Morgan Stanley

Post-2012 Election Look At Lame-Duck Session and 2013

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By a popular vote margin of approximately two percent and a resounding Electoral College vote, President Barack Obama was reelected President of the United States on Tuesday, November 6, 2012.

President Obama will head into his second term in January facing a divided Congress that looks a lot like the Congress of the last two years of his first term – with the Democrats controlling the Senate and conservative Republicans solidly controlling the House of Representatives. With the country facing immense and immediate fiscal challenges that require complicated political negotiation and compromise, and many of his top financial advisers expected to announce their resignations by the end of the year, there is no time or opportunity for the president to take a victory lap. The president and congressional leadership are both under intense financial market and public pressure to address the nation's troubled and uncertain fiscal condition before the end of the year.

This memorandum summarizes the challenges the president and Congress face during the final weeks of 2012 (and the path most likely to be taken that will provide temporary resolution) and highlights some of the major issues a second Obama administration and the 113th Congress will most likely address in 2013. As the Obama administration and congressional leadership take shape in early 2013, Morgan Stanley Government Relations will issue a follow-on memorandum that will provide a better understanding of who will comprise the second-term Obama administration and the key decision-makers in the 113th Congress.

Tax and Budgetary Issues – Immediate Concerns

With the 2012 election behind us, the 112th Congress must return and, in the short year-end "lame-duck" session, address the impending "fiscal cliff" and U.S. debt ceiling. With the fiscal cliff, the U.S. faces a daunting combination of tax increases and federal budgetary spending cuts totaling over $600 billion that come into effect on January 1, 2013, absent congressional action. With respect to the debt ceiling, in 2011 Congress authorized a federal spending limit of $16.4 trillion. The current spending level exceeds $16.2 trillion, and the U.S. Treasury estimates the federal government will reach the debt ceiling before the end of this year (or, using budgetary maneuvers, by early next year). It is these politically explosive and challenging "must deal with" matters that will drive the outcome in the lame-duck session and the U.S. legislative agenda in 2013.

Each component of the fiscal cliff scenario is important in and of itself; taken together, they amount to a massive headwind to the U.S. economy. The tax increases comprise the largest component of the fiscal cliff, totaling approximately $500 billion. These include the expiration of the Bush-era tax provisions affecting marginal tax rates, capital gains and dividends treatment, the estate tax, and numerous other provisions affecting primarily individual taxpayers.

But the fiscal cliff also includes annual expiring tax provisions affecting both businesses and individuals, such as business tax credits for research and development, 100% bonus depreciation, and energy-related tax credits, and individual tax provisions such as the expansion of the alternative minimum tax, to name a few. Many of these provisions expired in 2011, and must be addressed both retroactively and prospectively if not allowed to simply lapse. Other tax or revenue-related provisions that round out the tax side of the fiscal cliff include the expiration of the temporary lower payroll tax on employees, the expiration of the temporary reimbursement rate for doctors administering to Medicare patients, and the temporary reduction in the college student loan interest rate.

On the spending side of the equation is "sequestration." Sequestration refers to the automatic spending reductions, totaling $109 billion per year over the next nine years, mandated by the Budget Control Act of 2011. These spending cuts take effect automatically due to the inability of the congressionally-mandated "super committee," created in August 2011 by the Budget Control Act, to reach agreement on a spending reduction plan for the federal government. These cuts are split equally between defense and non-defense budget functions, with roughly $55 billion coming from defense, and $55 billion coming from non-defense programs (but with entitlements such as Medicare, Medicaid and Social Security generally exempted).

The third component of the fiscal cliff, and some have argued the most critical and immediate concern facing lawmakers, is the rapidly approaching debt ceiling limit. We believe the debt ceiling will be the driving force behind any deal reached during the lame-duck session. Without raising the debt ceiling, the country faces a potential default that would lead to a significant downgrade of its credit rating and would reverberate across the global capital markets. The debt ceiling must be raised, and it is this absolute imperative that will drive some form of broader compromise before the end of this year.

Likely Outcomes for the Fiscal Cliff

Neither the Obama administration nor Congress wants to be responsible for pushing the country over the "fiscal cliff." Accordingly, we believe the fiscal cliff will be addressed before the end of 2012. At the same time, given the lame-duck session's short time frame (approximately 5 weeks), the prospects for a "grand bargain" that provides a comprehensive solution to tax, deficit, and entitlement issues are minimal at best. Rather, we expect Congress to "kick the can" with an agreement for a short-term delay of the fiscal cliff's component parts, thereby providing time for the parties to negotiate a more complete and long-term fix in 2013.

We believe that a six-month extension has the greatest likelihood of being adopted during the lame-duck session, as Democrats will likely view a 12-month extension (the Republicans' preference) as too long. President Obama and the Democrats will be motivated by a desire to avoid a protracted and potentially devastating debate over an increase in the debt ceiling limit. Congressional Republicans want an extension of Bush-era tax breaks for taxpayers at all income levels, as well as a delay in military spending cuts forced by sequestration. While neither side will fully embrace the lame-duck deal, it is nonetheless the easiest to path to negotiate at this late stage of the 112th Congress. Permanent resolution of these issues will likely be left for the incoming Congress, with a possible mandate to act by a date certain (outlined in the lame-duck deal) and in an expedited manner to force the process to a conclusion.

The 113th Congress – Taxes and Budget

Assuming this Congress delays the timing of the fiscal cliff and increases the debt ceiling to cover another 12 to 24 months, the 113th Congress will face the task of addressing tax and spending issues in a more permanent manner. This obligation should lead to a serious effort at meaningful tax and budgetary reform beginning early next year.

With regard to taxation, the expiration of all the various tax laws and provisions described above will provide the catalyst for legislative action. The process began during the 112th Congress when both the House Ways and Means and the Senate Finance Committees began laying the foundation for tax reform through a series of hearings focused on international, business, and individual tax reform. On the business side, the business community should embrace a reduction in the corporate tax rate, a modification that could garner bipartisan support. A second business industry priority – moving towards a territorial system of taxation for multinational corporations – will face stronger headwinds, as the Obama administration has already signaled its opposition.

Much of the discourse on individual tax reform has focused on the idea that the code needs to be simplified. Simplification could take the form of lower marginal rates coupled with a broadening of the tax base. Such a broadening could impact capital gains and dividends rates, municipal bond treatment, and other tax benefits (i.e., deductions) enjoyed by individual taxpayers.

While tax reform for simplification's sake may drive the legislative agenda, it may also serve to address budgetary issues as well. President Obama campaigned on the need to increase marginal rates on upper-income earners as a way to promote tax "fairness" and generate revenue. Following Mr. Obama's successful campaign messaging, the administration will likely pursue this brand of tax reform as a key element of its deficit reduction plan. Congressional Republicans, on the other hand, oppose any increase in marginal rates, and instead hope to couple spending cuts with tax simplification that is focused on lower rates and an expanded tax base – to facilitate economic growth while maintaining overall revenues at today's percentage of our economy.

Tax reform may be achievable in the 113th Congress, but not without compromise between the White House and congressional Republicans. The likely impetus for moving such reform in the coming years, assuming compromise is achievable, is a grand bargain reached by the White House and Congress that addresses tax, spending, and entitlement issues in a single legislative package.

Securities, Banking and Housing

Dodd-Frank Implementation – Since passage of the Dodd-Frank Act in July 2010, the Obama administration has aggressively pursued financial services regulatory reform pursuant to its mandate in that law. Newly reelected President Obama and his second-term administration will continue to draft Dodd-Frank rules and implement those rules as 2013 unfolds.

As of Election Day, a brief snapshot of the Dodd-Frank rulemaking process shows a work in progress. A total of 237 rulemaking deadlines have passed, 60 percent of the total required 398 rules that must be written to fully implement the law. Regulators have issued 133 final rules (33% of the 398 they must write under Dodd-Frank), have proposed another 133 (33%), and have not yet released proposals for the remaining 132 rules (33%).

With only one-third of the rules fully completed, there remains much work to be done. Critically, regulators have yet to finalize rules on a host of issues that impact Morgan Stanley, other financial services firms, and our clients. For example, many components of the new derivatives rules must still be finalized and/or implemented, the Volcker Rule must be finalized, new qualified mortgage standards and securitization risk retention rules must be completed, and a myriad of rules that impact our Morgan Stanley Wealth Management retail brokerage business must take shape, among others.

A second term for President Obama will surely see some new faces in key positions atop the administration, including possibly at the Treasury Department and the SEC (where both Secretary Geithner and Chairwoman Shapiro are both expected to step down) as well as the Federal Reserve (where Chairman Bernanke's term ends in January 2014). Despite the individual shifting of chairs that typically follows the start of a new term, the critical theme will be one of continuity. Dodd-Frank rule writing will continue in earnest for the remainder of 2012 and early in 2013, and agencies will build upon the work they have been doing (and the policy approaches taken) in the preceding two years.

House Republicans will likely continue to use one of the few levers they have – the budget process – to pursue policy objectives in the face of Senate and presidential opposition. This includes many areas of Dodd-Frank rulemaking, including the continued build-out of the newly-created Consumer Financial Protection Bureau. Senate Democrats and President Obama will be forced to engage House leadership on these efforts.

Basel III and "Too Big To Fail" – More than four years after the financial crisis and over two years after the passage of Dodd-Frank, Congress and the Obama administration continue to explore additional measures to reduce systemic risk. Two areas of controversy that will continue to receive attention are (a) global capital standards, particularly the implementation and impact of Basel III, and (b) the ongoing debate around the concept of "too big to fail," which could focus on measures to reduce, cap or restrict systemically important financial institutions' activities, size and risk profiles.

On the latter, members of Congress in both political parties are expected to introduce legislative proposals in 2013 that would seek to further limit the size, growth and activities of the largest U.S. banks. We expect a healthy debate surrounding "TBTF" throughout 2013, but see any enactment of legislation as difficult given the other competing priorities of Congress and the Obama administration and the lack of consensus around the need for such additional reform measures. Similar bank restriction and limitation reforms being developed in Europe and the United Kingdom will be watched closely by U.S. lawmakers over the course of the year.

Housing Finance Reform – As Dodd-Frank rulemaking ebbs with the finalization of many of the remaining rules in 2013, the government will become increasing focused on the next monumental task in financial services policy: shifting out of the conservatorship of Fannie Mae and Freddie Mac and crafting a new platform for housing finance. This complicated task will be made even more difficult by the matriculation of several new players on Capitol Hill into leading roles at the banking committees, which is still yet to be fully determined.

Given the magnitude of policy and political hurdles, we are unlikely to see large-scale reform in 2013. At the same time, a tremendous amount of resources will be invested on Capitol Hill and in the administration toward finding a solution to reduce the role of the GSEs and to encourage greater private capital in the housing markets. Lawmakers will lay the foundation for reform with an aggressive review of policy options starting early in 2013, and the contours of a final product may start to take shape in the second half of the year, even if passage does not occur until later. Much of the housing reform endeavor is tied to Dodd-Frank reform of the secondary mortgage markets and attempts to revitalize quality private sector asset securitization. Congressional and Obama administration efforts here will also be affected by the ongoing recovery of the housing market and the degree to which the foreclosure crisis abates.

Equity Market Reforms – On Capitol Hill and at the SEC, equity market structure will continue to garner the interest of lawmakers through hearings, roundtables and, potentially, legislation and/or regulation. Regulators and legislators will increase their focus on high frequency and algorithmic trading, the role of dark pools, and efforts to increase liquidity to smaller issuers, among other related priorities. Ensuring equity market confidence and integrity, recently compromised by the Flash Crash and incidents of trading system failures and technological glitches, will be a priority in both House and Senate committees with jurisdiction over the financial markets.

Money Market Funds – Significant and controversial money market mutual fund reform (e.g., floating NAV, withdrawal limitations and restrictions, capital requirements), a goal of SEC Chairwoman Shapiro and the Obama administration, has been put on temporary hold for lack of political support within the SEC, but is expected to remain a priority in the Obama administration's second term. Congress will certainly take a strong interest in any money market reform rules proposed by the SEC in 2013, and will give close scrutiny to any related action taken by the U.S. Treasury-led Financial Services Oversight Council.

International Trade

In 2011, Congress concluded the drawn-out and contentious process of passing free trade agreements with Colombia, Panama and Korea. Throughout 2012, trade policy was defined by the elections. In response to widespread fear that American jobs were being shipped overseas, and that our largest trading partners were not playing by the rules, the administration avoided antagonizing organized labor or other trade skeptics by emphasizing strong enforcement of trade laws and promoting U.S. exports.

Earlier this year, the Senate passed the Currency Exchange Rate Oversight Reform Act – aimed at China's currency valuation – by a vote of 63-35. The bill would make it easier for a country to be cited under U.S. law as a currency manipulator and subjected to tariffs. The House did not bring the bill to a vote, but congressional frustration over China's currency policies remains strong and featured prominently in the presidential campaign. At this point, currency legislation is unlikely to pass into law, but friction in the U.S.-China trade relationship will remain an issue. The only "must pass" trade legislation left for the year is a measure to extend permanent normal trade relations to Russia, which Congress is expected to approve when it returns for the lame-duck session this month.

Next year, the focus on trade will increase as the administration ramps up its economic growth strategy. The National Export Initiative is a key component of this plan. Its goal is to create two million new jobs by doubling U.S. exports in five years, and so far, it is on track to meet this objective. Going forward, President Obama will continue to sympathize with U.S. labor concerns and to address trade skepticism, while simultaneously turning to trade liberalization to boost U.S. economic recovery. Specific measures include:

Trans-Pacific Partnership (TPP) – The Trans-Pacific Partnership (TPP) is a proposed regional free trade agreement being negotiated among the U.S., Australia, Brunei, Canada, Chile, Malaysia, Mexico, New Zealand, Peru, Singapore, and Vietnam. Japan and the TPP partners are conducting consultations on its possible entrance as well. The broad outline of an agreement was announced in 2011. If implemented, the TPP could eliminate tariff and non-tariff barriers to trade and investment among the parties and could serve as the premier vehicle of Asia-Pacific trade and investment liberalization and economic integration. It is possible that negotiations will conclude this year, but an agreement is not likely until mid-2013, at the earliest. Once the agreement is finalized, Congress must pass implementation legislation.

E.U.-U.S. Free Trade Agreement – While the United States and the E.U. are each other's largest trading partners, they have never negotiated a free trade agreement. In response to Europe's difficult economic circumstances, policymakers in Brussels and Washington are searching for a policy mechanism that can generate growth in the E.U. Business groups on both sides of the Atlantic have been actively pushing for a free trade agreement. The U.S. Congress and the European Parliament have also demonstrated strong support. Earlier this year, a U.S.-E.U. High Level Working Group on Jobs and Growth was formed to examine prospects for deeper economic integration through a free trade agreement; its conclusions will be released in December 2012.

Negotiating a U.S.-E.U. FTA would be no easy feat. Before moving forward, policymakers would need strong assurances that negotiations would not become bogged down in longstanding, deep-seated differences in areas like agriculture, regulatory approaches, access to government procurement, and intellectual property rights. That said, a final decision on launching a U.S.-E.U. free trade initiative is likely to be driven as much by political factors as by consideration of practicalities. Moreover, those political factors will be influenced considerably by developments in the Euro zone crisis over the coming months.

Energy Policy

A second-term Obama administration will see energy policy remain an issue of prominence. While partisan rancor dominated any discussion of energy-related issues during the presidential campaign, including the Keystone Pipeline project that drove the debate for much of the year, there remains an overriding desire for energy independence in both parties. There is some potential that this commonality could bring together diverse political interests in Congress that could seek a deal on a national energy strategy going forward.

With an "all of the above" strategy for achieving energy independence, Congress and the administration could move forward on policy that seeks expanded domestic energy production focused on all energy related resources, from conventional sources such as oil, natural gas, coal, and nuclear power, to renewable sources focused on wind, solar, geothermal, and other renewable energy projects. At the same time, achieving consensus will remain difficult. Wide ideological differences still exist, especially regarding the efficacy of focusing resources on the development of renewable versus traditional energy sources. Moreover, related issues such as the exportation of domestic energy sources, clean energy standards for utilities, and overall environmental protection will remain as obstacles to the success of any energy-related legislative effort.

Helping to move the process forward will be the absence of cap and trade legislation as a driver of energy legislation. On a separate note, with the election behind us we believe that the Obama administration will approve the northern leg of the Keystone Pipeline project in the second half of 2013—with energy independence and job creation driving this decision.

The tax component of energy policy will likely be included as a component of tax reform in the 113th Congress. As a part of that effort, the efficiency of the various tax credits as positive drivers of energy policy will be on the table for consideration.

While energy policy will be a key issue next year, absent bipartisan cooperation, moving forward on a national energy policy will be difficult at best.

Contacts

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