 years.

Chairman JOHNSON. Mr. Bentsen?

Mr. BENTSEN. I would say two things. One is voluntarily defaulting on the debt is just something that to me does not make any logical sense. It will create huge operational problems in the financial markets that will permeate across the markets. As pointed out, Treasuries are a reference rate. Treasuries are used in escrows. It will affect municipal bond issues that have been defeased by every State in the Union. It will have dramatic consequences on liquidity and could create certain liquidity crises if it were to go on for some period of time, even with potential work-arounds to deal with defaulted coupons.

But the other thing I would say is, with respect to the long-term fiscal condition, to default voluntarily would make resolving the long-term fiscal imbalances just that much more difficult. So it seems to me that it does not make any sense to do so if you do not have to.

Chairman JOHNSON. Mr. Thomas.

Mr. THOMAS. From the real estate perspective, I think that we would fall back into a deeper recession. There is no doubt in my mind that that would happen. If we reached a debt ceiling impasse, the default on U.S. debt could be very long lasting. Interest rates would undoubtedly rise, meaning less people could afford to buy or refinance homes. Housing prices would plummet again, and you would have a catastrophe in the real estate industry, which would lead the economy back into a deep recession, if not a depression.

So it also raises the rate at which we would borrow and would make it more difficult for us to meet our debts on into the future. So I do not see any possibility of it being a good outcome. It is going to be disastrous.

Chairman JOHNSON. Mr. Stevens.

Mr. STEVENS. Mr. Chairman, I think the key element here is confidence. We are the biggest borrower in the world. We have to engender confidence in those people who are lending us money. The Treasury's history of repayments and the smooth operating of the Treasury market has created that high level of confidence that permits us to borrow at very, very low rates.

I do not think it is in the interest of the American people to do anything to give our investors less confidence in the United States, and that would include either failing to repay or, as I said in my testimony, amassing so much debt that it is not going to be supportable.

Chairman JOHNSON. Mr. Stevens, some in Congress have proposed that payments to bond holders should be prioritized in the event of a default. Is this a workable, long-term solution?

Mr. STEVENS. Well, to go back to my previous answer, I think it to some degree misses the point. If you are a household and you are depending upon the bank for continuing financing and the bank learns that this month you are going to decide to pay these bills but not those bills, it does not engender greater confidence in the bank to continue to lend you money. And that is the key point. The money that you are lent, if you are lent any, is going to be much more expensive, and it makes the hole that you are in just that much deeper.

Chairman JOHNSON. Senator Crapo.

Senator CRAPO. Thank you, Mr. Chairman.

I want to come back to basically what I talked about in my opening statement, which is the fact that while we debate the consequences and the circumstances surrounding the debt ceiling battle we are having in the Senate and the House right now, the real issue that we need to be focused on—and I agree with all the comments about the seriousness of the consequences that would occur if we do not pay our debts. I understand that. But it seems to me that the real threat of default that the United States is facing is the debt crisis that we are facing.

I look back—I mean, we all know that one credit rating agency has already downgraded the United States, the good faith and credit of the United States. They did not downgrade it over a debt ceiling. They downgraded it because they lost confidence that we are willing to deal with our debt. And that is the issue that I believe we need to focus on.

CBO has recently stated that if we continue our current path, at some point investors would begin to doubt the Government's willingness or ability to pay U.S. debt obligations. I think at some point—and I think some point soon—another credit rating agency is going to become convinced that we will not deal with our debt crisis.

And so the question I have to the panel is: Is the threat of default that each of you have talked about, default on our U.S. Treasury obligations, is that threat greater because of the fight we are having in Washington right now over whether the debt ceiling will be extended? Or is it not far greater over the fact that we cannot get into negotiations to resolve our entitlement spending and to reform our Tax Code?

Mr. Stevens, I know you mentioned this in your comments, so let me start with you on this end.

Mr. STEVENS. Well, Senator, as I said in my oral statement, I think creditworthiness depends upon two things: it depends upon paying your bills on time, and it also depends on not racking up so much debt that you cannot support it. And so it is a combination of the two things. I do not think you can have one without the other if you really want to maintain a good credit rating.

Senator CRAPO. Mr. Thomas?

Mr. THOMAS. I would agree. I think you have to attack both, but you have to do it in a deliberate manner that does not upset the international marketplace. So I think we have to deal with the debt ceiling first and then go on to really the looming question, the elephant in the middle of the room, and that is the entire debt.

Senator CRAPO. Mr. Bentsen?

Mr. BENTSEN. Senator, the two are certainly linked, but it seems to me that, just as you would if you were going through, say, a corporate restructuring, if you were going to go through a fiscal restructuring of the United States to repair fiscal imbalances over the long run, you are still going to need to access the credit markets and the capital markets to do so. And so you would not want to do anything that impairs your ability to access the credit markets to get on a glidepath wherever the policymakers want to take fiscal policy.

So while I do think they are linked, no question, and they both need to be resolved, you do have one that is in front of the other. And so I think you want to be careful not to make the longer-term job any more difficult by not addressing the short-term issue.

Senator CRAPO. Mr. Keating?

Mr. KEATING. Well, I agree with Ken Bentsen. There are two issues, but they are interlinked. In the case of, let us say, for me as a community banker, if you came to me and you said, "I would like to borrow some money, but I am not sure I can pay it back," I assure you that the interest rate would be considerably higher, if I made the loan at all. If you said, "I will not pay it back," or "I have not paid back my other loans," I would not make the loan at all.

So that is a reality that faces families, and that is a reality that faces the United States. But a big part of our debt, the reason we cannot pay our bills or the reason we will not pay our bills is entitlements. So they are linked together, and as I said, mercifully, our families are living longer, but that is a huge actuarial challenge that we have not prepared for.

Senator CRAPO. Thank you. I am not going to ask another question, but I will conclude with a comment, and that is, I understand the linkage. There is another aspect of the linkage here. We just had a hearing about an hour ago with Secretary Jack Lew, Secretary of the Treasury, and in my questioning of him, I asked him whether or not the real threat we faced was not the long-term debt crisis and that that was a greater threat to our creditworthiness. And in his answer to me, he said, you know, we have been making some progress on our long-term debt crisis over the last couple of years. He admitted that we have not touched entitlements, have not touched tax reform. But he said, you know, we have in the last couple of years started to make some progress.

I pointed out to him and I will point out to you, that progress came in 2011 when we were fighting over a debt ceiling increase and we adopted the Budget Control Act, which put into effect our ability to deal at least with discretionary spending. And although we can argue over whether that was done well or whether it could have been done better, the fact is that that debt ceiling increase was accompanied by some fiscal reforms, and that is what we are trying to achieve here today.

Chairman JOHNSON. Senator Reed.

Senator REED. Thank you very much, Mr. Chairman.

Mr. Bentsen, if we default next week, even technically, your view, I believe, is that that will make our ability to do almost everything, including deal with the long-term entitlement problem, much more difficult. Is that fair?

Mr. BENTSEN. Yes, Senator. I mean, first of all, we are already seeing—and you commented on this in your opening statement, we are already seeing a risk premium being priced into the market today. So the short end of the Treasuries are up 30 basis points. It was a dramatic shift. Repo pricing is—the haircuts of repos are going up. So the pricing effect is already taking effect—is already happening. If we miss a coupon, we would assume that that pricing effect will be exacerbated on that.

But the other thing that we think would happen—and, again, our members are working to sort of war-game this out because no one has ever been through this, the documents are not structured for this, systems have never been set up for this. No one has ever thought that you would not pay Treasuries in the same way you would with a corporate debt offering or municipal debt offering. And while there are efforts being made to see if we get notice from Treasury that a coupon payment will be missed and extended to another day, how do you keep that Treasury security with the missed coupon payment transferable or pledgeable as collateral? You know, it is not entirely clear. We think that if it is done quickly and before the Asian markets open, it is possible. But you still have that coupon that is pulled out of the market, so there is some liquidity associated with that, and it is not clear when that would be paid. It is not clear whether it would be paid just through the stated interest date or whether interest would accrue. So you have potential lost income.

And then if it is not clear whether those securities are no longer considered eligible collateral, what chain effect might occur, not just with ability to do a repo transaction, but whether or not if they are in a municipal defeasance escrow, whether they are pledged as collateral for swaps or any other type of transaction, whether counterparties would ask for replacement or whether escrows would have to be restructured.

So it has a friction that can run across many parts of the market, and we think it would have a very negative effect.

Senator REED. In effect, what you are describing is a potential financial meltdown, perhaps worse than in 2008 with the collapse of Lehman Brothers, which required massive support by the Federal Government just to restore confidence and stabilize the Government. And, frankly, I do not know if that combination of factors today and the political forces here would be able to support such an effort. But, you know, you raise an excellent point, which is that everyone might have very good intentions of trying to manage through this crisis, but software systems, documents, legal requirements, uncertainty would be such that you could really paralyze the market. Liquidity could freeze, and you would have something that would make 2008 look like a walk in the park.

Governor Keating, again, I think your comments about the impact of this—and sort of proportionality, that, you know, we are looking at a crisis that could trigger, ironically, worst deficit complications that could exacerbate those long-term trends even more dramatically as interest rates go up in response to uncertainty. But you have, I think, a particularly valuable point of view, representing bankers all across the country. The impact on Main Street, I mean, one of the issue with prioritization Senator Brown mentioned was we are not prioritizing between paying Federal debt and trivial expenses of the Government. We are talking about Social Security payments, Medicaid payments to States; States basically could start running into their own complications. And you were a Governor. If you were told by HHS that no Medicaid payments are going in, what do you do? Are you on the hook for it? What do your hospitals do? Do they declare bankruptcy because their covenants require that they receive a certain amount of income each month? In some cases, yes.

Then we go down to Social Security benefits payments. Are we telling Social Security recipients that they are going to take a 5-percent haircut because we are going to pay debts or credit? And, frankly, as I read—you know, all of these constitutional advocates, as I read the Fourteenth Amendment, it does not make any distinction between types of debt. It says the "public debt." And all this would be, I think, construed as public debt.

So can you tell us on the street what your impression would be?

Mr. KEATING. The lay community, lending community, the borrowing community, the community banks, and even the large institutions that I work for are very alarmed because of the uncertainty, because of the panic, because of the potential for long-term destructive results. So if I were Secretary of the Treasury, if you were Secretary of the Treasury, and we had so many dollars, you would say, well, are we technically in default if we do not pay Social Security? I do not know. But I know we are technically in default if we do not pay all these bonds. So we have got to pay the bonds, and then we have got to continue to pay the bonds, the investments, the debt of the United States, you know, the coupons on Treasuries.

But then what? At some point, you are going to run out of money. At some point, because of the fear in the marketplace, there will be less lending, there will be less borrowing, there will be less buying, there will be less tax revenue. And you are trying desperately to figure out who do you pay first. Well, of course, I would try to figure out who do I pay first. In that desperate situation, I think most of us would do that. But that is a crazy way to run the greatest economy the world has ever seen.

I mean, in the history of the United States, it was after the Revolution that we had a very hard time—that is when Robert Morris, you know, the financier of the Revolution, made it very clear: We are not going to be able to pay our bills if we do not have access to credit. Otherwise, they are going to demand everything in specie; you better have gold and silver; otherwise, you know, nobody will deal with you. That was just a calamity about to physician, and we never defaulted, even in those days when we did not have anything.

And here we are, the world's largest economy, and we are seriously contemplating that as a sensible, intelligent reaction to a political stalemate. Well, I hope not because it would—you know, when the United States—as I used to say in Oklahoma to my Democrat friends, if the USS Oklahoma goes down, we all go down together, Democrats and Republicans. If the USS United States goes down, we all go down together, Democrats and Republicans.

Senator REED. Thank you.

Chairman JOHNSON. Senator Vitter.

Senator VITTER. Thank you, Mr. Chairman, and thanks to all our panelists. I know all of you agree that the debt limit should be extended because disruption would occur otherwise. I understand that. But I do think it is important to be precise about what we are talking about and what we are not talking about.

For instance, Senator Reed started his comments saying, "If we default next week," so I sort of want to pick it up there. By default, am I correct, we mean nonpayment or late payment on U.S. Government securities. Is that right?

[Witnesses nod affirmatively.]

Senator VITTER. Does anybody disagree with that? That is what "default" means. And in light of all of your testimony about the impact of that, would you all agree that if the debt limit were not extended immediately—and I understand that you think it should be. If it were not, those payments should be top priority. Does anyone disagree with that?

Mr. STEVENS. Senator, I would respond this way: I do not in a sense disagree with what you are saying, but the premise is that there are other payments that are not going to be made. And I would just revert to what I had said. The effect of confidence in the Treasury markets will be significant even if we are paying off those Treasury securities. Even if we do not have a late payment of principal, even if we keep our interest rate payments current, if we are failing, if we are choosing and picking what other obligations the country has, that will be felt in the market even though you could say, well, those securities are not technically in default.

Senator VITTER. I understand. I am not trying to trivialize this scenario. But I am trying to be more precise, because I think there has been a lot of loose language that actually is causing more premature disruption than necessary. So would anyone not prioritize those payments?

Mr. BENTSEN. Senator, what we have been told by the Treasury Department is that they do not have the operational capability to prioritize. I think that they make something like, I want to say, 4 million payments a day. And there is a question as to whether or not they can prioritize on that.

But the other point I would make is if you—it is not clear what revenues are coming in, and everybody tries to estimate, Treasury tries to estimate, market observers try to estimate. But on the 17th, you have about $129 billion in T-bills coming due; the next week you have about $93 billion in T-bills coming due; the following week you have principal and interest payment on bonds coming due, and every week thereafter.

So the point I would make is perhaps they could figure out how to do it operationally. I do not know their systems. That is just what they tell us. But there is a lot of debt coming due. Some can be rolled, some cannot be rolled because it would breach the debt limit. And so it does create quite a——

Senator VITTER. Well, to respond, Treasury has two systems: one is for payments on security obligations; one is for everything else. I think your comment is possibly accurate about the second system for everything else. But there is a separate system for payments on security obligations. I do not think there is any question that they can pay those first if they want to.

I am just suggesting that in a bad scenario that should be a priority. It can be a priority operationally. And if it were, those would be paid, and I do not think there is any question about revenue coming in covering it. I mean, for instance, Martin Feldstein has said, "There really is no need for a default on the debt, even if the debt ceiling is not raised later this month. The U.S. Government collects enough in taxes each month to finance interest on the debt."

Now, again, I am not trying to trivialize this scenario, but I do think it is important to talk a little precisely about what we are talking about and what we are not talking about. And I do not think it is accurate to talk about if we default next week, because I do not think there is any need, any chance of defaulting next week.

Does anyone disagree with that, defaulting on payments on Government securities?

Mr. THOMAS. Senator, I agree with you; however, let me tell you what is happening at the street level. The confidence of our buyers and sellers is waning very rapidly. We have transactions canceling right now. We have people not being able to get loans. We cannot get beyond where we are at. It is going to go backwards very, very fast.

Yes, you could probably mechanically do all of this, but the confidence of the American people is going to be really in the toilet. I am sorry.

Senator VITTER. Mr. Thomas, let me pick up on another comment of yours. In your testimony, you sort of bemoaned this episode in 2011 over the debt limit, said it was very disruptive; you know, we have recovered but it was disruptive.

As Senator Crapo pointed out, that episode led to the BCA, led to the only spending and debt cuts in the recent past. Do you consider that positive outweighed by that episode?

Mr. THOMAS. If nothing else would have happened after that, then, yes, I would agree with you. If we did not have to come up to it and still had the same outcome by negotiating separately and got to the same point, then we would not have had a fall-off of the confidence at that time.

Senator VITTER. Well, I will just end with this. I can guarantee, as somebody who was here and participating, that that would not have happened but for the deadline of the debt limit. I mean, no way, no how it would have happened. So I just want to underscore Senator Crapo's comment. There was what in my view is a distinct positive coming out of that, which is the only progress we have made on spending and debt in the recent past.

Chairman JOHNSON. Senator Menendez.

Senator MENENDEZ. Thank you, Mr. Chairman. I almost think we are in a surreal conversation.

Let me ask the first question of this panel. Understanding your collective concerns and our collective concerns on the question of debt, is there any member of the panel who advocates as a way of reducing debt defaulting on the Nation's full faith and credit?

Mr. KEATING. No.

Mr. BENTSEN. No.

Mr. THOMAS. No.

Mr. STEVENS. No.

Senator MENENDEZ. All right. Second, when we talk about this concept about prioritizing, I think Americans should understand that that suggestion means that we would make sure we would pay China, Japan, Caribbean banking centers, Brazil, but we would not maybe get to paying Americans who rely on Social Security and Medicare, as well as the concept that for anyone who is a banker or anyone who works under the concept that if I make a loan or I make an investment, some will be paid and some will not, and so I was fortunate this time to be paid, but in the future I may not be fortunate to be paid. And the consequences that flow from that are inevitable.

In that respect—and then, finally, to suggest that the way to reduce debt was the Budget Control Act—which I voted against because I did not see the willingness to include revenue as well as spending cuts, and I believe both must be achieved. But to have across-the-board cuts that the Chairman of the Joint Chiefs of Staff that, if it continues, will threaten the ability of the Defense Department to meet the challenges globally on multiple fronts, that really means that threatens the national security of the United States, where my colleagues go back to home to their State and rail against the consequences of sequester, even as they vote for it here, it is surreal.

So my question is—Governor Keating, you mentioned in your testimony—and I think this is an important point to realize. If you could give us a sense, again, you know, just the potential for default, not the default itself but the potential for default actually cost taxpayers money. By waiting until the last minute to act and threatening to default, they cause investors and U.S. Treasury securities to demand higher interest rates. If I am going to look at greater risk, I am going to demand higher interest rates to offset the risk.

Now, is it right that I read in your testimony that as a result of what happened in 2011 or the threat of default that it cost us $1.3 billion in fiscal year 2011?

Mr. KEATING. Well, I think the Bipartisan Policy Center's estimate was a $20 billion figure as a result of coming to the edge of the cliff and stepping back.

Senator MENENDEZ. Over the course of 10 years, yes.

Mr. KEATING. Right. Now, if you stepped over the cliff, the impact would have been and will be, obviously, far more uncertain, but most likely far more catastrophic.

Senator MENENDEZ. So $20 billion just for moving up to the deadline and not crossing over it, but $20 billion. So I do not understand how it is fiscally responsible for those who are driven fiscally to ultimately suggest that having the Nation cost $20 billion and not—and waiting until the last minute to meet its obligation is fiscally responsible.

I also want to ask Mr. Bentsen, I understand a large share of the financial markets use Treasury securities as a benchmark for evaluation and pricing or as collateral in a wide variety of transactions. How would a default affect the market functionality in these basic areas?

Mr. BENTSEN. Well, Senator, I guess there are two things that you raise there. Treasury securities are a reference security, so mortgages, credit cards, auto loans, pricing on swaps, it is used across the financial sector both in the consumer and in the institutional or wholesale market. So if you are affecting prices of Treasuries, particularly short-term Treasuries, you are going to affect the price of those instruments, and that will pass through to the end users of those instruments.

The second point would be that the repos and the like are used not just in financing between financial institutions and one another, but, for instance, municipal issuers, when they issue, do their initial debt pricing and debt offering, will often use repos in the short-term basis to invest their money before they put that money to work, whether it is building a road or a hospital, whatever they are doing for it.

So, again, it is used across the financial system quite a bit, and they would be affected by the price and the risk and over the long-term concerns about counterparty risk.

Senator MENENDEZ. Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heller.

Senator HELLER. Mr. Chairman, thank you, and thanks for holding this hearing, and to the Ranking Member also and to this panel. Thank you very much for taking time to be here today. I think this is as critical of a hearing as we can have at this date and time.

I was listening to an economist on TV this morning, and he talked about a lack of humility, honesty, and civility, but he was not talking about Congress. But he should have been—or he could have been. I look and watch what is going on here in Washington, D.C., and I think we do need a humble, civil, honest conversation about why we are here and why we are having the conversation today.

We are here because we have not passed a budget here in Washington, D.C., in 5 years. That is why we are having this conversation. We have not passed an appropriations bill, not a single appropriations bill, in 5 years. I have not been here that long, but, boy, I certainly have not seen this process move. We now think CRs is the norm, that a continuing resolution is the norm. And I have staffers that have been here long enough that would tell me and have told me that this place would freak out under those scenarios years ago. But there are a lot of people here that I think perhaps have not been here since the last time we actually passed a budget or passed appropriations, and that is why we are here. That is why we are here, because we do not budget. We have no financial responsibility in thinking that that is actually a good thing to do.

We are also, you know—and I am not telling you anything you do not already know—$17 trillion in debt—$17 trillion in debt and we want to add another $1 trillion to it. That is why we are here, because we think $1.1 trillion is OK. Add another—after $17 trillion.

And, by the way, it does not end there. We are another—I do not know—$30 to $50 trillion in unfunded liabilities. And that is why we are here. That is why we are having this conversation, because we cannot control ourselves. We cannot control that. And I think that is a very honest conversation that this Committee and this Congress needs to have.

We go back to Nevada, and Nevada is hurting. I do not know that I have to tell you this, but you know we are highest in unemployment—everybody has heard me say this—highest in bankruptcy, highest in foreclosures. We are in tough shape. I just got a letter here from the Governor, and he was talking—I think some of you may know about this, about how tough this shutdown is, has been, and will be for the State of Nevada, programs like child nutrition programs, SNAP benefits, unemployment insurance, dozens of other programs, and he says this undermines the economic security of Nevadans. I agree with that. And a default, that is due to an economic—that is due to a shutdown. A default would make matters even worse. And I am concerned. I am concerned about the direction that this country is going and obviously the effect that it has on my own State.

If I can ask the Governor a question, you said that when you were Governor—and I hope it is fair to say you did a good job. And you said both Houses were Democrat at the time. Under what circumstances did you tell the leaders of the other party that you would not negotiate or you would not compromise? What were the scenarios that you had that would make you say that?

Mr. KEATING. Well, I come from a very bipartisan background. My grandfather was a Congressman-at-Large from Illinois, a Democrat. In Oklahoma, when I was in the House and Senate, Republicans, they sought us out with flashlights on Sunday nights. And as Governor, the legislature was overwhelmingly Democrat, but I had Oklahoma and Oklahoma State University economics departments examine why we were poor, and they came back and said you do not have Right to Work, the trial lawyers run this place, workers' comp is too expensive, the kids do not take hard enough courses in school, you have got a personal and corporate income tax, and you need to address that, the two economics departments of our universities.

So I sat down with the pro tem and the speaker and said, "Here it is. This is not the Heritage Foundation." And we went through every one of those things, even a right-to-work vote in the constitution successfully, and got it all done, I mean together, because as I said, if we crashed and burned, Texas would laugh at us.

[Laughter.]

Mr. KEATING. And, you know, who in the world would want that to happen? And I do not think the analogy to the Federal Government is misplaced.

Senator HELLER. Mr. Stevens, you talk about confidence, and I want to stick to confidence for a minute. What sense does it make to raise the debt ceiling and yet do so without any structural changes to this Government? Can you have confidence with just raising the debt ceiling?

Mr. STEVENS. I think there needs to be high seriousness about both of them in the near term to deal with that because it would be a hugely self-inflicted wound, but there needs to be very promptly attention to the longer problem, because as I said, they are linked in terms of what creates and builds confidence in the millions of people, thousands of institutions that we turn to to help finance the United States.

Senator HELLER. Thanks for your time.

Mr. Chairman, thanks for allowing me to vent some of my frustrations.

Chairman JOHNSON. Senator Brown.

Senator BROWN. Thank you, Mr. Chairman.

I was in the House of Representatives a dozen years ago with Congressman Bentsen and others when we got to a balanced budget with a budget surplus. Then looked what happened in 2001, 2002, 2003, and 2004—an unpaid-for war, tax cuts that went overwhelmingly to the wealthiest people in this country, a Medicare benefit that was, shall I say, generous to the drug and insurance companies—and this budget surplus, the largest surplus in history, went to the largest deficit in history. So lectures about our big spending when some of us opposed a number of those actions is not necessarily welcome, but more importantly, never during that period did any of us say, well, if you do not stop this war or if you do not do this, we are going to shut the Government down or we are going to not honor our debts and obligations.

You know, I appreciate Senator Heller saying that we need to do some of both, but first we need to pay our bills. And this is not running—this is not accruing war bills by passing a clean debt ceiling vote. It is paying the things that we—it is the American way. You pay your bills. And it is just so clear, and that is what pretty much everybody on this panel said.

Let me talk about one issue in particular. I was downstairs 2 hours ago listening to Secretary Lew at the Finance Committee, and he said, "Every Thursday, we roll over"—and he actually said this in September, and I asked him about it. But he said in September, "Every Thursday, we roll over approximately $100 billion in U.S. bills. If U.S. bond holders decided that they wanted to be repaid rather than continuing to roll over their investments, we could unexpectedly dissipate our entire balance." You know, it is really—like he said this morning, when I asked him about that, failing to roll over the debt would put us in a situation where we would be like a homeowner who 1 month has to pay the entire mortgage off instead of the monthly payment. And, obviously, Mr. Thomas gets—he is the one nodding the most vigorously of the four of you. Effectively the U.S. Government could face the same kind of funding crunch that Lehman had in 2008, the parallel's there.

So my question is: You know, this discussion of uncertainty, and the uncertainty in our economy has always been there to a point, but never as endemic or as penetrating as this uncertainty we are facing this week and next week.

Talk to me about this uncertainty. What do you think will happen if—you know, there is a debate on the 17th and all of that, but we do know that the 17th, because it is a Thursday, it is possible we could experience something that Secretary Lew alluded to, suggested. What do you think will happen or—each of you, what do you think will happen, or do we throw up our hands and really just not know what will happen come Thursday when this $100 billion is rolled over, connected or not to the actual debt ceiling?

Do you want to start, Mr. Stevens, if you would, and go from there?

Mr. STEVENS. I appreciate all of the contingency planning and analysis that has gone into the what-ifs here. But, Senator, we should all be aware. We are in *terra incognita.* We really do not know what the impact would be. There will be lots of individual decisionmakers as holders of Treasury securities that would enter into whether we are able to roll our bills the next Thursday or what the rate would be that they are willing to lend us money at, and all of the knock-on effects. And that assumes, frankly, a fairly short duration default, if you will, or whatever the temporary measures are that are taken to avoid a technical default.

If we entertain this idea over a longer period of time, I think there is no question but it will be cataclysmic.

Senator BROWN. Thank you.

Mr. Thomas?

Mr. THOMAS. Yes, I think the problem is, even if we went right up to the precipice and then came to an agreement, the problem is to me, it is like a lender lending to my company and I come up to the deadline of a payment and say, “I am not sure if I can make it or not. I will let you know by next Thursday.” And then I do it again 2 years later. Eventually they are going to say, “Well, I am not sure I want to continue to lend to you.” So that is the problem I think we have. And I think that in any future, the rates have to go up. There is no doubt in my mind.

Senator BROWN. Congressman Bentsen?

Mr. BENTSEN. I guess a couple things I would say, Senator. First of all, we already know. We have empirical evidence, and that is in the pricing of the auction earlier this week. That is what is going on in the repo market right now. That is what is going on in certain investors moving out of short Treasuries. That is what is going in, as we understand it, with other funds that are moving out of what they believe will be affected CUSIPs or coupons coming up. So we already kind of know what is going to happen, at least in the short run.

To Paul’s comment, even with all the contingency planning that our members are doing around Treasury operations, we can do contingency planning. We can think what we know is going to happen. But we do not know. And so we will have to work our way through it, and we know we have deadlines like the Asian markets opening and what the reaction will be there.

So, you know, we know what we know, we know what we do not know.

Senator BROWN. Thank you.

Governor Keating?

Mr. KEATING. Well, who knows? But I would say empirically, just historically—yesterday, the market went up, probably because people said, well, everybody is going to get their act together, work in a bipartisan manner to fix the problem, no default. If we do default, I think for a time there will be the attitude on the part of the markets and banks, Well, they will fix it, so it is not going to be that bad.

But then we get to our Argentina moment, our Cameroon moment, our Venezuela moment, which could very definitely happen if people conclude that this whole thing is a train wreck and they are not going to fix it.

Senator BROWN. Thank you.

Mr. Stevens, I did not take high school Latin, but I know *"terra incognita"* is a place we do not want to be.

[Laughter.]

Senator BROWN. Thanks.

Chairman JOHNSON. Senator Moran.

Senator MORAN. Mr. Chairman, thank you very much. Thank you to our witnesses for appearing before our Committee. Perhaps because we are working so little on the Senate floor, we are having the debate about a debt ceiling increase here in the Committee, and so I think what you are getting from us is a number of statements kind of testing the waters, telling how we feel, and trying to find in my view some common ground to solve a problem.

Let me pose this issue. The way I see this is I hate where we are. I like certainty. This makes me uncomfortable. We often complain about the uncertainty in the economy that Government provides. My guess is that folks who represent your industry have been in my office and have spoken to me about the uncertainty of the Tax Code, the regulatory environment. We know that is damaging to business, which means it is damaging to job creation, and this is one more instance of more uncertainty. This is not a good place to be. I understand that.

I think the deficit and the debt is a defining issue for my generation. I think I have an obligation to my kids and grandkids and Americans that I have never met, will never meet, to do something during my time in Congress to get us on a path that lends itself to which we are working toward balancing the budget. I do not expect it to happen overnight, but I want to know that there is a path that we are following that lends itself toward a brighter future for future generations of Americans.

And the issue that I face in trying to resolve how we come to resolve this is: What moments of leverage do we ever have in Congress? What is the moment in which we are so worried that Texas is going to laugh at us that we do something? We do not do things unless there is this moment that we come together fearing more dramatic consequences to force us to do things that apparently we are never willing to do on our own.

We ought not be having this debate about raising the debt ceiling, is my point, except we never have the serious debate or any resolution of how do we solve our deficit problem in the absence of these moments.

Do you have some suggestion, do you have any belief that Congress and the President will actually deal with this other issue? So if your advice to me and to us is raise the debt ceiling, OK, what is your advice to me about getting something done about the deficit that is not just prolonging? We have—I think what we are talking about here is the—we are demonstrating our willingness to pay our bills when we raise the debt ceiling, but we are doing nothing about our ability to pay our debts when we do that. How do we do both? How do we show the willingness—we demonstrate that we are willing to pay our bills, but in the longer term we demonstrate we have the ability to pay our bills? Do you want to indict Congress and the President to respond to that? It is the frustration I have. If we are never going to come together and solve the deficit problem unless we have a crisis, do you have to take advantage of the crisis? What do we do?

Mr. KEATING. Everybody is trying to flip coins here to see who takes that first. Well, Senator, if we raise the debt ceiling and then 6 weeks we are back at it again and 6 years we are back at it again, this will never be resolved sensibly, intelligently, and patriotically unless and until, with the President's leadership and with the good will of everyone in this room, Democrat and Republican alike, and recognize that in the year 2025 our latest estimate, every cent of Federal tax revenue will go to Social Security, Medicare, Medicaid, and interest on the debt. So it is the actuarial tables, and they have to be addressed. So to tie in the debt ceiling increase with some kind of long-term reduction in the long-term liability of the country is the only way to do it. And how do you do that? By bringing together men and women of good will, and that is everybody, in my judgment, in the Congress. I really believe that as an American citizen. Under the leadership of the President, shut the door, sit around the table, and say, OK, this is what we have got to do, here is the plan going forward. And the ideas I have heard from both sides of the aisle, whether it is chained CPI or a longevity index on Social Security, all that makes abundant good sense, and it has been presented to this body and to the House and to the public at large in a bipartisan way. So it cannot be that difficult.

Mr. BENTSEN. Senator, I would just say very quickly, you raise a very serious political question, and we are not political scientists, I guess. And it is a difficult question, no doubt about it.

I guess what I would say is today the United States is not Greece, we are not Italy, we are not in a situation where—while we do have a serious debt problem, no question about it, and long-term fiscal imbalance, we were able to access the credit markets because of an understanding of our ability to repay, the strength of our underlying economy, the fundamentals of the Nation's economy. We want to avoid, no question, getting into a situation down the road that would put us in a situation like Greece or other countries who either have to pay a tremendous premium on their debt or cannot sell their debt whatsoever to where there are no buyers. We obviously do not want to get to that situation.

So, again, that is where I go back to my comment with Senator Crapo, is we are sort of in a two-part dance here or intertwined. We do not want to impair our ability today to fix our problems for tomorrow. We do not want to get to those problems tomorrow, so let us not create any more difficulty today. But I grant you, it is a difficult political question that you all are faced with to deal with.

Senator MORAN. I am not sure it is a political question. I mean, obviously how we work together is a political question, but there is a moral question here. There is an issue that is really important to the future of our country, and at what point in time do you get the leverage to force us to do things that cause us to come together and do things that not all of us want to do?

Chairman JOHNSON. Senator Tester.

Senator TESTER. Thank you, Mr. Chairman. I also want to echo my thanks to everybody on this panel for being here today.

Just a little editorial comment. I cannot tell you how many times in the State legislature and back here I have heard folks say, "You need to run Government like a business." Now, I do not necessarily believe that, but I think there is some merit in it. And I guess when I look at my own farm, I ask myself, would I do this to my own farm, a business? And the answer to that is resoundingly, "No." And I think that it is important for everybody to understand—I believe this to be true—I do not think there is anybody particularly proud of where we are at debt-wise in this country, whether you are Democrat or Republican. And I think there are ways we can address it, but not this way, not—and I know it has been used many times, not being held hostage. I think there are ways to do it through the budget process, which, by the way, has been particularly frustrating because there has been a minority that have held up the ability to go to budget conference. And, quite frankly, the majority needs to speak at some point, and I am not talking about Democrat-Republican majority. I am talking about the majority in this body needs to speak up and stop this kind of craziness.

With that, let us get down to real life. I assume agriculture is still pretty big in Oklahoma, Governor, and so my question is: Operating loans are a pretty common thing. If we default, could you tell me what the impacts on somebody going to get an operating loan, whether it was in agriculture or other small business, would be?

Mr. KEATING. Well, we still have to eat, so hopefully the lending will be available and the borrowing will be available. But any time there is the chill, the panic of uncertainty, there is a pullback. And there will be a pullback.

So we will all scramble around to try to do the best we can to find quality borrowers and quality lenders, and you will have commercial activity, but in the AG space particularly, there is, as you well know, real linkage between what happens in Washington and what happens in your farm or in my ranch. And we have to be sensitive to that. You know, those of us who are conservative may say this Government is too big, it is out of control, fine, but it is a reality of the marketplace right now. So that is long term. Whether it is a veteran's benefit or whether it is Social Security or Medicare or Medicaid reimbursement or in the AG space, commerce will not function efficiently and well in a climate of uncertainty or a climate of default. It just simply will not happen.

Senator TESTER. OK. Senator Warner talked a little bit about State and local governments, and I have only got a couple minutes left, so I will just throw it to anybody who wants to answer it. If you have thought about this issue, could you give me an idea on how a default might impact local and State governments?

Mr. BENTSEN. Senator, one thing in particular that could be of concern are State and local governments that have refunded outstanding debt, municipal or State debt, and defeased that debt using a Treasury escrow. They are already suffering right now because the State and local governments series, the "slug" market, has been closed down as far as extraordinary measures. So that means their escrows are not as efficient as they might be, so that has cost them a little bit on that end. But the other thing that could happen is if an escrow is affected—a defeased escrow is affected by a Treasury security that is deemed non-eligible collateral, then that State and local government would be on the hook to make up any further shortfall in that escrow. So there could be a cash effect to State and local governments depending on how their escrow is structured.

The only other thing I would say, to follow up on the Governor's comments, among the largest holders of Treasury securities are banks of all shapes and sizes. And if you affect the liquidity operations of a bank and their ability to pledge those securities, that is going to affect their ability to put money out on the street. So, you know, it may be far down the road and this could be short, but they ultimately are affected across the system.

Senator TESTER. Thanks. I think I will just close it out right there. I would say this: We have seen the worst recession since the 1930s. You guys felt it straight up. I know Gary Thomas has felt it in the housing industry in a big, big way, and our country has suffered for it. It would seem to me that certainty and predictability and confidence are huge if we are going to talk about growing this Government and growing the tax revenue that comes with that growth. And I just want to say I appreciate you guys standing up and telling it like it is very much, and I certainly appreciate you being here today. Thanks, guys.

Chairman JOHNSON. Senator Merkley.

Senator MERKLEY. Thank you very much, Mr. Chair, and thank you to all of you for your testimony.

Mr. Thomas, your testimony laid out that just a 1-percent increase in real estate rates can have a dramatic impact: a lot fewer homes sold; a lot higher payment per month for those who buy, say, a $200,000 house, I think it was $120 per month more; a decrease of 700,000 to 900,000 jobs, and that is just in the real estate market. But that is a pretty significant part of our economy, home construction and home sales, so could one anticipate that there would be less revenue coming from that sector of the economy into the Federal Government if we continue on this path?

Mr. THOMAS. Well, absolutely. You would have less revenue coming into the Federal Government as well as the State governments, because, you know, you are not going to have the same revenue base because of that. And this is a 1-percent—we feel a 1-percent rate increase just because of this—it is not considering the rate increases we are going to have over time, which we are going to have.

We have already seen that. But this is a bump in rates immediately because of the crisis.

And so, you know, it is going to have a detrimental effect on the housing industry, which obviously has a detrimental effect on the overall economy because of the amount of GDP that the housing industry represents.

Senator MERKLEY. Is it reasonable to assume that in other sectors of the economy, for example, car sales, higher interest rate on car loans, that we would see a similar impact, car lots would make less money, pay less in taxes, and people would be paying a lot more out of their budget for that next purchase?

Mr. THOMAS. Absolutely, because, you know, if you raise what it costs to purchase a home and the payments that you would have to make, whether it is rolling over an existing loan or purchasing a new home, it is that much less that they can spend on other items—cars, you know, groceries, gas, you name it. It impacts all of it.

Senator MERKLEY. So it really seems like the path we are on right now is equivalent to creating a huge tax on the American economy, one that really hurts families across the board, hurts businesses, hurts employment, and yet we get nothing productive for—I mean, it is one thing if you have tax revenue that can do something valuable, build infrastructure, so on and so forth. In this case, it is like taxing families with no value, in fact damage.

Mr. THOMAS. We need to keep the economic growth that we are seeing right now intact and continue to grow. If we do not, we are going to fall backwards rapidly.

Senator MERKLEY. I really hope this point gets through to all of the colleagues on Capitol Hill of how this impacts ordinary working families, that when there is this sort of dysfunction just here in this square mile of Capitol Hill, how people across America are hurt.

I wanted to turn, Governor Keating, to an issue which is the potential impact on tier 1 capital that occurs if Treasury bonds basically drop in value because interest rates increase. Is that a concern of the industry?

Mr. KEATING. Well, it certainly is, and it is very much, Senator, a concern among the community banks out there, because whether it is Oregon or Massachusetts or Oklahoma or South Dakota, whatever the State might be, there are only so many places you can go to make up for the lost opportunity that the diminished value of the securities that you hold make you face. And so I think that—you know, I know my grandfather in Illinois, as a community banker, he had everybody in town on his board, every investor he could find. If he had to go out and get money quickly from some other source, particularly if people did not even know where Salem, Illinois, was, he would be very hard pressed. So this could create real issues for the community banking environment.

Senator MERKLEY. I will just note, because my time is running out, that I am also concerned about the impact on repurchase agreements, or repo lending, that is very important to many institutions. It sounds to me like the path we are on can decrease revenues, and it can raise costs. Families that lose their job may be more likely to need food stamps, for example, the whole series of—

so isn't it possible that in the name of reducing the deficit, this path could actually increase the deficit by decreasing revenues and increasing costs? Is that possible?

[Witnesses nod affirmatively.]

Senator MERKLEY. Would it be fair of me to call that kind of extraordinarily wrong-headed and destructive in a technical way?

[Laughter.]

Mr. BENTSEN. Your word, Senator, I guess it would be.

Senator MERKLEY. Thank you. I am out of time. I appreciate your testimony.

Chairman JOHNSON. Senator Warren.

Senator WARREN. Thank you, Mr. Chairman. Thank you, Ranking Member. I appreciate your having this hearing. I appreciate your being here today.

Mr. Keating, I read your article in the Washington Post that using the debt ceiling as leverage in the deficit debate is unwise and dangerous. You also noted that the respect and admiration of the United States and its institutions inspire around the world are based on the certainty that when our Nation makes a promise, we keep it. And I take it from what I have heard here today that all of you agree with that same sentiment. I had read yours, Mr. Bentsen, that it is unacceptable for Congress to ever voluntarily default on the debt and that continual short-term extensions of the debt limit increase unnecessary market uncertainty and raise questions about our Nation's creditworthiness. So I think we are all on the same page here, and I agree, I think that makes sense.

But here is my question: If the very prospect of a default costs us money and costs us our good name, I do not understand why we keep voluntarily raising the prospect of default with all these votes on the debt limit. Congress already controls the size of the debt. It gets to decide how much the Government taxes and how much it spends. So don't you think it would be better if Congress replaces the arbitrary debt limit with the commitment that Treasury can borrow exactly as much as it needs to pay our bills? Mr. Keating?

Mr. KEATING. Well, the technical issue, Senator, of how you change the process, if you change the process, will have to be resolved among and between you and your colleagues. There are probably many different approaches that make good sense.

I think what me and my colleagues are saying is when it is all said and done, whether you scrap the debt ceiling process as it exists now, if you go to another structure, another system, if you include or do not include the President in the process, then, fine, I mean, just get it fixed. But I do not know what the very best solution would be. I just think it is very important to look for a solution that we do not do this every year, every 2 years, or every 6 weeks.

Senator WARREN. So I think we are in the same place, Mr. Keating. We cannot do this every year, every 2 years, every 6 weeks since what I hear you saying is the very threat is costing us money. It is costing us our good name in the marketplace. And the way we stop doing that, it seems to me, is to take responsibility for these debts. Does that make sense?

Mr. KEATING. You are right. I mean, they are our debts. We have to pay them off eventually.

Senator WARREN. We have got to pay them.

Anybody disagree with that?

Mr. STEVENS. Senator, I would just say that so much of our spending is on autopilot already. If you look at the next 10 years, mandatory spending, which does not get a vote here in the Congress, is 61 percent of outlays. Interest on the Federal debt is 11 percent of outlays. That is about three-quarters of all our spending.

My worry is if there was not a gut check about increases in the debt, those numbers would simply get worse. If you are a household and you sit down with your spouse and you say, well, where are we? You have got to make a decision about whether you want the next credit card or the next purchase because at some point it gets unmanageable.

Senator WARREN. So, Mr. Stevens, I hear you saying in effect you want some accountability in the system. But it seems to me that accountability means that we want to reduce wasteful and unnecessary spending even if those votes are not politically popular. Accountability means voting to close tax loopholes so that wealthy individuals and big corporations are going to pay a fair share here. Accountability does not mean taking easy political votes and then turning around and grandstanding over whether or not we are going to raise the debt limit.

The way I see it, I appreciate your thoughts on this and the importance of our not voting over and over and over on raising the possibility that we are not going to pay our debts as they come due. You know, a U.S. default is the economic equivalent of a nuclear bomb. But thanks to this arbitrary debt limit, we routinely arm that bomb and watch in horror then as the clock ticks down to zero. There has to be a better way to do this. And it seems to me the least we can do, the bare minimum we can do, is pass a long-term debt ceiling increase as quickly as possible.

But, really, I think we should take this option off the table. The United States should honor its obligations and pay its bills in full and on time, period. Anything else, I think you have made clear, hurts our families, hurts our businesses, hurts our country. Thank you.

Thank you, Mr. Chairman.

Chairman JOHNSON. Senator Heitkamp.

Senator HEITKAMP. First off, I would like to thank the Chairman for holding this very important hearing. We are at 5 percent. Five percent of the American people think we are doing a good job. Why would they believe anything we said about the consequences of the debt limit, of what we are doing here? And that is why it is so important they hear from you. That is why it is so important that you participate.

You know, I am kind of new to this business, but I come with a dad who was a truck driver, but he had a saying: “When you are in a hole, stop digging.” Right?

So what have we done? We have shut down Government, but unanimously, over in the House, passed a resolution saying we are going to pay everybody who is not working. Do you know how absurd that is to the Federal Government and to farmers in my State who had a huge natural disaster that they cannot report anything to the FSA? I mean, just think about that.

And so there we are representing dysfunction, and now we are willing to take the greatest threat of all and jeopardize this economy and jeopardize this recovery, and I want to—because we came here to listen to your thoughts, and I just want to kind of reiterate some of the wise things you have told us today.

Mr. Bentsen, you said no amount of planning could take into consideration all the possible consequences. No amount of planning can take into consideration all the consequences. And I want to finish with a couple statements of yours, Mr. Stevens. Lessons cannot be unlearned. If we default, if we continue to do this, we will reap the whirlwind of the consequences of that. And, finally, more importantly, damages will be visited on every American if we do this.

There are people in this body who honestly are trying to find a way forward to say it does not matter. This matters dramatically, and it matters not just to the livelihood and to the political popularity of this group and whether we are going to get, you know, a pox on all your houses. That should be most irrelevant. What should be relevant is the consequences on the American people. It is understanding that when you say we are going to pick and choose our debts that we are going to pay.

You know, every American out there, when they look at their credit score—let us say I am going to buy a car. I always paid off my car loan, always late on my credit card. What is my credit rating? Do I tell the bank, hey, look, do not worry about all those credit cards I have not paid, because I always paid my bank loan, I always paid my car loan?

That is not how it works in the real world, and they know it. They know that this is dysfunction that has to be addressed. And I agree with my friends and my colleagues on the other side that we have a debt and deficit problem, and anyone who wants to ignore that is not looking at facts, not looking at the statistics, Governor, that you have raised here. But we cannot do it. We had Bowles-Simpson. They said they want to negotiate. When have we heard this before? Bowles-Simpson, Super Committee. You know, and all along, all the ultimatums of we are not going to raise taxes or we are not going to touch entitlements—it is equal opportunity blame—have led us to this point where we are not functioning the way we need to function on behalf of the American people.

You have been here and lots of great questions, but I just want to thank you, and I want to encourage you to continue to tell your story, continue to do what you are doing here, reiterating that we cannot let this happen, because I do not want to be here—I do not want to be here saying, “I told you so.” And you do not want to be here saying, “I told you so.” We want to stop this nonsense from happening. We want to abide by the full faith and credit of the American people because that is who we represent. It is not the American Government. It is the trust and the responsibility that we have to the American people.

And so thank you so much. Continue your good work. I am almost out of time. I know there is no question there. I did not get a chance for an opening statement. But I do want to tell you how invaluable your work on this is and how important it is that you continue to ring the bell, that you continue to sound the alarm, because in the end it is not about us in this room. It is about people who are getting car loans. It is about people who are retiring. It is about people who want to finance a house and they cannot even go and get approval because now we are shut down. So if they saw the rates rising, so what is their chance? And that is who we are here to represent, those farmers that Senator Tester talked about.

So thank you and continue your good work. It is so important that your voice get heard in the next couple days here.

Chairman JOHNSON. I am told that Senator Schumer is on his way.

Mr. Bentsen, GAO has said that the costs from the recent financial crisis may exceed $13 trillion, and some have suggested a default could be even worse. What would a default mean for investors, including both current retirees and future ones?

Mr. BENTSEN. Mr. Chairman, I think that in the case of current investors, if there was a default and coupon payments were missed, then at least immediately, you know, they would be out money for some period of time. It is not clear whether they would be paid accrued interest from the due date or the date of actual payment; and if they were not, then obviously they would have lost earnings associated with that.

If they are holding Treasury securities at this point in time, as Treasury securities move down in price, then they would take a loss accordingly on that as well. So I think it is fair to say that current investors would certainly have negative consequences as a result of this.

Chairman JOHNSON. Mr. Stevens, what do you think?

Mr. STEVENS. It will hurt in some fashion or other. Everyone who saves, everyone who invests, everyone who borrows, everyone who has a stake in the economy, not people of one category or another necessarily uniquely, but certainly retirees would be among those, people who are saving for longer-term purposes, institutions as well. The effects will be, I think, very, very broad cast.

Chairman JOHNSON. Thank you.

Senator Schumer?

Senator SCHUMER. Well, thank you, Mr. Chairman. I appreciate the courtesy that the Committee always extends, and I apologize. As you can imagine, there is a lot going on. But thank you for holding this hearing. It is a very important hearing at a very crucial time, and I want to thank all our witnesses, and I want to thank Senator Crapo as well.

First, I want to just make a few responses to some of the committees made earlier today, that the most urgent threat to our economy is overall debt, not debt limit. Well, I agree in the long run we are going to have to make serious adjustments to deal with our debt load. We have made some progress there. By the way, I would add middle-class incomes are declining in America. To me, that is a greater problem than our debt. If it happens for another 5 or 10 years, it is a different America.

But having said that, I do not want to gainsay the importance of getting our deficit down, but we have made decent progress there.

Mr. Stevens, I heard you spoke about confidence earlier. Well, it is safe to say investors have confidence in the ability of the United States to pay its obligations. If that changes, it is going to make our debt worse considerably. Interest rates will go up. It is going to make the country less strong. And I would argue that one of the best ways to increase our debt is to not pay our debt obligations, to not pay our bills, plain and simple. The two are not unrelated. They are very related.

So I want to agree with Senator Menendez. It is mind-boggling we are even discussing this here, but here we are just 2 years after the last prolonged discussion about whether we would pay our debt, and we have to ask the question.

So an important purpose of this hearing, Mr. Chairman, is to deal with the debt ceiling deniers. There are two types of debt ceiling deniers: one group generally confined to a small minority in the House that thinks default does not matter, that it is all a lie ginned up by the Obama administration. I have noticed that one of the people most quoted is Congressman Brown from Georgia who says it does not matter. This is the same man that said something to the effect a third of what he learned in medical school were lies. If we are having someone like that lead one party of this country or lead this country, we are in trouble.

But there is a more sober group which has gained steam in the Senate over the last few weeks, and maybe that is more troubling. They think there is a magic solution that many members of this body have put forward as a way out of our predicament. "We do not need to default," they say. "We can pick and choose which payments to make, and if we prioritize paying interest on our debt, we would avoid default."

So, Mr. Bentsen and Mr. Stevens, I want to ask you to elaborate on prioritization a bit and the effects it could have on the market. Treasury Secretary Lew said prioritization is default by another name. I agree with that statement. But we have hundreds of billions of dollars of Treasury securities maturing between October 17th and the end of the month, $120 billion October 17th, $93 billion October 24th, $89 billion October 31st. We rely on investors' willingness to roll over these debts as they mature.

So, Mr. Stevens, you have talked a lot about confidence today. How confident can we be that investors will be willing to roll over these debts as we are actively deciding, if some of these folks had their way, that we will not repay some of our creditors?

Mr. STEVENS. Well, Senator, as I said, if you think about a household that relies upon the bank for financing on an ongoing basis, if the bank finds out that the household is choosing to pay some bills but not others, it does not inspire great confidence in the bank to continue to lend; and to the extent that it does, it is going to charge a higher interest rate. And I think that is the analogy. I honestly believe that the confidence of this vast market of lenders that we depend upon to finance debt at the level of almost $17 trillion will take a blow, irrespective of which bills we decide not to pay.

Senator SCHUMER. And isn't it true we have never had this experience before except for one day where there was a mishap somewhere, that we have never had an active—that we have had an active decision made we are going to pay some debts and not others?

Mr. STEVENS. It is not an experiment we have run or should run.

Senator SCHUMER. Well said. I yield back my remaining time.

Chairman JOHNSON. Thank you again to all of our witnesses for being here today. This hearing is adjourned.

[Whereupon, at 11:58 a.m., the hearing was adjourned.]

[Prepared statements and responses to written questions supplied for the record follow:]

PREPARED STATEMENT OF FRANK KEATING

PRESIDENT AND CHIEF EXECUTIVE OFFICER

AMERICAN BANKERS ASSOCIATION

OCTOBER 10, 2013

Chairman Johnson and Ranking Member Crapo, my name is Frank Keating, President and Chief Executive Officer of the American Bankers Association (ABA). The ABA is a 135-year old association that represents banks of all sizes and charters and is the voice for the Nation's $14 trillion banking industry and its two million employees. I also served as Governor of Oklahoma for two terms and as a member of the Bipartisan Policy Center's Debt Reduction Task Force.

I appreciate the opportunity to be here to represent the ABA regarding the need to raise the debt ceiling and the consequences of failing to do so.

Let me be very clear: we need to meet our obligations and not create any uncertainty that we will do so—on-time, every time. In this country, our word is our bond. The respect and admiration that the United States and its institutions inspire around the world are based on the certainty that when our Nation makes a promise, we keep it.

Ordinary Americans will bear the brunt of the damage if our leaders do not prevent the United States from defaulting on its debt for the first time in history. We are much closer to disaster this year than we were just over 2 years ago when the debt-ceiling standoff caused economic uncertainty to spike, consumer confidence to plummet and stock prices to spiral downward—all because of the perceived risk of the United States defaulting on its domestic and international debt obligations. The Bipartisan Policy Center (of which I am a board member) estimated the 2011 debt standoff cost taxpayers close to $20 billion as nervous investors demanded higher interest on U.S. Treasury bonds to account for the risk of Government default. If our Nation defaults on its nearly $17 trillion in debt, the harm is likely to be measured in hundreds of billions of dollars.

Even the slightest uptick in Treasury interest rates would cascade through the economy. It would raise the costs for taxpayers to service our country's debt and would raise the cost of borrowing for businesses, meaning job losses and price increases. Default would be a blow to retirement funds, leaving fewer resources available for retirees. For banks, which hold $3 trillion in Treasury, agency and mortgage-backed securities, the sharp decline in value of those securities would translate into fewer resources available for mortgages, business, auto, credit card and student loans.

If Congress fails to act and we hit the debt ceiling we will set off a chain of events that will cover our entire economy and impact all Americans. These impacts would not be easily reversible. The repercussions could linger for years, providing a constant drag on our economy.

Default would also put the United States in the category of reckless debtor nations that have broken their word in the markets, including Argentina, Venezuela and Cameroon. Defaults left those countries financial pariahs and debilitated their economies.

No one takes our national debt more seriously than I do. As a Republican Governor, I balanced my State's budget 8 years running and worked with colleagues from both sides of the aisle to ensure that Oklahoma honored its debts and expanded its economy. Later, I joined the Bipartisan Policy Center's Debt Reduction Task Force (also known as the Domenici-Rivlin commission), which endorsed painful but necessary measures to put the country's fiscal house in order. Rather than inflict damage upon ourselves by failing to pay our existing obligations, we should instead focus on reducing our future spending and bringing our debt to a sustainable path.

Honoring U.S. Fiscal obligations is not a Republican or Democratic issue—it's the American thing to do. As George Washington said, "No pecuniary consideration is more urgent than the regular redemption and discharge of the public debt; on none can delay be more injurious, or an economy of the time more valuable."

Since May, the Treasury has used extraordinary measures to keep us from hitting the debt limit. We have been lucky to avoid it thus far, but time is up. With the U.S. economy and our Nation's honor on the brink, our leaders must—in the spirit of patriotic compromise—do what it takes to make a deal.

If confidence is lost in our country's willingness to pay its bills on time, we will have lost something that may be impossible to regain—the world's trust.

The Debt Ceiling Must Be Raised To Pay What Our Country Has Already Spent

It is essential that Congress act to raise the debt ceiling and pay the debts it has already incurred to maintain our Nation's credibility. U.S. Treasuries are the world's risk-free assets and lifeblood of global financial markets. When times are tough, it is Treasuries that are the world's safe financial harbor. This is only possible because governments, businesses and investors around the world have unparalleled confidence in both our ability and willingness to pay out debts. Our country has been a huge beneficiary of this and we should never take it for granted. We need to manage carefully our debt levels, but we cannot inject doubt as to our willingness to meet our obligations.

By raising the debt ceiling, Congress does not authorize any new spending, it simply commits to paying the bills it has already approved and money already spent. Paying our debts should not be confused with controlling future spending. Both must be done. At over 70 percent of GDP, there is no denying our overall debt level is too high. We need as a country to find a path forward that makes the most effective use out of the hard-earned tax dollars our citizens entrust to the Government to manage.

Default Will Have Severe Long-term Consequences

Failing to raise the debt ceiling in time would be an unprecedented mistake that would have dire consequences for our economy. Even the ***prospect*** of a default has shown to be massively disruptive to our economy. The debt ceiling standoff in 2011 gave a clue to the potential damage. As I mentioned above, that event alone cost U.S. taxpayers nearly $20 billion in increased interest costs, all of which could and should have been avoided. The market today is already pushing short-term Treasury rates up and credit default insurance spreads on Treasuries have widened.

If the United States were to fail to pay its debts, even for a few days, the consequences would be many times worse. In the first 2 weeks of November alone $345 billion in U.S. Government bonds will come due. If we have not raised the debt ceiling by this point, the ability to roll over that debt and pay bond holders could be impaired. Interest rates would spike, as investors demand a higher premium for the risk they now take by holding our Government's debt.

The inevitable increase in Treasury interest rates would cascade through the economy, directly impacting the lives of every American. Taxpayers will have to pay the higher government interest costs. Stocks would plummet, dealing a sharp blow to retirement funds. Borrowing costs for companies—both large and small—would rise, making businesses less willing and able to invest in new plants, buy equipment and hire additional workers. Because banks hold large portfolios of Treasury, agency and mortgage-backed securities, any rise in rates would create unrealized losses that would end up reducing capital ratios and limiting the supply of funds that could be lent to individuals wanting to buy a home, finance a new car or go to college.

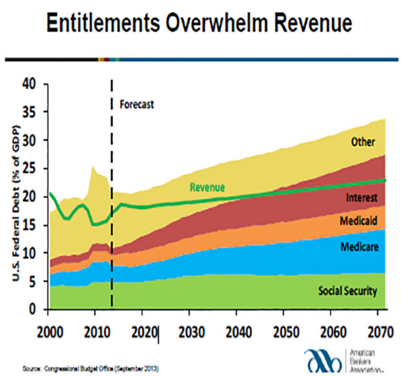
The short-term impacts will certainly knock the current economic recovery back on its heels. These consequences are not easily reversible and are likely to linger for years, providing a constant drag on our economy. While the failure to pay our country's bills on-time would have the biggest cascading impact, failure to raise the ceiling would also reduce the available funds to pay salaries to our armed forces, retirees on Social Security, and thousands of other commitments we have already made.

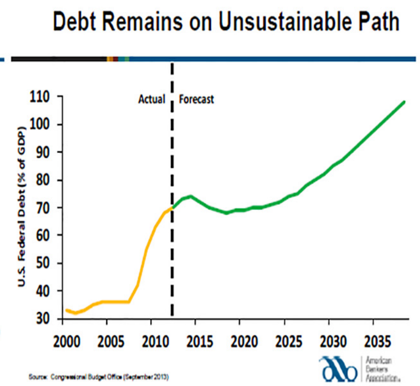
A Sustainable Solution to Our Long-term Debt is Needed

There should be a wholesome debate about how taxpayer dollars are spent in the future. We need to be sure that those precious tax dollars from hardworking American's are used in the most productive way. But we should not confuse the need to pay our bills for things that Congress has already approved and spent with the management of spending that is appropriate for the future. To use a credit card analogy, the decision about what to buy on credit tomorrow must take into account the debt we already owe, but that is never an excuse for not paying the current bill on time and in full.

Markets, not Congress, truly determine our Government's ability to borrow. Our debt is already 70 percent of our GDP. While the sequester is expected to reduce debt-to-GDP for a few years, even it fails to arrest the longer-term upward trajectory. According to the Congressional Budget Office (CBO), by the year 2043 entitlement programs and debt service payments alone are projected to outstrip revenues. This means that there will be no funds at all for any discretionary spending. It is impossible to address the long-term sustainability of our debt without addressing the growing costs associated with our entitlement programs.

The CBO predicts that in the next 25 years our debt will surpass 100 percent of our GDP. This would put us in the same league as the fiscally unstable countries that led Europe into crisis. Already, the U.S. debt amounts to nearly $54,000 per person, and $148,000 per taxpayer. The interest payments alone on our debt will cost over $8,000 per U.S. citizen in 2013.





Addressing future spending and bringing our debt down to sustainable levels must be done in a bipartisan way. My experience serving on the Domenici-Rivlin commission gives me hope that tough decisions can be made for the good of our country.

Conclusion

The answer to managing our debt is not to simply stop making our payments on money already spent. We should never inject uncertainty into the markets that we as a country will not keep our word and pay the debts that we owe. We must pay our bills on-time and in full; then we must carefully manage our future spending so that we can begin to pay down our accumulated debt. I urge Members of this Committee and the full Senate and House to engage in a bipartisan way to find long-term solutions to our growing debt levels.

Our role in the global economy is too important to flirt with danger of a default. Once trust is lost, it is difficult, if not impossible, to regain.

PREPARED STATEMENT OF KENNETH E. BENTSEN, JR.

PRESIDENT, SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

OCTOBER 10, 2013

Chairman Johnson, Ranking Member Crapo, and Members of the Committee, my name is Ken Bentsen and I am President of the Securities Industry and Financial Markets Association (SIFMA).[1] Thank you for the invitation to testify today regarding the risks associated with a default on the Nation's public debt. SIFMA appreciates the opportunity to provide input on consequences to the financial markets and the overall economy should the United States fail to make timely payments on any of its outstanding debt obligations. Given the important role U.S. Treasury debt plays as a world currency and store of value, any such default would likely negatively impact the economy and certainly disrupt the operations of our financial markets. Indeed market observers have already noted the effects of the current uncertainty regarding the public debt limit, including fairly dramatic pricing effects on the short end of the Treasury market and re-purchase agreements or repos. While we firmly believe that the time is long overdue for the Administration and the Congress to come together and develop long-term solutions to our very real fiscal chal-

[1] The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit *http://www.sifma.org*.

lenges, voluntarily defaulting on the Nation's obligations should not be an option for policymakers to consider. Even a short-term failure to fulfill our obligations would seriously impair market operations and could have significant consequences to our fragile economic recovery.

Should Congress fail to raise the debt limit and the Treasury is unable to meet interest and principal payments coming due, it would in effect trigger a series of events which inevitably would lead to American taxpayers paying more to finance our debt. We strongly urge the President and the Congress to come together and negotiate a workable solution to avoid these consequences.

Since the threat of default first arose in the summer of 2011, SIFMA has been engaged with its members in developing scenarios to better understand the consequences of a failure to pay on Treasury securities. I would stress that while market participants believe that the likelihood of a default remains low, the industry also believes that, given the potential negative consequences, it is prudent from an individual member perspective as well as a broad market and economic perspective, to develop plans to further cooperation, coordination, and information sharing. Based on our work, we believe market participants are operationally prepared to deal with the scenarios that a Treasury failure to pay would present. Market participants have worked to develop reasonable assumptions and to prepare accordingly so that this important market continues to function. However, as you know, a default by the U.S. Government would be unprecedented and the consequences for the market and the economy would be dangerously unpredictable so no amount of planning can identify and mitigate all of the potential short- and long-term consequences of a default. But we are certain that one of the most significant consequences to the Nation would be a rise in Treasury's cost of funding as investors demand a default premium that will result in higher rates at auction to compensate for the additional risk.

Working with SIFMA's broad membership from both the buy and sell side, as well as key operators of the settlement infrastructure of the Treasury market, SIFMA has developed scenarios based on a number of reasonable assumptions. Working through these scenarios, SIFMA developed possible approaches and noted questions and issues that could not be resolved. I would stress that over the course of the industry's consideration of the dangers of default, no scenario presents a clear cut answer. Indeed, the settlement arrangements for Treasury securities do not contemplate or recognize the possibility of a default and thus the ability to sell, finance, or post as collateral, defaulted Treasuries may be compromised. This ultimately could lead to a liquidity drain from the market. It is important to note that Treasury securities are a key factor in the daily financing of market operations with the U.S. Treasury repo market totaling between $1.2 and $1.9 trillion daily. Undermining that market would have a deleterious effect on every market participant. I outline additional consequences below based on discussions among our members.

October 17 and Beyond

The Secretary of the Treasury has stated that the Treasury will have exhausted all "extraordinary measures" by October 17, and that estimated cash on hand will be insufficient to meet current obligations. Significantly, Treasury has payments coming due of $120 billion on October 17 and $93 billion on October 24, followed by additional principal and interest payments due every week thereafter.

Settlement Timeline and Impact on Payments

Settlement and processing for daily transactions in Treasury securities takes place in the evening after the trading day in the U.S. Fedwire (the Federal Reserve service that provides transfer services for Treasury securities) normally runs its evening processing around 7:00 pm eastern time, and other processes, including those of the clearing banks and DTCC's Fixed Income Clearing Corporation (FICC), run shortly after that. Should there be an announcement that Treasury will be postponing a payment due the following day because of an inability to pay, before these systems run, the systems should be able to adjust to reflect changed payments dates. Under this scenario, securities may be transferred and can be sold, financed and, if acceptable to a counterparty, used as collateral. However, we note that it is impossible to predict what overall impact on the market for these securities, on the price, on their acceptability as collateral in repo transactions or as to their acceptability as collateral throughout the global financial system since in effect Treasury would be acknowledging that it could not pay principal and/or interest when due.

If a Treasury determination and announcement were delayed beyond the time when systems normally run, some processes may be delayed for a short-period in the evening. It is not clear how late systems can be held and the potential consequences of any delay on the opening of the trading day in Asia. An announcement of an intent to extend a payment beyond the current expected maturity after systems have been run (with the assumption that payments will be made the following day) would not be reflected in the evening's processing and would result in the inability to transfer further the security after the payment is missed on the following day. That is, certain Treasury securities may no longer be eligible collateral and may have limited ability to be pledged or sold.

In addition, Treasury securities are traded in a global market with the global trading day beginning in Asia at 8:00 pm eastern time. Market participants normally run their own internal processes prior to the trading open in Asia in order to provide a clear cutoff to reflect positions in their books and records. Failure to provide early indications of intention could further confuse positions and could cause trading confusion in the Asian markets as it will be unclear whether certain securities will be paid in a timely manner. The disruption to pricing and trading behavior is impossible to predict.

Announcements from Treasury

The timing of Treasury's announcement of its intention not to make a payment timely remains the key variable under all the scenarios our members reviewed. Given what we understand to be the limitations of the transfer mechanism for Treasury securities, failure to provide sufficient notification for a payment failure prevents the security from being further transferred. Holders of such a security may have limited opportunity to sell it, finance it through repo or post it as collateral.

As noted above, as a result of a late notification, a Treasury security on which a payment is not made may not be further transferable. While we assume that the missed payments will eventually be made, while the payment remains unpaid the holder of the security that expected its payment may not be able to sell the security or to finance it in the repo market. Similarly, collateral and margin requirements at clearing houses and central counterparties may no longer be able to be met with these securities. Further, it is entirely possible that for purposes of any escrow, collateral or margin arrangement involving such securities could result in them being deemed non-eligible and subject to replacement. Essentially the holder would have a receivable from the Treasury that could not be further transferred and, overall we would expect some frictional decrease in liquidity in the market-liquidity that would be available for further investments, loans and important business development. The impact could be widespread. Counterparties might begin to question whether other counterparties would be able to replace ineligible collateral.

Disruptions in the Treasury repo market would further impact price changes on Treasury securities. Treasuries are the world's safest asset and the most widely used collateral for both risk mitigation and financing. Shrinkage in the financing market would further pressure rates as haircuts on Treasuries would increase—thus reducing financing capability—and disrupt the collateral market because of margin calls throughout the financial system that would reflect the overall repricing of Treasury collateral.

Inability to Plan

Our understanding is that Treasury will determine payments/postponements on a day-by-day basis. Once Treasury fails to make a timely payment, markets will have to wait each day for Treasury's indications as to its intentions for payments due on the following days. If this were to continue for any length of time, market participants would need guidance on missed payments as well as future payments on additional securities. In addition, we understand that coupon payments that are not paid will ultimately be paid to the holder of record of the security on the day the payment should have been made. Uncertainty on that payment will continue until payment is finally made Clearly, securities that are coming due in the short-term would be less attractive to hold and may become harder to finance as doubts about the payment of interest and principal when due would be more prevalent. Even if the debt ceiling were raised at the last minute, experience from the 2011 event suggests that securities that may be the subject of a default in the near future will trade at a premium and will be more expensive to finance.

Municipal Funding Challenges

Some specific issues arise with regard to the municipal securities market. A key interaction between municipal securities—the principal means by which State and local governments finance investment in schools, highways, airports, water and sewer systems, hospitals and other key infrastructure—and Treasury securities involves municipal refunding transactions. A refunding typically occurs when interest rates have fallen since a State or municipality issued long-term bonds, and a borrower is able to achieve interest cost savings by refinancing bonds at the current lower rates. When a refunding can be achieved before the old, higher-interest bonds can be redeemed early, the borrower invests the proceeds of the new, lower-interest bonds in Treasury securities, and the income earned from these investments is used to pay debt service on and eventually redeem the old bonds. When old, higher-interest bonds are fully backed by an escrow portfolio, they are said to be "defeased" or "escrowed" and treated as triple-A rated.

One issue involves a category of nonmarketable Treasury securities, State and Local Government Series ("SLGS"), special, customized securities sold by Treasury specifically for the purpose of funding State and local government escrow portfolios. The Treasury Department stopped selling SLGS on May 15, 2013 as the Government's debt outstanding approached the current debt ceiling, making it more difficult and costly for States and localities to refund outstanding bonds. An even bigger issue would arise if the Treasury defaulted on outstanding bonds which are backing defeased municipal bonds. Because defeased bonds are backed by the income from the escrow portfolio, a Treasury default would "pass through" to the municipal bond holders, calling into question the reliability of escrowed municipal securities in general.

Industry Playbook

Given the significant uncertainty of the timing of a default and the uncertain impacts, market participants and SIFMA have developed a playbook this is intended to provide key market participants and service providers a forum to share information about the latest developments including decisions from the Treasury, the Administration and Congress and the status of the infrastructure and settlement providers. Of particular concern to market participants is whether an early indication from Treasury that securities will be extended has been made and, if not, whether processes are being—or can be—delayed. Our current playbook calls for an initial call with market participants at 2:00 pm eastern time to share the latest information and set in motion the later planned calls. The schedule suggests industry wide calls at 6:30 pm, 8:00 pm, 10:00 pm and 8:00 am eastern time the following morning in order to allow market participants to monitor in real time the impact on the settlement process. Without a resolution of the debt ceiling before the Treasury's expected limit of extraordinary measure on October 17, we expect to initiate this call protocol on October 16 as a Treasury bill is scheduled to mature on October 17. Of course, we maintain the ability to call the industry together at any time should events dictate.

Conclusion

U.S. debt obligations are the currency of U.S. and global financial markets and the real economy and their soundness should not be questioned. No amount of planning can anticipate all the potential consequences of a default. Short- and long-term costs to the taxpayer can be anticipated but the further limits on the ability to transfer, sell, finance and post as collateral defaulted securities would only serve to undermine investor confidence and hurt our fragile economic recovery. SIFMA and its member firms have frequently called on Congress and the Administration to work together to put our fiscal house in order but unnecessarily triggering a historic default will result in dramatic, and possibly permanent, damage to our economy and markets in ways both anticipated and unanticipated, and must be avoided. Again, SIFMA appreciates the opportunity to testify today and I look forward to answering your questions.

PREPARED STATEMENT OF GARY THOMAS

2013 PRESIDENT, NATIONAL ASSOCIATION OF REALTORS®

OCTOBER 10, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and Members of the Committee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of Realtors® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of Realtors®. We thank you for the opportunity to present our views on the potential economic consequences if Congress fails to raise the statutory limit on our Nation's debt before the limit is breached.

State of Housing

It is no secret that real estate is a cornerstone of our Nation's economy. The housing sector accounts for roughly 18 percent of GDP and research has shown the social and financial benefits to all Americans. As our economy slowly improves from the Great Recession, the U.S. housing market will be key to this recovery. Our Nation will not return to full employment and robust economic health unless the real estate market makes a broad-based and lasting comeback. Fortunately, the U.S. housing market recently has shown some hopeful signs.

Housing has been instrumental in pulling the economy out of the Great Recession, substantially contributing to our Nation's economic growth since 2011. Home sales, housing prices, and residential construction have increased during this time, supported by low mortgage rates and improved consumer confidence in both the housing market and overall economy. In the past 2 years, home prices have gone up 15 percent, pushing up the value of household real estate to $18.6 trillion at the end of the 2nd quarter of this year. Additionally, home sales were 13.2 percent higher in August 2013 than a year earlier with 5.48 million homes sold, but were well below the 7.23 million homes sold in August 2005. Also, the residential construction industry has recovered almost half a million jobs of the 2.3 million lost during the recession; however, it still lags behind as a job creation engine.

Impact of a Default

While these figures are promising, the housing market clearly remains far from healthy. Maintaining momentum in the housing market is particularly crucial right now. Sustaining the housing market rebound will increase economic and job growth, as it has in past U.S. economic recoveries. However, the momentum of the housing recovery will be in serious jeopardy if Congress is unable to move passed unnecessary political brinkmanship over raising the debt limit. A default, or even the perceived threat of a default, could result in a harsh and long-lasting recession, which may be even more severe than the previous economic downturn.

Congress must raise the $16.7 trillion Treasury debt limit before the middle of October 2013, which is when the Treasury will exhaust all its extraordinary measures to stay under the limit. At that point, incoming revenue would be the only way for the United States to finance its debt obligations. However, the Government is expected to experience a monthly deficit of $50 billion in FY2014, which will rapidly diminish any remaining cash the Treasury has on hand. If this occurs, the United States would be unable to meet its financial commitments and be in default on some or all of its obligations. Investor confidence along with consumer and business sentiment will likely fall sharply, placing both domestic and global financial markets into turmoil.

2011 Debt Ceiling Impasse

Given that the United States has never defaulted on its debt obligations, it is impossible to predict the exact economic impact in the event our Nation is unable to pay its creditors. However, economic theory and evidence of significant economic disruptions resulting from the 2011 debt ceiling impasse, when Congress delayed raising the debt limit until the very last minute, can help illustrate the severity of an actual default.

According to the U.S. Department of the Treasury, the political brinkmanship during the 2011 debt ceiling was responsible for financial market disruptions, reduced consumer and business confidence, and slower job growth. The debt ceiling stalemate ultimately led Standard & Poor's to downgrade our Nation's credit rating. Even though lawmakers were able to raise the debt limit before the Treasury expended its remaining cash on hand, political gridlock nearly caused our economic recovery to freeze. Furthermore, the Bipartisan Policy Center estimates that delays in raising the debt limit during 2011 led to higher borrowing costs for the Federal Government, which the Bipartisan Policy Center estimates will cost taxpayers an estimated $19 billion over the next 10 years.[1]

Higher Treasury Rates Mean Higher Mortgage Rates

Long-term mortgage rates are closely linked to U.S. Treasury rates. As a result, an increase in U.S. Treasury rates would result in higher mortgage rates. In the event of a default, U.S. Treasury prices would fall and yields, which move inversely to prices, would rise. Both banks and borrowers would be sensitive to this change.

[1] Bipartisan Policy Center. Debt Limit Analysis. By Steve Bell, Shai Akabas and Brian Collins. Available at: *http://bipartisanpolicy.org/sites/default/files/Debt%20Limit%20Analysis%20Sept%202013.pdf.*

Banks, which face requirements regarding the amount of capital they hold, would see declines in the value of one of their core capital assets—U.S. Treasury securities. Banks would likely restrict new lending in order to shore up capital and charge more for mortgages they originate. Borrowers would be impacted by both tighter credit standards and the compounding of higher rates.

Historically, an increase in mortgage rates of 1 percentage point reduces home sales by roughly 350,000 to 450,000 units. That relationship might prove more robust in an environment of rising mortgage rates and bank tightening. For a borrower earning $60,000 and taking out a $200,000 mortgage, that 1 percentage point increase would raise the monthly payment by roughly $120 and could raise the borrower debt-to-income ratio (principle and interest only) from 27 percent to 29 percent, enough to disqualify them from many lending programs and potentially under the terms of the qualified mortgage (QM) rule.[2]

Researchers at the Federal Reserve Bank of St. Louis found similar results in their analysis of trends in mortgage finance from 1940 through 1960.[3] According to the study's authors, 8.5 percent of the increase in home ownership from 45.5 percent to 62.5 percent was due to the 85 basis point decline in cost of mortgage credit during this period. African American, Latino Americans and first-time buyers who utilized low down payment loans are more susceptible to a tightening of credit and a resulting decline in ownership. Current homeowners seeking to trade up and baby boomers looking to traded own also would not be immune to the disruption as fewer qualified first-time buyers result in reduced demand for the homes they would sell before purchasing again.

A significant loss of home sales would have ramifications for the economy. Roughly 700,000 to 900,000 fewer jobs would be created as a result of a 1 percentage point increase in mortgage rates. This decline in industry and construction incomes along with fewer expenditures on services, renovations, appliances and other goods associated with home purchases that would weigh on ancillary businesses and their decisions to create jobs. Higher mortgage rates also hamper refinance activity, which would hold back additional consumption spending.

As noted by the U.S. Department of the Treasury, it is important to recognize the sovereign debt concerns in Europe, as well the sharp downward revision to 1st quarter GDP in the United States, had an impact on U.S. financial markets during the 2011 debt limit episode.[4] Thus, the widening of mortgage spreads in 2011 was due in part to these issues. However, those same concerns dropped Treasury yields, so on balance, mortgage rates decreased even as the spreads widened. If mortgage spreads widened today as a result of a debt ceiling impasse, with Treasury yields rising, the negative consequence for borrowers would be higher mortgage rates, which would curtail household spending and prevent the housing market from contributing to our economic recovery.

The Federal Reserve's ability to support the housing market could be affected as well. The Federal Reserve has been purchasing $40 billion of mortgage backed securities and $45 billion in Treasuries per month since the fall of 2012, but has indicated its intent to wind down this program. A decline in Treasury prices could undermine the Federal Reserve's ability to wind down its purchases in an orderly fashion, potentially creating volatile movements in mortgage rates. In the long term, lower Treasury and mortgage-backed security (MBS) prices could hamper the Federal Reserve's ability to manage its significant holdings of Treasuries and MBS. What's more, if weaker confidence in the Treasury results in less and more erratic demand for it, the Federal Reserve's open market operations would become more difficult, limiting the Federal Reserve's ability to respond to the next crisis.

The impact of an actual default would have far greater and long-lasting impact on interest rates on Treasuries than concerns about a potential default during a temporary standoff.

High Mortgage Rates & Lower Consumer Confidence

Consumer spending is a key driver of our Nation's housing market and overall economy. The consumer confidence index measures the degree of optimism that consumers feel about the overall state of the economy and their personal financial situ-

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[2] For this example a 30-year fixed rate of 4.25 percent is assumed as well as a 5 percent down payment, 0.67 percent primary mortgage insurance, $70 monthly homeowner's insurance, and 1 percent real estate taxes.

[3] Federal Reserve Bank of St. Louis. *Did Housing Policies Cause the Postwar Boom in Homeownership?* By Matthew Chambers, Carlos Garriga and Don Schlagenhauf. Available at: *http://research.stlouisfed.org/wp/2012/2012-021.pdf.*

[4] U.S. Department of the Treasury. *The Potential Macroeconomic Effect of Debt Ceiling Brinkmanship.* By Sabrina Siddiqui. *Available at: http://www.treasury.gov/connect/blog/Pages/Report-on-Macroeconomic-Effect-of-Debt-Ceiling-Brinkmanship.aspx.* Accessed: 10/4/13.

ation. Confidence in the stability of their incomes affects consumer economic decisions, such as spending activity, and therefore serves as one of the key indicators for the overall shape of the economy.

In essence, if consumer confidence is high, consumers likely purchase more goods and services. Conversely, if confidence is lower, consumers tend to save more and spend less on goods and services. A month-to-month trend in consumer confidence suggests the outlook of consumers on their ability to find and retain good jobs according to their perception of the current state of the economy and their personal financial situation.

Falling stock values, weak employment numbers, and higher mortgage rates can weigh on consumer confidence. This was evident during the debt ceiling stalemate between June and August 2011. According to the U.S. Department of the Treasury, consumer confidence eased in the spring of 2011 over employment concerns before it plummeted 22 percent in response to the impasse; it took several months after the debt limit stalemate was resolved before consumer sentiment recovered.[5] A home is the largest and most complicated purchase of most consumers' lives. A general decline in confidence would weigh on consumers.

Just as with interest rates, the impact of an actual default would have far greater and long-lasting impact on consumer confidence than concerns about a potential default during a temporary standoff.

Mortgage Rates & Consumer Confidence Impact on Housing & Economy

Higher mortgage rates and lower consumer confidence are associated with fewer home sales because the cost of borrowing goes up for consumers. This mechanism is more relevant today given today's tighter underwriting and debt-to-income requirements, as well as regulatory requirements from the qualified mortgage (QM) rule. Home sales decline when interest rates go up, and housing prices moderate as a result. As seen in recent years, stagnant or falling prices weigh on sales growth as buyers fear the value of their purchase may decline. Slow price growth slows equity accumulation, forcing some consumers to pay mortgage insurance longer, hampering refinancing during recessions, and making owners more susceptible to default as a result of unemployment or loss of income.

Interest rates tend to fall during recessions and eventually, demand for housing and new construction increases as a result. This pattern has been an important driver of U.S. economic expansions in recent decades with the notable exception of the most recent episode. Furthermore, the U.S. Treasury securities status as a safe or risk-free store of wealth attracts capital especially during an economic and fiscal crisis when investors shy away from riskier activities which augments this pattern resulting in shallower recessions. A decline in the Treasury securities low-risk of default status could reverse this pattern.

Fewer home sales means less construction, less income from transactions, and fewer purchase of appliances, renovations and the services that accompany a purchase. As discussed earlier, this pattern is circular as it weighs on the economy, job growth, and future home ownership.

As previously noted, the impact of an actual default would have a much more severe and drawn out effect on home prices and sales than concerns about a potential default during a temporary standoff.

Challenges Facing the Housing Recovery

Luckily, our economy has been able to bounce back from the 2011 debt ceiling debate and home prices have increased 14.7 percent over the 12-month period ending in August. However, they are still 7.6 percent lower than in August of 2006. Today, home prices have led to positive gains in the net worth of homeowners, $18.6 trillion of which is saved up in residential real estate. Rising home prices have also cut the number of underwater homeowners by nearly half, but have put pressure on potential home buyers who have not yet completed their home purchase. Home sales rose 13.2 percent from August of 2012 to August of 2013, but are 24.2 percent below the level from August of 2006.

In addition to increases in home prices, mortgage rates have begun their ascent from historically unprecedented lows. While mortgage rates have stabilized recently due to the Federal Reserve's delay in the tapering of asset purchases, all expectations of a healing housing market and recovering economy point to higher mortgage rates ahead. These two factors combined with meager increases in family income are squeezing the affordability of homes. Affordability has plunged 18 percent to the

[5] U.S. Department of the Treasury. *The Potential Macroeconomic Effect of Debt Ceiling Brinkmanship*. By Sabrina Siddiqui. Available at: *http://www.treasury.gov/connect/blog/Pages/Report-on-Macroeconomic-Effect-of-Debt-Ceiling-Brinkmanship.aspx.* Accessed: 10/4/13.

lowest level since 2006. While affordability remains above historic levels, a swift reduction will undoubtedly have an impact on buyer options and psychology.

Consumer sentiment is already facing headwinds from rising interest rates and the recent Government shutdown will likely be an additional blow to consumer confidence and our economic recovery. Some economists have predicted that a weeklong Government shutdown could slow GDP growth by a quarter of a percent. Any longer shut down could result in a more significant effect. In either case, U.S. economic expansion will be more susceptible to the adverse effects from a debt limit impasse than prior to the shutdown.

Conclusion

The U.S. housing sector is in the midst of recovering from the worst economic downturn since the Great Depression. Home prices and sales, as well as household wealth, are all up from a year ago. While this industry continues to face many headwinds such as higher interest rates and affordability challenges, maintaining the housing recovery will be key to boosting economic and job growth, as it has in past recoveries. This will only be possible if Congress has the willingness to raise the debt limit in a timely manner.

We have already experienced the negative economic consequences from even the prospect of a default during the debt ceiling impasse in 2011. Let's not repeat this mistake again. More importantly, let's not allow a debt limit impasse lead to the Unites States defaulting on its debt. An actual default by the Federal Government along with a protracted Government shutdown could have serious implications on the U.S. economy and may result in a recession even more severe than any since the Great Depression. This scenario may include higher interest rates, reduced consumer spending and business investment, diminished household wealth, and high unemployment levels that could last more than a generation.

PREPARED STATEMENT OF PAUL SCHOTT STEVENS

PRESIDENT AND CEO, INVESTMENT COMPANY INSTITUTE

OCTOBER 10, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, Members of the Committee, thank you for the opportunity to appear before you once again. My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute, the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. Members of ICI manage total assets of more than $15 trillion.

I am honored to appear before the Senate Committee on Banking, Housing, and Urban Affairs to testify on the "Impact of a Default on Financial Stability and Economic Growth."Members of ICI serve more than 90 million shareholders, including half of all U.S. households. Much of our policy work accordingly focuses on the effect that actions—or inactions—in Washington have on investors and financial markets.

Funds and their investors have a significant stake in the stability and predictability of the market for U.S. Treasury securities. The most recent ICI data show that as of June 30, funds registered under the Investment Company Act of 1940 [1] (1940 Act) held more than $1.7 trillion in securities issued by the Treasury and U.S. Government agencies—accounting for more than 10 percent of their assets. Mutual funds and their investors are not uniquely at risk, however, because the health of the Treasury market underpins all financial markets. U.S. Treasuries trade in the deepest, most liquid market in the world. Their interest rates set the benchmark for other debt issuers—and as the "risk-free rate of return," these rates factor into the pricing of a wide range of other assets, including stocks and real estate.

Today, fund advisers and the investors they serve are watching Washington's approach to debt and deficits with alarm. They see on all sides—at both ends of Pennsylvania Avenue—a lack of action on our Nation's current fiscal policies.They are deeply concerned about the potential results of this inaction.

After all, there are two things that individuals, households, businesses large or small, or nations must do to maintain a high level of creditworthiness:

[1] Data include mutual funds (long-term funds and money market funds), exchange-traded funds, closed-end funds, and unit investment trusts. Total net assets of these funds on June 30, 2013, were $15.4 trillion. "Agency" securities include those issued by the Federal National Mortgage Association (Fannie Mae), the Federal Home Loan Mortgage Corporation (Freddie Mac), the Federal Home Loan Banks, and the Federal Farm Credit Banks.

- They must pay their bills on time, when they come due; and
- They must avoid taking on an unsupportable level of debt—more debt than they can reasonably afford to service and pay.

For our Nation, a violation of either of those principles would be ruinous. One failure—default, which we are here to discuss today—could lead to a sudden crisis and degradation of the United States' financial and economic standing. But the other failure—to bring our debt under control—is equally insidious, equally destructive, and, on current trends, even more likely.

With that perspective in mind, and on behalf of more than 90 million Americans saving and investing to meet their financial goals through mutual funds, I am here today to state unequivocally that no one should take lightly the prospect of a default on the United States' debt obligations. The credit of the United States most emphatically should not be put into question.

Let me say with equal force, however, that those who dismiss or minimize our current budget problems also are playing with fire. The risks they are taking may be less immediate, but they are no less consequential—and the longer our Nation delays action, the larger and more difficult the necessary corrective steps become.

My testimony that follows outlines the risks of a default on debt for investors, including registered funds and their shareholders; our economy; and our standing in the world. It then discusses the long-term outlook for national debt and the hazards of failing to address our budget imbalances.

The Uncharted Waters of a Treasury Default

Since September 2007, the gross national debt[2] has risen by $7.9 trillion, or an average of $1.3 trillion each year. The debt ceiling that is at issue today—$16.7 trillion—is 85 percent greater than the debt 6 years ago. It is also larger than the U.S. economy—at 105 percent of GDP—for only the second time in our history, the first being immediately after our Nation bore the costs of protecting freedom in World War II.

How has the United States managed to fund its national debt at such historically high levels? Some factors are obvious. Our Nation has the largest and one of the most dynamic economies in the world. Our stable Government, steady social institutions, and strong rule of law help make our securities a safe haven for investors. We actively promote the free flow of capital around the globe—including substantial purchases of U.S. Treasury securities by foreign investors. The dollar's status as the world's reserve currency—used as a store of value for foreign central banks and as the means of exchange to price such crucial commodities as oil—makes Treasury securities an attractive holding for those investors.

But one crucial element in the United States' success in funding its debt is the Treasury market itself. U.S. Treasury securities trade in the deepest, most liquid market in the world. Every day, trading in Treasury securities just by "primary dealers"—the 21 brokers with which the Federal Reserve Bank of New York conducts open market operations—exceeds $500 billion.

The Treasury market depends for its stability first, on the unquestioned "full faith and credit" of the United States and second, on the certainty of its regular operations. Both of those features are at risk as Treasury runs through the "extraordinary measures" it has used since mid-May to maintain sufficient financing for Government operations. According to the Treasury Department's latest projections, those measures will be exhausted by October 17—one week from today.

I will leave it to others to describe the mechanics of what will happen if the debt ceiling is not raised by that date. I also will avoid parsing the differences among "technical default," "selective default," and "actual default," or whether missing a Social Security payment is equivalent to missing an interest payment or failing to redeem a maturing Treasury bill.

All such discussion misses the key point: the United States, like any other major debtor, must maintain the confidence of its creditors—or risk the consequences.

What makes the Treasury market so deep and so liquid is the certainty of investors that the U.S. Treasury will pay its obligations, on time and in full, when interest or principal become due. Whether corporate treasurer, fund manager, or retiree, an investor holding a Treasury bill, note, or bond has always known that an upcoming interest payment or maturing security is "as good as cash."

[2] The debt ceiling applies to gross national debt, which includes both debt held by the public and debt held by governmental agencies and trust funds, most notably the Social Security Trust Fund and Government retirement plans. Discussion of Federal debt and its economic impact usually focuses on debt held by the public, which was $12.0 trillion as of August 30, 2013. My testimony carefully distinguishes between these two concepts.

Conversely, investors with cash know that the Treasury Department auctions new debt securities on a predetermined, regular schedule. This predictability is another strength of this market.

If the debt ceiling is not increased and at some point the Treasury cannot honor an interest payment or redeem a maturing security, investors holding affected securities will not have the cash they expect. If they have cash needs, they must find a buyer willing to assume the risk of an uncertain date for payment. Risk and uncertainty always bear a price, so the original Treasury investor must suffer a loss on securities that were deemed "as good as cash."

Once Treasury has exercised the option to delay payments, investors will learn a lesson that cannot and will not be unlearned—even after all missed or delayed payments have been made good. That lesson is simple: Treasury securities are no longer as good as cash—they carry a future risk of further missed payments. That risk will be priced into the interest rate that investors demand, and into traders' reluctance to treat Treasuries as liquid.

We already can see early signs of these effects developing in the market, as the October 17 debt-ceiling deadline approaches. Unsure about its future ability to borrow, the Treasury Department is scaling back its auctions of bills—squeezing the supply of securities that are in high demand and undermining the predictability of Treasury issuance.

Rates on the Treasury securities most at risk have risen sharply. Yields on Treasury securities maturing between October 17 and October 31 rose from around 2 basis points on September 24 to between 20 and 25 basis points on October 8. The price of credit default swaps on 6-month and 1-year Treasury securities—basically, the premium for insurance against default on those securities—hovered between $11,000 and $12,000 per $10 million of coverage in mid-September. By this week, these premiums were over $50,000.

We saw similar rate spikes in 2011, when a previous stalemate over the debt ceiling brought the United States to the edge of default. In the weeks before the 2011 debt ceiling impasse was resolved, yields on maturing Treasury securities rose sharply. The rate on the Treasury bill set to mature on August 4, 2011, climbed from slightly above zero in early July to almost 30 basis points by the end of that month. Even as Congress and the White House averted a default, the confrontation reflected so badly on the Nation that Standard & Poor's felt compelled to issue its historic downgrade of the United States' AAA sovereign debt rating.

The effects of a default would quickly spill beyond the Treasury markets and into the broader economy. As noted, failure to meet interest payments or to redeem maturing Treasury securities could directly hit the finances of those who depend on Treasuries in their cash management—individuals, businesses, nonprofit institutions, and State and local governments. These entities in turn may struggle to meet their obligations to suppliers and creditors, undermining economic activity and damaging confidence.

When the asset valued by millions of investors for its "risk-free" nature suddenly assumes unanticipated risk of illiquidity or default, these investors and others will rapidly adjust their expectations—and grow increasingly cautious. Rising rates on Treasury securities could be expected to drive up interest rates for other borrowers and increase the cost of capital for corporate issuers and State and local governments. Home buyers hoping to price mortgages during the default period could face unpredictable swings in rates, and other variable-rate household borrowing could be affected.

The damage would not be limited to our shores. The U.S. dollar is the world's reserve currency not because foreign banks and investors own huge stacks of greenbacks, but because they have access to highly liquid, low-risk securities denominated in dollars—namely, Treasuries. Default, as Fitch Ratings has noted, would undermine "investor confidence in the full faith and credit of the United States . . . This 'faith' is a key underpinning of the U.S. dollar's global reserve currency status and reason why the U.S. 'AAA' rating can tolerate a substantially higher level of public debt than other 'AAA' sovereigns." Lack of confidence in U.S. Treasuries is likely to reduce the value of the dollar relative to other currencies below what it otherwise would be.

These multiple shocks—cash shortfalls, higher interest rates, diminished confidence, and international impacts—would be likely to undermine economic activity and growth. Their effects would also persist well beyond any resolution of the debt ceiling standoff and repair of defaults.

How would this turmoil affect registered funds and their investors?

Since the earliest days of the American Republic, mutual funds have been engaged in the markets for U.S. Government debt. In 1788, a pair of bankers in Amsterdam organized the first of what became more than 30 investment trusts formed to speculate on the debts issued to finance the Revolution by the Continental Congress, the Continental Army's quartermaster and commissary corps, and the States. These complicated schemes could be "possible only as long as the United States did not default on its interest payments."[3] Fortunately, even in those shaky early days of independence, the United States honored its obligations—and it has done so ever since.

Earlier, I reported that funds registered under the 1940 Act held more than 10 percent of their assets in Treasury and U.S. Government agency securities. Such holdings are pervasive—as of June 30, 30 percent of mutual funds held these securities—as even equity funds rely upon Treasury securities for cash management and liquidity. The 90 million Americans invested in funds thus share significantly in the risks associated with a Treasury default.

It is important to note, however, that registered funds and their investors are not *uniquely* at risk. Nothing about the structure or activities of registered funds makes them or their investors any more vulnerable to the hazards of a Treasury default than any other investment product or investor. The damage of a default—or even of a second near-miss in a little over 2 years' time—would be visited upon every American who saves, who borrows, or who participates in the economy. No class of Americans will be immune to the impact.

Given these effects, let me repeat my earlier message: no one should take lightly the prospect of a default on the United States' debt obligations. The credit of the United States emphatically should not be put into question.

Outlook for Fiscal Policy and the Risks of 'Slow Default'

The first fiscal year of the United States government was 1789. The national debt held by the public[4] did not reach $1 trillion until 1983—the 194th fiscal year in our history. Contrast that with our recent history: in four of the last 5 years (2009 through 2012), debt held by the public grew by more than $1 trillion.[5]

The massive deficits of the past several years were accumulated as our Government fought the financial crisis and the subsequent recession and slow recovery. Future economists and historians will have to sort out whether these huge deficits were justified or had the effects that their advocates have claimed for them. However that may be, even the most ardent supporters of fiscal stimulus, beginning with John Maynard Keynes, would tell you that budget deficits incurred to counter a recession should be a temporary expedient.

The tax and spending bargains reached so painfully in the past 3 years have slowed the growth of debt, at least for the short term. But CBO's latest long-term projections show that progress will be short-lived: by 2018, the debt held by the public will be rising again as a share of GDP. After that, CBO notes, "growing deficits would ultimately push debt back above its current high level." CBO projects that by 2038, under current law and budgetary policies, Federal debt held by the public will reach 108 percent of GDP.[6]

CBO also estimates an "extended alternative fiscal scenario" that projects deficits and debt under arguably more realistic budget assumptions: that the current spending caps of sequestration end, that spending constraints on Medicare and other Federal health programs are not maintained, and that discretionary spending resumes its historic growth rates. Under this alternative scenario, CBO projects that debt will reach 190 percent of GDP in 2038.[7]

Those two projections are based on CBO's best estimate of the impact of deficits and debt on economic growth. CBO points out that its projections are very sensitive to its forecasts of interest rates and economic growth. Moderate changes in those projections can drive the estimates of the debt burden up or down significantly.

For example, CBO estimates that a 75 basis point increase in interest rates over its forecast would drive the debt held by the public to 132 percent of GDP in 2038,

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[3] "The Origin of Mutual Funds," in *The Origins of Value: The Financial Innovations That Created Modern Capital Markets* (William N. Goetzmann and K. Geert Rouwenhorst eds., Oxford University Press 2005), at 264.

[4] As noted previously (Note 2), debt held by the public is the concept most commonly used in discussions of budget policy and its economic impacts. CBO's long-term projections, for example, are expressed in terms of debt held by the public. The discussion in this section will follow that convention.

[5] White House Office of Management and Budget, "Historical Tables," Table 7.1, available at *http://www.whitehouse.gov/omb/budget/Historicals.*

[6] Congressional Budget Office, *The 2013 Long-Term Budget Outlook,* September 19, 2013 ("CBO, Long-Term Budget Outlook"), available at *http://www.cbo.gov/sites/default/files/cbofiles/attachments/44521-LTBO2013.pdf,* at 3.

[7] *Id.* at 84.

compared to 108 percent of GDP in the current-law baseline.[8] Similarly, a reduction in the long-term economic growth rate of 0.5 percentage point drives the debt held by the public to 156 percent of GDP in 2038.[9]

Let me point out two events that could make these downside risks more likely—resulting in a greater debt burden than CBO's baseline.

First, nearly half of the debt held by the public is held by foreign investors. A rapid change in foreign investors' willingness to hold Treasuries could significantly increase the Government's interest costs, in excess of the rates CBO used in its forecasts.

The sensitivity of interest rates has been demonstrated by recent events involving the Federal Reserve—the largest domestic holder of tradable Treasury securities, holding $2.1 trillion as of October 3.[10] The mere suggestion by Fed officials earlier this year that they would slow purchases of Treasury bonds under their" quantitative easing" policies drove interest rates on the 10-year Treasury bond up by as much as 125 basis points (1.25 percentage points).

A second event that could worsen the debt outlook would be a larger than anticipated impact of the higher debt burden on economic growth. Economists generally agree that high levels of Government debt are associated with slower economic growth,[11] but the mechanisms through which higher debt levels may cause economic growth to slow are not fully understood. A more sluggish pace of economic growth could cause the debt burden to worsen more than the baseline forecast.

Beyond these worrisome events, we must also recognize that the composition of our Federal budget is shifting in ways that will make it increasingly difficult to establish and maintain any discipline on spending. This trend involves the accelerating trajectory of growth for "mandatory spending"—programs, such as Social Security, Medicare, and veterans' benefits, which are funded automatically each year. It is these programs, outside the annual spending process, that increasingly drive the Federal budget.

In its near-term forecast for 2014 to 2023, CBO projects that mandatory outlays will represent 61 percent of Federal spending over the next 10 years.[12] Interest payments on the national debt—another unavoidable cost—will account for 11 percent. Discretionary spending will account for just about one-quarter of Federal spending—27 percent. In fact, mandatory spending has become so dominant that eliminating all nondefense discretionary spending would just barely balance the budget over the forecast period.

The dominance of mandatory spending is growing. By 2038, CBO says, Federal spending for health care and Social Security will be running at twice the average level of the past 40 years, while "total spending on everything other than the major health care programs, Social Security, and net interest payments would decline to . . . *a smaller share of the economy than at any time since the late 1930s"* (emphasis added).[13]

It is inconceivable that the U.S. electorate or political system would allow the discretionary activities of the Federal Government—defense and domestic alike—to shrink to the scale that prevailed prior to World War II. Given that reality, it is difficult to maintain even the relatively pessimistic view of the CBO's baseline projection for the course of the national debt, absent significant reform and controls on mandatory spending.

Rather than address the growth of mandatory spending, however, recent policy has tended to tilt the balance further. The automatic cuts of sequestration, for example, apply only to discretionary spending—leaving mandatory programs unscathed.

Let me be clear—the programs funded through mandatory spending are very important. For example, on many occasions, ICI has expressed strong support for Social Security as the foundation of Americans' retirement security. Fulfilling our social contract by putting Social Security on a sustainable footing for the indefinite future is nothing less than a moral obligation.

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[8] *Id.* at 97.

[9] *Id.* at 95.

[10] Federal Reserve Board, "Factors Affecting Reserve Balances: Federal Reserve Statistical Release H.4.1," October 3, 2013, available at *http://www.Federalreserve.gov/releases/h41/current/h41.htm#h41tab1.*

[11] Carmen M. Reinhart, Vincent R. Reinhart, and Kenneth S. Rogoff, "Public Debt Overhangs: Advanced-Economy Episodes Since 1800," 26 *The Journal of Economic Perspectives 69,* Summer 2012.

[12] ICI calculations based on Congressional Budget Office, "Updated Budget Projections: Fiscal Years 2013 to 2023," available at *http://www.cbo.gov/sites/default/files/cbofiles/attachments/44172-Baseline2.pdf.*

[13] CBO, Long-Term Budget Outlook, *supra* note 6, at 3.

But paying our own bills—as a Nation, as a generation—that, too, is a moral obligation. The Father of Our Country, George Washington, warned against "ungenerously throwing upon posterity the burden which we ourselves ought to bear."[14] Yet that is exactly the course that we are following.

Conclusion

The imperative need to increase the national debt ceiling and ensure that Treasury can borrow to finance the Government focuses urgent attention on the prospects and consequences of a default on Treasury securities. Make no mistake: that is an event our Nation must avoid. For generation after generation, since 1789, the United States has stood behind its financial obligations. Ours should not be the generation that fails to do so.

It is no less imperative, however, to focus on the less dramatic—but equally insidious—threat that our Nation faces from growing and unsustainable levels of debt. Even the relatively optimistic CBO baseline forecast paints a dire picture. The longer we delay decisive action, the worse our problems become and the harder they are to fix.

The 90 million American investors that ICI's member funds serve are investing for a brighter future—a secure retirement, a better education, or a solid financial foundation. They need responsible action by their Government to protect the health of the economy and the financial markets on which they depend. They want Congress and the Administration to work together to put America on a path of fiscal responsibility.

The health of our markets, the prosperity of our Nation, and the security of future generations all depend upon it.

Thank you for your attention.

[14] "Washington's Farewell Address 1796," posted by The Avalon Project, Lillian Goldman Law Library, Yale Law School, available at *http://avalon.law.yale.edu/18th_century/washing.asp*. For a more complete discussion of Washington's views on the national debt, as expressed in his Farewell Address, see Paul Schott Stevens, "'Warnings of a Parting Friend: Today's Fiscal Crisis and U.S. National Security,'" National Strategy Forum Review, Winter-Spring 2012, at 20; available at *http://www.nationalstrategy.com/Portals/0/documents/Winter-Spring%202012/Stevens-Warnings%20of%20a%20Parting%20Friend.pdf*.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR COBURN FROM FRANK KEATING

Q.1. Since Congress has in the past always raised the debt limit in a timely manner, is it your opinion that during these discussions, or in the future, we will at some point deviate from this behavior? Why or why not?

A.1. Although Congress has never allowed debt limit debate to lead to an actual default, even approaching the deadline has severe consequences. Make no mistake, every time the U.S. government's willingness to pay its bills is questioned, there is a real cost to both taxpayers and the economy.

The Bipartisan Policy Center (of which I am a board member) estimated the 2011 debt standoff cost taxpayers close to $20 billion as nervous investors demanded higher interest on U.S. Treasury bonds to account for the risk of Government default. S&P highlighted this as additional risk when it stripped us of our coveted triple-A rating citing willingness to pay, not ability.

Even the slightest uptick in Treasury interest rates would cascade through the economy. It would raise the costs for taxpayers to service our country's debt and would raise the cost of borrowing for businesses, meaning job losses and price increases. Default would be a blow to retirement funds, leaving fewer resources available for retirees. For banks, which hold $3 trillion in Treasury, agency and mortgage-backed securities, the sharp decline in value of those securities would translate into fewer resources available for mortgages, business, auto, credit card and student loans.

Although Congress has never allowed the U.S. government to default on its debts, any debate that creates uncertainty has real costs, felt across the country. We need to change the way these discussions are held, or risk more self-inflicted injuries that will further undermine our still-fragile economic recovery.

Q.2. Do you believe Congress should reduce the deficit and begin toward the path of reducing the debt? If yes, and if the debt limit discussion is not the appropriate venue to discuss deficit reduction, what budgetary pressure points do you believe should be used by Congress to bring about legislative changes needed to enact meaningful deficit reduction?

A.2. The debt limit has risen twice as fast as the economy has grown in the last two years. While our debt has increased roughly $2.4 trillion, our increase in GDP has been less than half that. As our standard of living continues to decline, and the Government continues to borrow beyond its means, at what point do you believe our lenders stop lending money? If this were to occur, what would be the financial and economic impact on your particular industry?

There should be a wholesome debate about how taxpayer dollars are spent in the future. We need to be sure that those precious tax dollars from hardworking American's are used in the most productive way possible. But we should not confuse the need to pay our bills for things that Congress has already approved and spent with the management of spending that is appropriate for the future.

To use a credit card analogy, the decision about what to buy on credit tomorrow must take into account the debt we already owe, but that is never an excuse for not paying the current bill on time and in full.

Markets, not Congress, truly determine our Government's ability to borrow. Our debt is already 70 percent of our GDP. While the sequester is expected to reduce debt-to-GDP for a few years, even it fails to arrest the longer-term upward trajectory. According to the Congressional Budget Office (CBO), by the year 2043 entitlement programs and debt service payments alone are projected to outstrip revenues. This means that there will be no funds at all for any discretionary spending. It is impossible to address the long-term sustainability of our debt without addressing the growing costs associated with our entitlement programs.

The CBO predicts that in the next 25 years our debt will surpass 100 percent of our GDP. This would put us in the same league as the fiscally unstable countries that led Europe into crisis. Already, the U.S. debt amounts to nearly $54,000 per person, and $148,000 per taxpayer. The interest payments alone on our debt will cost over $8,000 per U.S. citizen in 2013. Addressing future spending and bringing our debt down to sustainable levels must be done in a bipartisan way. My experience serving on the Domenici-Rivlin commission gives me hope that tough decisions can be made for the good of our country.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR COBURN FROM KENNETH E. BENTSEN, JR.

Q.1. Since Congress has in the past always raised the debt limit in a timely manner, is it your opinion that during these discussions, or in the future, we will at some point deviate from this behavior? Why or why not?

A.1. We believe it is vitally important for the Government to make good on its financial obligations and not default in any manner. The consequences of a delay or failure to raise the debt ceiling creates significant uncertainty throughout the financial markets, raises the cost of borrowing for the U.S. Government, and threatens the continued benchmark status of Treasury securities. As has been documented by the GAO and the Bipartisan Policy Council, the 2011 delay in raising the debt ceiling increased Treasury borrowing costs by $1.3 billion in 2011 with 10-year costs estimated at $19 billion. In the most recent run-up to the debt ceiling deadline Treasury borrowing rates for short-term bills increased significantly just one month previous. For example, on October 9 the Treasury auctioned a five-day cash management bill at 30 basis points; one month before, on September 10 the Treasury had auctioned a five-day cash management bill at 4 basis points. Also, in the weeks immediately preceding the October 2013 deadline short term rates, particularly in the repo market, rose significantly. As wholesale funding costs rise in the repo market, the cost of credit throughout the economy will rise. Given the expectations in the market that Treasury will pay its debt timely, the consequences of any delay raise cost throughout the economy unnecessarily.

Q.2. Do you believe Congress should reduce the deficit and begin toward the path of reducing the debt? If yes, and if the debt limit discussion is not the appropriate venue to discuss deficit reduction, what budgetary pressure points do you believe should be used by Congress to bring about legislative changes needed to enact meaningful deficit reduction?

A.2. SIFMA believes that Congress and the Administration must come together and develop a plan to substantially reduce our long-term budget deficits with a goal of at least stabilizing our Nation's debt as a percentage of GDP—which, we recognize, will entail difficult choices for policymakers. The resulting plan must be long-term, predictable and binding. The financial markets and Main Street businesses need confidence that the long-term fiscal outlook will be addressed.

Q.3. The debt limit has risen twice as fast as the economy has grown in the last two years. While our debt has increased roughly $2.4 trillion, our increase in GDP has been less than half that. As our standard of living continues to decline, and the Government continues to borrow beyond its means, at what point do you believe our lenders stop lending money? If this were to occur, what would be the financial and economic impact on your particular industry?

A.3. Default, delays in payments, weak Treasury auctions, and a perception that policymakers are unable to deal with either short or long-term fiscal issues, could result in a reduction in foreign purchases of Treasury securities, or sell offs of existing foreign holdings. Foreign investors, most notably foreign governments and central banks, hold 40% of outstanding Treasury debt or about $5.6 trillion of the currently outstanding debt. Foreign investors would be less likely to participate aggressively at auction and may sell current holdings to reduce exposure. The truly unprecedented nature of a failure to make timely payment on Treasury debt would have thrown markets into disarray by undermining the important benchmark characteristics of Treasury debt.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR COBURN FROM GARY THOMAS

Q.1. Since Congress has in the past always raised the debt limit in a timely manner, is it your opinion that during these discussions, or in the future, we will at some point deviate from this behavior? Why or why not?

A.1. We certainly hope Congress will continue to raise the debt ceiling in a timely manner; however, we remain concerned that congressional gridlock over raising the debt ceiling has unintended consequences which may harm the housing market. A default, or even the perceived threat of a default, could result in a harsh and long-lasting recession, which may be even more severe than the previous economic downturn. As the U.S. Treasury and others have stated, political brinkmanship during the 2011 debt ceiling was responsible for financial market disruptions, reduced consumer and business confidence, and slower job growth. Even though lawmakers were able to raise the debt limit before the Treasury expended its remaining cash on hand, we worry that continued political gridlock could cause our economic recovery to freeze.

Q.2. Do you believe Congress should reduce the deficit and begin toward the path of reducing the debt? If yes, and if the debt limit discussion is not the appropriate venue to discuss deficit reduction, what budgetary pressure points do you believe should be used by Congress to bring about legislative changes needed to enact meaningful deficit reduction?

A.2. We believe that Congress should continue to debate about how best to continue the path of reducing the deficit and ultimately the debt. Again, our concern is that even the hint that the United States might not pay some or all of its debts could hinder our nascent economic recovery and damage the fragile housing market.

Q.3. The debt limit has risen twice as fast as the economy has grown in the last two years. While our debt has increased roughly $2.4 trillion, our increase in GDP has been less than half that. As our standard of living continues to decline, and the Government continues to borrow beyond its means, at what point do you believe our lenders stop lending money? If this were to occur, what would be the financial and economic impact on your particular industry?

A.3. Predicting if or when our creditors will stop lending to the United States is beyond the capability of our organization. However, if the United States were unable to borrow at all, we anticipate it would be devastating to the real estate industry and for our overall economy.

RESPONSE TO WRITTEN QUESTIONS OF SENATOR COBURN FROM PAUL SCHOTT STEVENS

Q.1. Since Congress has in the past always raised the debt limit in a timely manner, is it your opinion that during these discussions, or in the future, we will at some point deviate from this behavior? Why or why not?

A.1. If the Government is spending more than its revenues, failing to raise the debt ceiling means that the United States does not pay someone for services rendered or debts owed bond holders, businesses, contractors, businesses, Government workers, *etc.* Reneging on any payment owed will imperil the finances of those who are due the payments.

And once the Treasury has exercised the option to delay debt payments, investors will learn a lesson that cannot be unlearned, even after all missed or delayed payments have been made good. One crucial element of the United States' success in funding its debt is the Treasury market itself. The Treasury market depends for its stability on the "full faith and credit" of the United States and certainty of its regular operations. The United States, like any other debtor, must maintain the confidence of its creditors or risk consequences. Treasury securities will carry a future risk further missed payments, and that risk will be priced into the interest rate.

Not raising the debt limit when the Government is spending more than its revenues would put into question the credit worthiness of the United States. The credit of the United States should not be put into question.

Q.2. Do you believe Congress should reduce the deficit and begin toward the path of reducing the debt? If yes, and if the debt limit discussion is not the appropriate venue to discuss deficit reduction, what budgetary pressure points do you believe should be used by Congress to bring about legislative changes needed to enact meaningful deficit reduction?

A.2. As I indicated in my testimony, the failure of the United States to bring our debt under control is as insidious and destructive as missing a debt payment, and on current trends seem seven more likely. It is imperative for our Nation to face the growing and increasingly unsustainable levels of national debt. The longer we delay decisive action, the worse our problems become and the harder they are to fix.

As I noted in an answer to Senator Warren's question, it is certainly appropriate, and even valuable to have a debt ceiling to focus our attention on the urgent need finances. Nevertheless, for the Treasury to spend more than its revenues requires debt to finance that gap, and ultimately an increase in the debt ceiling.

Q.3. The debt limit has risen twice as fast as the economy has grown in the last 2 years. While our debt has increased roughly $2.4 trillion, our increase in GDP has been less than half that. As our standard of living continues to decline, and the Government continues to borrow beyond its means, at what point do you believe our lenders stop lending money? If this were to occur, what would be the financial and economic impact on your particular industry?

A.3. It is not easy to predict exactly where the tipping point is when our debtors stop lending money. Nearly half of the U.S. Government's public debt is held by foreigners. A rapid change in foreign investor's willingness to hold Treasuries could significantly increase the Government's interest costs and seriously impair our Nation's ability to fund vital expenditures. Should we reach such a tipping point, the consequences would extend well beyond our 90 million fund investors, and would imperil our economy and security more broadly.