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Report to the Secretary of the Treasury

December 2002

# DEBT CEILING

# Analysis of Actions During the 2002 Debt Issuance Suspension Periods

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Accountability ★ Integrity ★ Reliability

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# Contents

United States General Accounting Office
Washington, D.C. 20548

December 13, 2002

The Honorable Paul H. O'Neill
The Secretary of the Treasury

Dear Mr. Secretary:

The Congress has traditionally imposed a limit on the size of the federal government's public debt by establishing limits, known as debt ceilings, on the amount of Treasury securities that can be outstanding. On various occasions over the years, normal government financing has been disrupted because Treasury had borrowed up to, or near, the debt ceiling and legislation to increase the debt ceiling had not been enacted. As you are aware, in April, May, and June 2002, before the current debt ceiling was raised to $6.4 trillion, Treasury used its statutory authority to invoke two debt issuance suspension periods.[1] Accordingly, during these periods, Treasury took several actions to raise funds to meet federal obligations without exceeding the debt ceiling.

In connection with fulfilling our requirement to audit the financial statements of the U.S. government, we audit the Schedules of Federal Debt Managed by the Bureau of the Public Debt,[2] which includes testing compliance with the debt ceiling. To assist us in this testing and because of the nature of and sensitivity toward actions taken during a debt issuance suspension period, we (1) developed a chronology of significant events, (2) analyzed the financial aspects of Treasury's actions taken during the debt issuance suspension periods and assessed the legal basis of these actions, and (3) analyzed the impact of the policies and procedures used by Treasury to manage the debt during the debt issuance suspension periods. This report presents the results of our review of the actions taken and the policies and procedures implemented by Treasury during the 2002 debt issuance suspension periods.

[1]Subsection (j) of 5 U.S.C. 8348 defines a debt issuance suspension period as any period for which the Secretary has determined that obligations of the United States may not be issued without exceeding the debt ceiling.

[2]U.S. General Accounting Office, *Financial Audit: Bureau of the Public Debt's Fiscal Years 2002 and 2001 Schedules of Federal Debt*, GAO-03-199 (Washington, D.C.: Nov. 1, 2002).

## Background

The federal government began with a public debt of about $78 million in 1789. Since then, the Congress has attempted to control the size of the debt by imposing ceilings on the amount of Treasury securities that can be outstanding. In February 1941, an overall ceiling of $65 billion was set on all types of Treasury securities that could be outstanding at any one time.

The debt ceiling was raised several times between February 1941 and June 1946, when a ceiling of $275 billion was set that remained in effect until August 1954. At that time, the first temporary debt ceiling, which added $6 billion to the $275 billion permanent ceiling, was imposed. Since then, numerous temporary and permanent increases in the debt ceiling have been enacted. Total debt subject to the debt ceiling, as of June 30, 2002, was about $6.1 trillion. About 44 percent, or $2.7 trillion, was held by federal trust funds, such as the Social Security trust funds and the Civil Service Retirement and Disability Trust Fund (Civil Service fund), and by the Government Securities Investment Fund of the Federal Employees' Retirement System (G-Fund),[3] hereafter collectively referred to as Funds.

The Secretary of the Treasury has several responsibilities related to the federal government's financial management operations. These include paying the government's obligations and investing Funds' receipts not needed for current benefits and expenses. The Secretary has generally been provided with the ability to issue the necessary securities to the Funds for investment purposes and to borrow the necessary funds from the public to pay government obligations.

Under normal circumstances, the debt ceiling is not an impediment to carrying out these responsibilities. Treasury is notified by the appropriate agency (such as the Office of Personnel Management for the Civil Service fund) of the amount that should be invested (or reinvested), and Treasury makes the investment. In some cases, the agency may also specify the security that Treasury should purchase. These securities count against the debt ceiling. Consequently, if Funds' receipts are not invested, an increase in the debt subject to the debt ceiling does not occur.

[3]The G-Fund consists of nonmarketable Treasury securities held in trust by the federal government as custodian on behalf of individual federal employee participants. Treasury securities held by the G-Fund are considered debt held by the public.

When Treasury is unable to borrow because the debt ceiling has been reached, the Secretary is unable to fully discharge his financial management responsibilities using the normal methods. In 1985, the government experienced a debt ceiling crisis from September 3 through December 11. During that period, Treasury took several actions that were similar to those discussed in this report. For example, Treasury redeemed Treasury securities held by the Civil Service fund earlier than normal in order to borrow sufficient cash from the public to meet the fund's benefit payments and did not invest some trust fund receipts.[4] In 1986 and 1987, after Treasury's experiences during prior debt ceiling crises, the following statutory authorities were provided to the Secretary of the Treasury to use the Civil Service fund and the G-Fund to assist Treasury in managing its financial operations during a debt ceiling crisis:

1. *Redemption of securities held by the Civil Service fund.* Subsection (k) of 5 U.S.C. 8348 provides authority to the Secretary of the Treasury to redeem securities or other invested assets of the Civil Service fund before maturity to prevent the amount of public debt from exceeding the debt ceiling.

   Subsection (k) of 5 U.S.C. 8348 also provides that, before exercising the authority to redeem securities of the Civil Service fund, the Secretary must first determine that a "debt issuance suspension period" exists. Subsection (j) of 5 U.S.C. 8348 defines a debt issuance suspension period as any period for which the Secretary has determined that obligations of the United States may not be issued without exceeding the debt ceiling.

   The statute authorizing the debt issuance suspension period and its legislative history are silent as to how the Secretary should determine the length of a debt issuance suspension period. Specifically, subsection (j) (5) of 5 U.S.C. 8348 states that "the term 'debt issuance suspension period' means any period for which the Secretary of the Treasury determines for purposes of this subsection that the issuance of obligations of the United States may not be made without exceeding the public debt limit."

[4] U.S. General Accounting Office, *Civil Service Fund: Improved Controls Needed over Investments*, GAO/AFMD-87-17 (Washington, D.C.: May 7, 1987), and Opinion on the legality of the plan of the Secretary of the Treasury to disinvest the Social Security and other trust funds on Nov. 1, 1985, to permit payments to beneficiaries of these funds, B-221077.2 (Washington, D.C.: Dec. 5, 1985).

2. *Suspension of Civil Service fund investments.* Subsection (j) of 5 U.S.C. 8348 provides authority to the Secretary of the Treasury to suspend additional investment of amounts in the Civil Service fund if the investment cannot be made without causing the amount of public debt to exceed the debt ceiling. This subsection of the statute also authorizes the Secretary to make the Civil Service fund whole after the debt issuance suspension period has ended.

3. *Suspension of G-Fund investments.* Subsection (g) of 5 U.S.C. 8438 provides authority to the Secretary of the Treasury to suspend the issuance of additional amounts of obligations of the United States to the G-Fund if issuance cannot occur without causing the amount of public debt to exceed the debt ceiling. The subsection authorizes the Secretary to make the G-Fund whole after the debt issuance suspension period has ended.

We have previously reported on aspects of Treasury's actions during the 1995/1996 debt issuance suspension period[5] and earlier debt ceiling crises (see Related GAO Products).

## Results in Brief

In April and May 2002, Treasury announced two debt issuance suspension periods because certain receipts could not be invested without exceeding the statutory debt ceiling of $5.95 trillion. The first debt issuance suspension period occurred from April 4 to April 16, 2002, and involved use of the G-Fund. The second debt issuance suspension period occurred from May 16 to June 28, 2002, and involved use of the Civil Service fund and the G-Fund. Treasury also took other actions to avoid exceeding the debt ceiling, such as suspending the sales of State and Local Government Series (SLGS) Treasury securities[6] and recalling noninterest-bearing deposits held by commercial banks as compensation for banking services provided to Treasury (commonly referred to as compensating balances).

[5] U.S. General Accounting Office, *Debt Ceiling: Analysis of Actions during the 1995-1996 Crisis*, GAO/AIMD-96-130 (Washington, D.C.: Aug. 30, 1996).

[6] The SLGS securities program was established in 1972, following federal legislation enacted in 1969 restricting state and local governments from earning arbitrage profits by investing bond proceeds in higher-yielding investments.

During both debt issuance suspension periods, Treasury suspended some investments and reinvestments of the G-Fund's receipts and maturing securities. During the second debt issuance suspension period, Treasury also took the following actions related to the Civil Service fund:

- It redeemed about $4 billion in Treasury securities held by the Civil Service fund before they were needed to pay benefits and expenses.

- It suspended the investment of about $2 billion of trust fund receipts.

These actions were consistent with legal authorities provided to the Secretary of the Treasury. In addition, while these actions to prevent the debt ceiling from being exceeded initially resulted in interest losses of $167.3 million to the G-Fund and principal and interest losses of $15.4 million to the Civil Service fund, Treasury has fully restored these losses in accordance with 5 U.S.C. 8438(g) and 5 U.S.C. 8348(j), respectively.

Although the actions that are allowed during a debt issuance suspension period are well defined in law (e.g., suspending Civil Service fund and G-Fund investments and redeeming Civil Service fund securities earlier than normal to pay fund benefits and expenses), the policies and procedures needed to implement such actions are not documented. Our review disclosed some cases where the lack of documented policies and procedures contributed to confusion and errors that had to be corrected.

Properly documenting the policies and procedures will (1) allow Treasury management to better ascertain the impacts of these policies and procedures on Treasury's ability to manage the outstanding debt during a debt issuance suspension period and (2) if effectively implemented, reduce the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future. Such documentation is a prudent management action consistent with federal internal control standards and is a necessary hedge against the inevitable event of turnover of key personnel. Accordingly, we are recommending that the Secretary of the Treasury direct the Under Secretary for Domestic Finance to document policies and procedures to guide the department's actions during future debt issuance suspension periods.

Treasury officials agreed that accurate documentation of policies and procedures is a valuable objective, but stated that they were reluctant to develop policies and procedures that would limit the Secretary's flexibility to manage the debt during a debt issuance suspension period. In subsequent conversations with Treasury officials, we noted that our recommendation did not call for documenting the circumstances under which the Secretary should invoke specific actions, but rather envisioned documenting the policies and procedures needed to implement the Secretary's selected actions. Taken from this perspective, Treasury was in general agreement with our recommendation.

Regarding three instances where the lack of documented policies and procedures contributed to what we characterized as some confusion and errors, Treasury did not agree that there were any errors. As discussed in this report, Treasury's new financial management system clearly shows that errors had occurred and we continue to believe that the lack of documented policies and procedures contributed to them.

## Objectives, Scope, and Methodology

Our objectives were to

- develop a chronology of significant events related to the debt issuance suspension periods during April 2002 and May/June 2002,
- analyze the financial aspects of Treasury's actions taken during the 2002 debt issuance suspension periods and assess the legal basis of these actions, and
- analyze the impact of the policies and procedures used by Treasury to manage the debt during the 2002 debt issuance suspension periods.

To develop a chronology of the significant events related to the 2002 debt issuance suspension periods, we obtained and reviewed applicable documents. We also discussed Treasury's actions during the debt issuance suspension periods with senior Treasury officials.

To analyze the financial aspects of Treasury's actions taken, we (1) reviewed the methodologies Treasury developed to minimize the impact of such departures on the Civil Service fund and the G-Fund, (2) quantified the impact of the departures, (3) assessed whether any principal and interest losses were fully restored, and (4) assessed whether any losses were incurred that could not be restored under Treasury's current statutory authority.

To assess the legal basis of Treasury's departures from its normal policies and procedures, we identified the applicable legal authorities and determined how Treasury applied them during the 2002 debt issuance suspension periods. Our evaluation included those authorities related to issuing and redeeming Treasury securities during a debt issuance suspension period and restoring losses after such a period has ended.

To analyze the impact of the policies and procedures used by Treasury to manage the debt during debt issuance suspension periods, we reviewed the actions taken and the stated policies and procedures used during debt issuance suspension periods. To determine the stated policies and procedures used during the 2002 debt issuance suspension periods, we discussed with Treasury officials and examined the support for actions taken during these periods. We also compiled and analyzed source documents relating to previous debt issuance suspension periods, including executive branch legal opinions, memorandums, and correspondence.

We performed our work from April 4 through July 31, 2002, in accordance with U.S. generally accepted government auditing standards. We requested comments on a draft of this report from the Secretary of the Treasury or his designee. The written response from the Fiscal Assistant Secretary of Treasury is reprinted in appendix I.

## Chronology of Events

In December 2001, Treasury analysts concluded that the debt ceiling of $5.95 trillion might be reached in February 2002. Table 1 shows the significant actions the Congress and the executive branch took from December 2001 through June 2002 to address the debt ceiling.

Table 1: Chronology of Events Relating to the 2002 Debt Ceiling Increase

| Date | Action |
| --- | --- |
| December 11, 2001 | The Secretary of the Treasury wrote to the congressional leadership requesting that the statutory debt ceiling be raised to $6.7 trillion. |
| February 13, 2002 | The Secretary of the Treasury reiterated the need for an increase of $750 billion in the statutory debt ceiling. |
| April 1-2, 2002 | Treasury called back about $7 billion in Treasury cash balances from three banks. According to Treasury officials, these funds were returned on April 4, 2002. |
| April 2, 2002 | The Secretary of the Treasury announced his intent to suspend G-Fund investments beginning on April 4, 2002, and ending on or about April 18, 2002. |
| April 17, 2002 | Treasury ended the first debt issuance suspension period primarily because of April tax receipts. Treasury fully restored the G-Fund. |
| April 17, 2002 | The Secretary of the Treasury again urged that the debt ceiling be increased. |
| May 14, 2002 | The Secretary of the Treasury declared a debt issuance suspension period beginning no later than May 16, 2002, and lasting until June 28, 2002. This allowed Treasury to redeem Treasury securities held by the Civil Service fund earlier than normal and to suspend investments of Civil Service fund and G-Fund receipts. |
| May 15, 2002 | Treasury suspended the sales of SLGS Treasury securities. Treasury authorized the resumption of SLGS issuances effective July 8, 2002, as a result of the increase in the debt ceiling. |
| June 3, 2002 | Treasury called back about $20 billion in Treasury cash balances from five banks. According to Treasury officials, these funds were returned on June 17, 2002. |
| June 18, 2002 | The Secretary of the Treasury announced that by June 28, 2002, the U.S. government would not have sufficient money to pay its bills unless the debt ceiling was increased. |
| June 26, 2002 | Treasury postponed the auction of the 2-year note. |
| June 27, 2002 | Treasury postponed the announcement of its weekly 13- and 26-week bill auctions. |
| June 28-30, 2002 | On June 28, 2002, Public Law No. 107-199 was enacted, which raised the debt ceiling to $6.4 trillion. Treasury restored the losses incurred by the Civil Service fund and G-Fund. |

Source: Department of the Treasury and GAO.

## Actions Related to the Civil Service Fund

During the second 2002 debt issuance suspension period, the Secretary of the Treasury redeemed Treasury securities held by the Civil Service fund earlier than normal and suspended the investment of Civil Service fund receipts.

### Statutory Authority Exercised to Redeem Treasury Securities before Needed to Pay Civil Service Fund Benefits and Expenses

Subsection (k) of 5 U.S.C. 8348 authorizes the Secretary of the Treasury to redeem securities or other invested assets of the Civil Service fund before maturity to prevent the amount of public debt from exceeding the debt ceiling. The statute does not require that early redemptions be made only for the purpose of making Civil Service fund payments. Further, the statute permits early redemptions even if the Civil Service fund has adequate cash balances to cover such payments.

Before redeeming Civil Service fund securities earlier than normal, the Secretary must determine that a debt issuance suspension period exists. The statute authorizing the debt issuance suspension period and its legislative history are silent as to how to determine the length of a debt issuance suspension period. On May 14, 2002, the Secretary of the Treasury declared that a debt issuance suspension period would begin no later than May 16 and would last until June 28, 2002.

On May 16, 2002, Treasury redeemed about $4 billion of the Civil Service fund's Treasury securities using this authority. The $4 billion of redemptions was determined based on (1) the length of the debt issuance suspension period (May 16 through June 28, 2002) and (2) the estimated monthly Civil Service fund benefit payments that would occur during that period.[7] These were appropriate factors to use in determining the amount of Treasury securities to redeem early.

[7]According to Treasury officials, they use the amount of expected benefit payments that will be issued on the first business day of a month in this calculation. Securities are redeemed on the payment date to cover any other benefit payments and expenses incurred during the month by the Civil Service fund.

Since Treasury had redeemed the securities associated with the June 3, 2002, payments in May, it redeemed only the difference between the amount that had been redeemed early (less any reinvestments)[8] and the actual amount of benefit payments made on June 3. In this case, Treasury redeemed about $728 million associated with reinvestments and about $8 million that represented the difference between the estimated payments and the actual payments made on June 3, 2002.

### Statutory Authority Used to Suspend Investment of Receipts

Subsection (j) of 5 U.S.C. 8348 authorizes the Secretary of the Treasury to suspend additional investment of amounts in the Civil Service fund if the investment cannot be made without causing the amount of public debt to exceed the debt ceiling. From May 17 to June 28, 2002, the Civil Service fund had about $2 billion in receipts that were not invested. On June 28, 2002, after the debt ceiling was raised, these receipts were invested.

## Actions Related to the G-Fund

Subsection (g) of 5 U.S.C. 8438 authorizes the Secretary of the Treasury to suspend the issuance of additional amounts of obligations of the United States to the G-Fund if the issuance cannot be made without causing the amount of public debt to exceed the debt ceiling. Each day from April 4 to April 16, 2002, and from May 16 to June 28, 2002, Treasury determined the amount of funds that the G-Fund would be allowed to invest in Treasury securities and, when necessary, suspended some investments and reinvestments of the G-Fund receipts and maturing securities that would have caused the debt ceiling to be exceeded.

On April 4, 2002, when the Secretary determined that the first debt issuance suspension period had begun, the G-Fund held about $41 billion of Treasury securities that would mature that day. To ensure that it did not exceed the statutory debt limit, Treasury did not reinvest about $13.7 billion of these securities on this date. On April 16, 2002, the debt issuance

[8]From May 17 to May 31, 2002, Treasury was able to reinvest a portion of the May 16, 2002, advance redemption. In one case, the department redeemed a security later, while in the other cases it did not redeem the securities until the benefit payment date. Specifically, on May 17, 2002, Treasury reinvested about $445 million in the Civil Service fund, because sufficient room was available under the statutory debt limit and the G-Fund was fully invested, excluding interest to be restored at the end of the debt issuance suspension period. However, on the next business day (May 20), Treasury redeemed this security again, since Treasury was once again at the statutory debt limit. Other reinvestments made during May were not redeemed until the June benefit payments were made.

suspension period ended, and Treasury fully invested the G-Fund and compensated the G-Fund for its interest losses. The G-Fund remained fully invested until the start of the second debt issuance suspension period on May 16, 2002. On that date, the G-Fund held about $41 billion of maturing Treasury securities. To ensure that it did not exceed the statutory debt limit, Treasury did not reinvest about $9.2 billion of these securities.

During both debt issuance suspension periods, the amount of the G-Fund's receipts that Treasury invested changed daily, depending on the amount of the government's outstanding debt. Although Treasury can accurately predict the outcome of some events that affect the outstanding debt, it cannot precisely determine the outcome of others until they occur. For example, the amount of securities that Treasury will issue to the public from an auction can be determined some days in advance because Treasury can control the amount that will be issued. On the other hand, the amount of savings bonds that will be issued and redeemed and of securities that will be issued to, or redeemed by, various government Funds is difficult to precisely predict. Because of these difficulties, Treasury needed a way to ensure that the government's Funds activities did not cause the debt ceiling to be exceeded and also to maintain normal investment and redemption policies for the majority of the government Funds. To do this, each day during a debt issuance suspension period, Treasury

- calculated the amount of public debt subject to the debt ceiling, excluding the receipts that the G-Fund would normally invest;
- determined the amount of G-Fund receipts that could safely be invested without exceeding the debt ceiling and invested this amount in Treasury securities; and
- suspended investment, when necessary, of the G-Fund's remaining receipts.

For example, on May 23, 2002, excluding G-Fund transactions, Treasury issued about $32.2 billion and redeemed about $29.1 billion of other Funds' securities that counted against the debt ceiling. Treasury also issued about $66.4 billion and redeemed about $56.1 billion of other securities. Since Treasury had been at the debt ceiling the previous day, Treasury could not invest the entire amount that the G-Fund had requested ($41 billion) without exceeding the debt ceiling. As a result, the $13.4 billion difference between the $98.6 billion of securities issued and the $85.2 billion of securities redeemed was added to the amount of uninvested G-Fund receipts. This raised the amount of uninvested funds for the G-Fund from about $900 million to about $14 billion on that date. Interest on the uninvested funds was not paid until the debt issuance suspension period ended. Treasury used the same policies and procedures for calculating the interest losses for both the 1995/1996 and 2002 debt issuance suspension periods.

## Civil Service Fund and G-Fund Losses Were Restored

On June 28, 2002, the statutory debt limit was raised to $6.4 trillion. By June 30, 2002, Treasury restored all losses to the Civil Service fund and the G-Fund.

### Restoring Civil Service Fund Losses

The Civil Service fund incurred about $15.4 million in principal and interest losses during the second 2002 debt issuance suspension period. When 5 U.S.C. 8348 was amended to expressly authorize the Secretary of the Treasury to redeem securities earlier than normal or to refrain from promptly investing Civil Service fund receipts because of debt ceiling limitations, it was also amended to ensure that such actions would not result in long-term losses to the Civil Service fund. Thus, the Secretary of the Treasury was authorized to immediately restore, to the maximum extent practicable, the Civil Service fund's security holdings to the proper balances when a debt issuance suspension period ends and to restore lost interest on the subsequent first normal interest payment date.

Under this statute, Treasury took the following actions once the debt issuance suspension period had ended:

- Treasury invested about $2 billion of uninvested receipts on June 28, 2002.

- Treasury paid the Civil Service fund about $15.4 million as compensation for losses incurred because of the actions it had taken. Treasury made payment on June 30, 2002, because this was the next semiannual interest payment date.

We verified that after these transactions the Civil Service fund's security holdings were, in effect, the same as they would have been had the debt issuance suspension period not occurred.

## Restoring G-Fund Losses

For the two periods from April 4 to April 16, 2002, and from May 16 to June 28, 2002, the G-Fund lost about $27.7 million and $139.6 million in interest, respectively, because its excess funds were not fully invested. As discussed above, the amount of funds invested for the G-Fund fluctuated daily during the debt issuance suspension period, with the investment of some funds being suspended.

When 5 U.S.C. 8438 was amended to expressly authorize the Secretary of the Treasury to suspend G-Fund investments because of debt ceiling limitations, it was also amended to ensure that such actions would not result in long-term losses to the G-Fund. Thus, the Secretary of the Treasury was authorized to make the G-Fund whole by restoring any losses once the debt issuance suspension period ended.

On April 16, 2002, when the first debt issuance suspension period was terminated by the Secretary of the Treasury, and on June 28, 2002, when the debt ceiling was raised, Treasury restored the lost interest on the G-Fund's uninvested funds. Consequently, the G-Fund was fully compensated for its interest losses during the 2002 debt issuance suspension periods.

# Documented Policies and Procedures Needed during a Debt Issuance Suspension Period

The basic actions taken during the 2002 and the 1995/1996 debt issuance suspension periods were similar[9]—G-Fund and Civil Service fund receipts were not invested and Civil Service fund securities were redeemed earlier than needed to pay fund benefits and expenses. However, Treasury had not documented the policies and procedures that should be used to implement these actions. Further, the stated policies and procedures used to implement the actions taken on the Civil Service fund between the 2002 and the 1995/1996 debt issuance suspension periods were different. Accordingly, some confusion existed about how to implement these actions and some errors were made that had to be corrected. More importantly, documented policies and procedures would allow Treasury to better

[9]Although the actions taken during the 2002 debt issuance suspension periods were similar to those taken during the 1995/1996 debt issuance suspension period, Treasury did not have to use all the options that were used during the 1995/1996 debt issuance suspension period. For example, although Treasury noted that one option available during the second 2002 debt issuance suspension period was to exchange securities held by the Federal Financing Bank (which do not count against the debt ceiling) for Treasury securities held by the Civil Service fund, this option was not exercised. During the 1995/1996 debt issuance suspension period, Treasury did exchange securities held by the Civil Service fund for securities held by the Federal Financing Bank.

determine the potential impacts associated with the policies and procedures it implements in managing the amount of debt subject to the limit.

## Impact of Using Different Stated Policies and Procedures to Implement Actions Related to the Civil Service Fund

The stated policies and procedures Treasury used to implement its actions related to the Civil Service fund during the second 2002 debt issuance suspension period differed from those used in the 1995/1996 debt issuance suspension period. These differences were as follows:

- Current-year securities were redeemed earlier than normal during the second 2002 debt issuance suspension period, while long-term securities were redeemed earlier than normal during the 1995/1996 debt issuance suspension period.
- Accrued interest was used in the calculation of the securities that were eligible to be redeemed earlier than normal during the second 2002 debt issuance suspension period, while accrued interest was not considered in the calculation of securities redeemed during the 1995/1996 debt issuance suspension period.

As discussed below, the policies and procedures used in 2002 and 1995/1996 have different impacts on Treasury's flexibility to manage the amount of debt subject to the statutory debt limit.

## Redeeming Securities Earlier Than Normal

Two basic policies and procedures can be used to redeem Civil Service fund securities earlier than normal. The normal redemption policy, which involves redeeming current-year securities first,[10] was used during the second 2002 debt issuance suspension period. For example, when Treasury redeemed about $4 billion earlier than normal on May 16, 2002, the securities selected were those that matured on June 30, 2002. During the 1995/1996 debt issuance suspension period, the early redemptions were made from long-term securities that matured about 14 years later. The impact between the two approaches on Treasury's ability to manage the amount of outstanding debt during a debt issuance suspension period can be significant when a debt issuance suspension period also includes the date when securities mature. This could have occurred during the second 2002 debt issuance suspension period as the Civil Service fund had more than $45 billion of Treasury securities scheduled to mature on June 30, 2002.[11]

Should a debt issuance suspension period cover a June 30 rollover date, the securities selected for early redemption can have a significant impact on the amount of maturing securities, as shown in tables 2 and 3.

[10] Treasury's stated policy is to redeem the securities with the shortest maturity first. For a group of securities with the same maturity but differing interest rates, the securities with the lowest interest rate would be redeemed first.

[11] Treasury invests Civil Service fund receipts in nonmarketable Treasury securities commonly referred to as par value specials. These securities can be redeemed any time at their face value, or "par." The interest rate on these securities is based on the average rate for comparable marketable securities, as defined by Treasury, with 4 or more years to maturity. This rate is established on a monthly basis, and all investments for a given month must bear the same rate. When Treasury is notified by the Office of Personnel Management to invest Civil Service fund receipts, such investments are normally made in par value specials that mature on the following June 30, which is considered the end of the fund's investment year. On June 30, the maturing securities are converted into long-term par value specials with maturities of 1 to 15 years. Once this calculation has been made and the funds invested, the Civil Service fund's security holdings balances are equally divided among the 15-year period.

Table 2: Early Redemption of Civil Service Fund Investments Funded with Current-Year Securities

| Action | Securities maturing on June 30, 2002 |
|---|---|
| Balance on April 30, 2002 | $53 billion |
| Redeem $4 billion of current-year securities to fund early redemption authorization | (4 billion) |
| Normal redemption transactions less investments made from May 1 to June 30 | (1 billion) |
| Balance to be reinvested on June 30, 2002 | $48 billion |

Source: Bureau of the Public Debt.

Table 3: Early Redemption of Civil Service Fund Investments Funded with Long-Term Securities

| Action | Securities maturing on June 30, 2002 | Securities maturing after June 30, 2002 |
|---|---|---|
| Balance on April 30, 2002 | $53 billion | $474 billion |
| Redeem $4 billion of long-term securities to fund early redemption authorization | 0 | (4 billion) |
| Normal redemption transactions less investments made from May 1 to June 30 | (1 billion) | 0 |
| Balance to be reinvested on June 30, 2002 | $52 billion | Not applicable |

Source: Bureau of the Public Debt.

The amount of maturing securities to be reinvested is important because, as in the case of the G-Fund, Treasury does not have to reinvest the maturing Civil Service fund securities during a debt issuance suspension period.[12] This, in turn, allows Treasury to take other actions, such as investing other Funds' receipts or issuing securities to the public to raise cash. As illustrated in tables 2 and 3, the amount of maturing securities to be reinvested can have a significant impact on Treasury's debt management options. For example, (1) if the Civil Service fund had $48 billion of maturing Treasury securities and (2) Treasury needed to invest $52 billion of other Funds' receipts that could not remain legally uninvested on June

[12]During a debt issuance suspension period, Treasury is also not required to invest the interest payments associated with Civil Service fund and G-Fund investments.

30, by not reinvesting the maturing Civil Service fund's current-year securities Treasury could invest all but $4 billion of these receipts (see table 2). Treasury would then need to find some other method of generating room under the debt ceiling in order to invest the remaining $4 billion. On the other hand, if Treasury had redeemed long-term securities, then the $52 billion of other Funds' receipts could have been invested by simply not reinvesting any of the Civil Service fund's maturing securities (see table 3).

During the second 2002 debt issuance suspension period, Treasury expected to make about $50 billion in interest payments to the Funds, excluding the Civil Service fund and the G-Fund, on June 30, 2002. Had Treasury redeemed the long-term securities rather than the current-year securities, the resulting $52 billion of maturing Civil Service fund securities would have been adequate to fully invest the $50 billion of interest payments. This assumes that Treasury would have decided to suspend the reinvestment of these maturing securities and use the resulting room under the debt ceiling provided by this suspension to invest the interest payments to the other Funds. On the other hand, by redeeming short-term securities, the $48 billion of maturing Civil Service fund securities available would not have been adequate to fully invest the interest payments, and Treasury would have had to obtain $2 billion of debt limit from other sources, such as the G-Fund.

## Accrued Interest Used in Redemption Calculations during Second 2002 Debt Issuance Suspension Period

Treasury's normal redemption policy is to include the accrued interest on the security that is being redeemed when determining the amount of principal that should be redeemed. For example, if Treasury needed to redeem securities to make a $4 billion payment and $3,950 million of securities had earned $50 million of interest, then Treasury would need to redeem only $3,950 million of securities because the accrued interest would make up the difference between the payments to be made and the securities redeemed.

During the second 2002 debt issuance suspension period, Treasury used the accrued interest when it redeemed Civil Service fund securities early and when it redeemed funds associated with one of the early redemptions that had been reinvested. The interest payments associated with these redemptions totaled about $84 million. However, during the 1995/1996 debt issuance suspension period, which had a 14-month debt issuance suspension period, Treasury did not use the accrued interest in determining the amount of securities that should be redeemed. Including accrued interest in the calculation, as noted below, can have a significant impact on the amount of securities that are redeemed. This in turn affects the amount of securities Treasury can issue to the public for cash or issue to other Funds that have receipts that need to be invested.

Table 4 provides a hypothetical example showing that the reduction in outstanding debt can be significantly lower when accrued interest is used in the computation of securities redemptions. For purposes of this table, we assumed a 14-month debt issuance suspension period.

**Table 4: How Including Accrued Interest Affects the Amount of Securities Redeemed**

| Action | Effect on outstanding debt if accrued interest is included | Effect on outstanding debt if accrued interest is not included |
|---|---|---|
| Treasury declares debt issuance suspension period of 14 months and decides to redeem the full amount of securities associated with the Civil Service fund benefit payments for that time period. | Amount of outstanding debt is decreased by $54.6 billion.[a] | Amount of outstanding debt is decreased by $56 billion.[a] |
| Treasury reinvests $10 billion of early redemptions. | Amount of outstanding debt is increased by $10 billion. | Amount of outstanding debt is increased by $10 billion. |
| Treasury redeems the $10 billion of reinvested funds associated with the early redemptions. | Amount of outstanding debt is reduced by $9.7 billion.[b] | Amount of outstanding debt is reduced by $10 billion. |
| | Net effect on outstanding debt after all transactions would be that the amount of outstanding debt is reduced by $54.3 billion. | Net effect on outstanding debt after all transactions would be that the amount of outstanding debt is reduced by $56 billion. |

Source: GAO.

[a]For purposes of this example, it is assumed that the monthly Civil Service fund benefit payments are $4 billion per month, or $56 billion for the 14-month period. It is also assumed that the securities redeemed would have accrued $1.4 billion of interest.

[b]The example assumes that the redeemed securities would have accrued about $300 million of interest.

A number of factors affect the amount of interest that is associated with a given redemption. For example, the length of the debt issuance suspension period affects the amount of funds subject to early withdrawal—the more funds withdrawn, the greater the interest calculation. Another important factor is the time of year that the redemption is made. Since December 31 and June 30 are semiannual interest payment dates, securities redeemed in January and July will have significantly less interest associated with them than similar securities redeemed in May and November.

## Policies and Procedures Are Not Documented

Treasury has not documented the policies and procedures it used to implement the actions that it takes during a debt issuance suspension period. Although the actions that are allowed are well defined in law (e.g., suspending Civil Service fund and G-Fund investments and redeeming Civil Service fund securities earlier than normal), the policies and procedures needed to implement them are not documented. Our review disclosed some cases in which the lack of documented policies and procedures contributed to some confusion and errors that had to be corrected, as necessary. As stated in *Standards for Internal Control in the Federal Government*,[13] all transactions and other significant events need to be clearly documented, and documentation should be readily available. The limited number of people involved in and the complex nature of managing the debt during a debt issuance suspension period are factors that further support the need to document policies and procedures to be implemented. As noted above, policies and procedures can have an impact on managing the debt during a debt issuance suspension period. Furthermore, the policies and procedures developed should identify which office is authorized to approve any modifications to the policies and procedures.

Treasury officials noted that the changes to the stated policies and procedures used during the 2002 debt issuance suspension periods made the operations more consistent with those that it uses during its normal operations. They also noted that since the 1995/1996 debt issuance suspension period, Treasury has implemented a new financial management system that allows Treasury to use a more sophisticated approach to ensuring that the Civil Service fund is adequately compensated for any losses incurred. Therefore, the Treasury officials believe that the current stated policies and procedures are an improvement over those used in the 1995/1996 debt issuance suspension period.

As discussed earlier in this report, the approaches used during the 2002 debt issuance suspension periods allowed Treasury to restore the fund balances. At the same time, due to the limited number of people involved and the complex nature of managing debt during a debt issuance suspension period, Treasury would benefit from documenting the necessary policies and procedures to be used in such situations.

[13] U.S. General Accounting Office, *Standards for Internal Control in the Federal Government*, GAO/AIMD-00-21.3.1 (Washington, D.C.: November 1999).

We noted that the lack of documented policies and procedures contributed to some confusion and some errors that were subsequently corrected, as necessary. The following errors occurred during the second 2002 debt issuance suspension period:

- When Treasury decided to redeem Civil Service fund securities earlier than normal, it initially redeemed long-term securities. It subsequently reversed this transaction and redeemed current-year securities.

- When Treasury decided to reinvest funds associated with some of the early Civil Service fund redemptions, it did not include the accrued interest associated with those funds when they were subsequently redeemed to pay the June 3, 2002, Civil Service fund benefit payments. This was inconsistent with a similar reinvestment made on May 17, 2002, that was redeemed on May 20, 2002, in which Treasury included the accrued interest in its calculations.

- When Treasury restored the losses incurred by the Civil Service fund, it misclassified about $1.2 million of principal losses as interest losses. Treasury's practice of keeping a dual set of accounts in its new financial management system—one to track actual debt issuance suspension period transactions and one to track transactions that would have occurred had there not been a debt issuance suspension period—is a good first step toward ensuring that losses caused by Treasury's actions can be restored. However, as a result of the restoration policies and procedures Treasury used during the 2002 debt issuance suspension period, according to Treasury's new financial management system, the amount of the Civil Service fund's security holdings was about $1.2 million less on June 28, 2002, than it would have been had the debt issuance suspension period not occurred. Nevertheless, as previously noted, the restoration made on June 30, 2002, fully compensated the Civil Service fund for all losses.

Although these errors were not significant and were subsequently corrected as necessary, we believe that had Treasury established documented policies and procedures and effectively implemented them, the likelihood of these errors would have been greatly reduced.

## Conclusions

During the 2002 debt issuance suspension periods, Treasury acted in accordance with its statutory authorities when it (1) suspended some investments of the Civil Service fund and G-Fund and (2) redeemed securities earlier than normal from the Civil Service fund. These and other actions discussed in this report allowed the government to avoid default on its obligations and to stay within the debt ceiling.

Although some of the stated policies and procedures Treasury used to implement the actions it took on the Civil Service fund during the second 2002 debt issuance suspension period differed from those used in the 1995/1996 debt issuance suspension period, they were adequate to ensure that the Civil Service fund did not incur any losses after the debt issuance suspension period had ended and Treasury was able to take the necessary restoration actions. However, Treasury's stated policies and procedures to be used for the Civil Service fund and G-Fund during a debt issuance suspension period have not been documented. Properly documenting the policies and procedures will (1) allow Treasury management to ascertain the impacts of these policies and procedures on Treasury's ability to manage the outstanding debt during a debt issuance suspension period and (2) if effectively implemented, reduce the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future.

## Recommendation for Executive Action

We recommend that the Secretary of the Treasury direct the Under Secretary for Domestic Finance to document the necessary policies and procedures that should be used during any future debt issuance suspension period. Further, the document developed should clearly state which office is responsible for approving any modifications to the documented policies and procedures.

## Agency Comments and Our Evaluation

In written comments on a draft of this report, Treasury agreed that accurate documentation of its policies and procedures is a valuable objective and said that it believed it was desirable to maintain the preexisting policies and procedures for the redemption of securities and crediting of interest to the maximum extent possible. Treasury said that maintaining these standards makes the operations transparent and reduces confusion to the stakeholders of the funds affected by early redemption activities. Because it was unclear whether Treasury's proposed development and documentation of guidelines for debt issuance suspension periods would address our recommendation to document the necessary policies and procedures that should be used during any future debt issuance suspension period, we held subsequent discussions with Treasury officials to clarify the department's intentions.

Treasury officials were concerned that developing detailed policies and procedures would limit their flexibility to manage the debt during debt issuance suspension periods because they believed such situations may have unique characteristics with distinct circumstances that need to be addressed. We explained that our recommendation did not call for documenting the circumstances under which the Secretary should invoke specific actions. For example, we did not call for stipulating (1) how to determine the length of a debt issuance suspension period, (2) which funds should be used by Treasury to help manage its operations, (3) when to exchange securities held by the Federal Financing Bank for securities held by the Civil Service fund, (4) when to recall compensating balances, or (5) when to suspend fund investments. On the other hand, we did envision that such policies and procedures would document how to implement the actions directed by the Secretary, including (1) how to implement a given course of action, such as redeeming Civil Service fund securities earlier than normal, and (2) how to fully compensate a fund for its losses.

Taken from this perspective, Treasury officials generally agreed with the need to document the necessary policies and procedures relating to implementing actions determined by the Secretary. They did note, however, that such procedures might need to contain options in order to maintain the flexibility needed. For example, the policies and procedures might have two or more options on how to handle the redemption of Civil Service fund securities earlier than normal. Documenting policies and procedures that contain options would meet the intent of our recommendation. As we noted in our report, properly documenting the policies and procedures will (1) allow Treasury management to better ascertain the impact of these policies and procedures on Treasury's ability to manage the outstanding debt during a debt issuance suspension period and (2) if effectively implemented, reduce the chance for confusion and risk of errors should Treasury need to use the policies and procedures in the future.

Regarding three instances where the lack of documented policies and procedures contributed to what we characterized as some confusion and errors, Treasury did not agree that these instances were errors. As discussed below, we continue to believe that errors occurred.

As a backdrop for this discussion, the recurring theme of our report is that Treasury did not have documented policies and procedures that should be used during a debt issuance suspension period. Based on discussions with cognizant Treasury officials, it was our understanding that Treasury intended to apply what it referred to as its standard redemption policies and procedures—those used in normal daily operations. In commenting on this report, however, Treasury stated that it initially modeled its actions during the 2002 debt issuance suspension period on actions it had taken during the 1995/1996 debt issuance suspension period but that after further analysis it decided to instead use its standard redemption policies and procedures. The 1995/1996 procedures for redeeming securities earlier than normal used long-term securities and did not consider accrued interest in determining the amount to be redeemed. In contrast, Treasury's standard redemption policies and procedures use current-year securities and consider accrued interest.

Regardless of which approach Treasury opted to follow for the debt issuance suspension period transactions discussed in our report, Treasury did not consistently adhere to either approach and consequently made the following errors:

- When Treasury first redeemed securities earlier than normal, it redeemed long-term securities and included the accrued interest on the securities when determining the amount of principal that should be redeemed. Although the choice of long-term securities for early redemption was consistent with the practices used during the 1995/1996 debt issuance suspension period, including accrued interest in calculating the amount of principal to be redeemed was a departure from Treasury's 1995/1996 practices.

- For subsequent redemptions of securities reinvested, although Treasury used current-year securities, it was inconsistent in considering accrued interest in determining the amount of principal that should be redeemed. When Treasury redeemed the May 17, 2002, reinvestment on May 20, 2002, it redeemed current-year securities and included accrued interest in this calculation. This was consistent with its standard redemption policies and procedures. However, on June 3, 2002, when Treasury redeemed 10 reinvestments, it did not consider accrued interest. Instead, the June 3, 2002, redemption followed the practices used in the 1995/1996 debt issuance suspension period.

Regarding the third instance, the classification of $1.2 million of losses incurred, Treasury did not agree that its classification of this amount as interest losses was in error. As discussed in our report, the dual set of accounts maintained by Treasury's new financial management system—one that tracks actual debt issuance suspension period transactions and one that tracks transactions that would have occurred had there not been a debt issuance suspension period—clearly showed that the principal balances in the Civil Service fund differed by $1.2 million on June 28, 2002. As such, we concluded that when Treasury restored the losses incurred by the Civil Service fund, it misclassified about $1.2 million of principal losses as interest losses.

As stated in our report, these errors were not significant and were subsequently corrected as necessary; however, we believe that had Treasury established documented policies and procedures and effectively implemented them, the likelihood of these errors would have been greatly reduced.

Specific technical comments provided orally by Treasury were incorporated in this report as appropriate.

We are sending copies of this report to the chairmen and ranking minority members of the Senate Committee on Appropriations; the Senate Committee on Governmental Affairs; the Senate Committee on the Budget; the Subcommittee on Treasury and General Government, Senate Committee on Appropriations; the Senate Committee on Finance; the House Committee on Appropriations; the House Committee on Government Reform; the House Committee on the Budget; the House Committee on Ways and Means; and the Subcommittee on Treasury, Postal Service, and General Government, House Committee on Appropriations. We are also sending copies of this report to the Under Secretary for Domestic Finance, the Inspector General of the Department of the Treasury, the Director of the Office of Management and Budget, and other agency officials. In addition, the report will be available at no charge on the GAO Web site at http://www.gao.gov.

The head of a federal agency is required by 31 U.S.C. 720 to submit a written statement on actions taken on this recommendation to the Senate Committee on Governmental Affairs and the House Committee on Government Reform not later than 60 days after the date of this report. A written statement must also be sent to the House and Senate Committees on Appropriations with the agency's first request for appropriations made more than 60 days after the date of this report.

If I can be of further assistance, please call me at (202) 512-3406. Should you or members of your staff have any questions concerning this report, please contact Mr. Chris Martin, Senior Level Technologist, at (202) 512-9481 or Ms. Louise DiBenedetto, Assistant Director, at (202) 512-6921.

Sincerely yours,

Gary T. Engel

Gary T. Engel
Director
Financial Management and Assurance

# Comments From the Department of Treasury

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

ASSISTANT SECRETARY

4 NOV 2002

Mr. Gary T. Engel
Director
Financial Management and Assurance
General Accounting Office
Washington, DC 20548

Dear Mr. Engel:

Thank you for the opportunity to comment on the draft report entitled DEBT CEILING: Analysis of Actions During the 2002 Debt Issuance Suspension Periods (GAO-03-134). First of all, we would like to express our appreciation for the cooperation and consideration provided by your office both during and following the debt issuance suspension periods of 2002. Over the years, our offices have developed a cooperative and productive working relationship and we look forward to continuing this valuable and effective association.

We are also pleased that you concluded that Treasury's actions were "consistent with legal authorities provided to the Secretary of the Treasury" and that the Government Securities Investment Fund of the Federal Employees' Retirement System and Civil Service Retirement and Disability Fund were fully restored in accordance with the applicable statutory authorities.

We are in agreement that the accurate documentation of policies and procedures is a valuable objective. We feel it is desirable to maintain the pre-existing policies and procedures for the redemption of securities and crediting of interest, to the maximum extent possible. Maintaining these standards makes the operations transparent and reduces confusion of the stakeholders of the funds affected by early redemption activities.

However, as you will appreciate, each debt limit situation is unique with distinct circumstances that need to be addressed. There is a limit to the extent that Treasury can anticipate the actions necessary to address individual circumstances. Therefore, it is necessary for Treasury to preserve some level of flexibility. Balancing the desirability to maintain pre-established procedures with the need to preserve flexibility is a strong rationale for not developing an inflexible set of policies or procedures to address inherently dynamic and unique debt limit situations. We propose to document guidelines for the redemption of securities and crediting of interest where practical and to develop operational guidelines for debt issuance suspension periods that can be adapted for the unique circumstances of a specific debt limit occurrence. We suggest that the sentence on page 29 of the draft report stating that Treasury officials agree on the need for documentation be modified accordingly.

Specific editorial and other technical comments were provided orally to your office. However, we wish to take this opportunity to respond to several specific points made in the draft report.

1. In response to your recommendation to identify the office responsible for the policies and procedures relating to activities in debt limit situations and for any modification that may be required, the Office of the Under Secretary for Domestic Finance is that office.

2. We do not agree that the three "errors" listed are in fact errors. As the circumstances of each debt limit situation change, so does the government's ability to address these situations. Many of the benchmark practices used during the debt limit suspension period of 1995/1996, and advocated in the report, were developed to deal with the largely manual financial system in place at the time. Since that time, Treasury has implemented a new financial management system that allows for a greater degree of sophistication and precision. In fact, the first two circumstances classified as errors on page 28 of the draft report are examples of these changes. The initial actions in both situations were executed using the actions of the 1995/1996 debt limit suspension period as the model. Upon further analysis, it was determined that the new automated financial management system would allow the Treasury to maintain a high degree of control and accuracy over outstanding debt balances and still comply with its standard redemption policies and procedures. Treasury feels that in both these circumstances, the changes made were improvements over the practices used in the 1995/1996 period.

   It is our view that the $1.2 million referenced as the third error in the draft report was not misclassified. This amount reflects lost interest on early redeemed securities and not univested principal. Therefore, the most appropriate source to use to credit this lost interest to the Civil Service Retirement and Disability Fund, and the only source available to Treasury, was the Restitution of Forgone Interest Account. These funds did not become available for use until the next interest payment date following the end of the debt issuance suspension period (i.e. June 30, 2002).

Again, thank you for the opportunity to comment on this draft report. If you have any questions, please do not hesitate to call me or Carl Maryott, of my staff, on (202) 622-1795.

Sincerely,

Donald V. Hammond
Fiscal Assistant Secretary

# Related GAO Products

We have previously reported on aspects of Treasury's actions during the 1995/1996 debt issuance suspension period and earlier debt ceiling crises in the following reports:

*Debt Ceiling: Analysis of Actions during the 1995-1996 Crisis.* GAO/AIMD-96-130. Washington, D.C.: August 30, 1996.

*Information on Debt Ceiling Limitations and Increases.* GAO/AIMD-96-49R. Washington, D.C.: February 23, 1996.

*Debt Ceiling Limitations and Treasury Actions.* GAO/AIMD-96-38R. Washington, D.C.: January 26, 1996.

*Social Security Trust Funds.* GAO/AIMD-96-30R. Washington, D.C.: December 12, 1995.

*Debt Ceiling Options.* GAO/AIMD-96-20R. Washington, D.C.: December 7, 1995.

*Civil Service Fund: Improved Controls Needed over Investments.* GAO/AFMD-87-17. Washington, D.C.: May 7, 1987.

Opinion on the legality of the plan of the Secretary of the Treasury to disinvest the Social Security and other trust funds on November 1, 1985, to permit payments to beneficiaries of these funds. B-221077.2. Washington, D.C.: December 5, 1985.

*A New Approach to the Public Debt Legislation Should Be Considered.* FGMSD-79-58. Washington, D.C.: September 7, 1979.

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