# FISCAL CLIFF AND BANKRUPTCY COURT: WHY IS THIS FAMILIAR?

Hill impasses and court filings both mean people stopped communicating

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What do the current "fiscal cliff" and a bankruptcy filing have to do with each other?

Unfortunately, to this veteran credit man, quite a bit.

Bankruptcy--sometimes the best alternative, but ...

Many bankers, especially those not experienced in dealing with debtors under the bankruptcy court jurisdiction, see bankruptcy as an option that--carefully used--can be an important tool in working out a troubled credit.

There's some truth in that. My many years of workout experience taught me that a bankruptcy filing may sometimes be the only sensible recourse for the best interests of both creditors and debtors.

However, bankruptcy should be a last resort.

Why? The bankruptcy process changes relationships.

As soon as a relationship comes under the process, the free-flowing give and take of a typical loan workout process becomes stratified and codified. The law and court procedures set up a scheme in which all players receive an assigned priority and rights that often can only be adjudicated by the judge. Each class of creditor has its own set of statutory priorities. Parties who once cooperated can easily become adversarial.

In other words, the rules of the game change. The impact on the ability and willingness of the parties to negotiate subsequent to the filing is impossible to fully calculate.

Why the "cliff" resembles bankruptcy

Not usually ideal, in other words. And the fiscal cliff strikes me as being quite similar.

In a way, there's been a workout going on, albeit one of epic proportions.

For many months, representatives of the executive and legislative branches have been negotiating a resolution of the impasse over the size of the federal budget and the related deficit. There have been both political and fiscal facets to this. And if it were easy, we would have seen a solution a year ago.

Today, less than a month after the presidential election, our government continues to negotiate a resolution of the coming fiscal cliff. Everyone seems to profess a strong wish to avoid the consequences of not coming to an agreement. And it's impossible for outsiders to really know whether substantive progress is occurring. But it's entirely likely at this stage that there is predictable, deliberate posturing going on. It's for consumption of each elected participant's home constituency and political caucus.

What worries me at the moment is the very real possibility that we'll go over the cliff.

That's always been the risk that this could happen, due to miscalculation, misunderstanding, or worse. And there's nothing quite as unbreakable as ideology hardened into entrenched, almost fortified positions after almost two years of non-stop political campaigning.

But there's also now a political calculus developing by some on either side that explicitly tries to analyze the advantages to each of a deliberate strategy of going over the cliff.

This is alarming. The consequences will be material. They will be painful. And perhaps most importantly, they cannot be anticipated in full.

What we know

Among the certain outcomes of not reaching an agreement by Dec. 31: We will see tax increases that will hit virtually everyone in many places--ordinary income, capital gains, inheritance, alternative minimum tax.

We can also anticipate an extremely negative reaction from the financial markets both international and domestic. Interest rates on federal debt are virtually the lowest they have ever been. It strikes me as unreasonable to simply assume, as the world's largest debtor nation, that our creditors will continue to hold our debt at such low rates if we are unable to fix our deficit spending tendencies.

Our bond rating will most certainly be downgraded--again--and can we be assured that the drop will simply be one grade?

The required spending cuts are only outlined in the law by general category and aggregate amount. It will be up to the political leadership to determine the specifics. If there's no firm consensus on the big picture, how will the specific cuts be viewed by each side of the political divide?

The effects will be immediate in some ways, gradual in others. We'll all feel the higher tax rates on the first payday of the New Year. But the pink slips to be handed out to government workers as well as vendors and contractors to the federal government will take longer. Uncorrected, the impact of lower discretionary income in the hands of individuals is likely to trigger another recession.

While the federal Treasury will be collecting taxes at higher rates, it's hard to know the impact on actual tax collections as business activity slows over time, returning to recessionary levels of economic activity.

The government will not run out of money in the first week of January but it will lack the ability to borrow new money to fund deficits by issuing debt. Government outlays will be limited to its operating cash flows. Eventually, government payrolls and transfer payments such as Social Security, Medicare, Medicaid, food stamps, and the like will be limited to available cash flows. The various impacts in both financial and psychological terms are incalculable.

It will be a mess.

"The bankruptcy effect": Challenge to rebuilding communication

If we go over the cliff, there will be calls for change.

Citizens will expect our government, at a minimum, to take immediate corrective action to repeal the tax increases on the 98%.

But, just as in a bankruptcy scenario, relationships will have been altered.

Where will any consensus originate?

- • Will Republicans be accommodative to Democrats who have been blaming them for months over intransigence on tax policy?

- • Will Democrats be any more likely to negotiate painful curtailments to entitlements?

No longer will either side have consistent reasons--including a wish to avoid going over the cliff--to negotiate with the other.

Deals, understandings, negotiated points both large and small already accomplished or assumed will likely be voided. How long will it take both sides to reconstruct an environment where constructive outcomes can occur?

If the parties can't arrive at an agreement today, how much more difficult will it be to untangle the mess after we've crash landed in the valley?

A banker's eye on the approaching cliff

Bankers understand the need to maintain liquidity in the banking system to be able to fund deposit withdrawals and meet contractual lending commitments. But if confidence in our government's ability to function responsibly is lost, even temporarily, what will be the ultimate ingredient that props up our national liquidity and our collective trust that our systems will continue to work properly?

There are too many cowboys, politicians, and pundits, who just don't understand what is ultimately at stake.

Let's help them wake up to the challenge. There's not much time left.

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Disclaimer: Ed O'Leary's views are not necessarily those of the American Bankers Association.

Interested ABA members may also want to read the association's recent analysis, "Looking Beyond The Fiscal Cliff: Fundamental Strength Of The U.S. Economy."

The ABA white paper states in part:

"The justifiable concern over the potential impacts of the fiscal cliff have served to obscure a number of fundamental strengths in the U.S. economy that could see economic growth pick up notably in 2013. If we are to take advantage of these strengths, however, Congress must act, providing both short-term relief from the front-loaded fiscal cliff as well as a long-term plan that provides confidence in the fiscal sustainability of our nation."

About Ed O'Leary

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functi working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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