The Debt Ceiling and Money Market Funds

Frequently Asked Questions

On January 19, 2023, Treasury Secretary Janet Yellen informed Congress that the outstanding debt of the United States had reached its statutory limit and that the Treasury Department began implementing certain "extraordinary measures" to prevent the nation from defaulting on its obligations. Secretary Yellen also indicated that the period of time those measures may be deployed was subject to considerable uncertainty. Still, it was unlikely that cash and extraordinary measures would be exhausted before early June. Private forecasters put the so-called "X-date" (the term used to reference the expected date that the U.S. Treasury would no longer be able to meet all its financial obligations) sometime in the third quarter.

In a more recent letter to Congressional leaders on May 1, Secretary Yellen provided updated information noting, "Our best estimate is that we will be unable to continue to satisfy all of the government's obligations by early June, and potentially as early as June 1, if Congress does not raise or suspend the debt limit before that time." That pulled forward the potential X-date to a date much earlier than anticipated.

Secretary Yellen commented in her recent letter that "waiting until the last minute to suspend or increase the debt limit can cause serious harm to business and consumer confidence, raise short-term borrowing costs for taxpayers, and negatively impact the credit rating of the United States" and that failing to act "would cause severe hardship to American families, harm our global leadership position, and raise questions about our ability to defend our national security interests."

The timing of when the Treasury could run out of money is a critical factor in understanding the urgency of political negotiations, the Treasury maturities most at risk of a potential default, even if only for a short period of time, and potential market volatility leading up to that date.

The X-date estimate remains uncertain because of the significant daily flows into and out of the Treasury General Account (TGA). While the Federal government typically runs a surplus in April due to individual income tax receipts, the U.S. has run a deficit in May for 55 straight years. June is a mixed bag but has been at a surplus 70% of the time, while July and August are uniformly at deficits. However, funding capacity must be met on a day-by-day basis.

Moody's recently noted that April tax receipts were running 35% below last year's pace, which is meaningfully weaker than anticipated, partly because of weaker capital gains revenue from last year's stock market declines. When Secretary Yellen wrote the original letter in January, the TGA balance was $455 billion; it dropped to a low of $86 billion just prior to the April 15 tax date; and was $188 billion as of May 3. In addition to other ongoing expenditures, there are large upcoming Social Security benefits or supplemental security income payments on May 10, 17 and 24, and June 1 and 14. The Treasury would expect large inflows from corporate and individual tax payments on June 15. If the Treasury can cover funding needs to June 15, inflows at that time would likely take them to late July.

Because previous expectations were that the Treasury would not hit the X-date until late July or early August, the market reacted to Yellen's updated information by initially pushing up the yield on Treasury bills maturing in early to mid-June. For example, on May 4, the Treasury sold $50 billion of 4-week Treasury bills maturing June 6, 2023, at a rate of 5.84%—the highest yield for any Treasury bill auction since 2000. Yields on Treasuries with maturities in the June-August timeframe remain elevated. In contrast, yield on Treasury bills maturing in May yield 100 basis points (1.00%) less than those maturing in June.

In addition to higher short-term yields, there are uncertain implications from a Treasury default, or even risk of cutting it too close. Economic risks and market volatility would likely spike well before the Treasury's account balance is exhausted. In a recent press conference, Fed Chair Jerome Powell stated: "It's essential that the debt ceiling be raised in a timely way so that the U.S. government can pay all of its bills when they're due. A failure to do that would be unprecedented. We'd be in uncharted territory, and the consequences to the U.S. economy would be highly uncertain and could be quite averse."

President Biden and House Speaker McCarthy met at the White House on May 9 to attempt to resolve the potential crisis. Initial reports suggest that the parties remain at an impasse. Congressional Republicans want to tie any debt ceiling increase to significant spending cuts, while the Biden administration wants a clean debt ceiling increase with any spending cuts to take place through normal budget negotiations ahead of the October 1 start to the next U.S. government fiscal year. A temporary option used in the past has been a short-term extension of the debt ceiling. This could be used to get through the near-term June 1-15 critical period and provide more time for further discussion and negotiations.

To help you understand how a debt ceiling default could impact your money market mutual fund (MMF), here are answers to some frequently asked questions.

What is First American Funds' portfolio strategy for investments around the debt ceiling?

When selecting securities for First American Funds (Funds), the portfolio managers consider general economic factors, market conditions, and the short-term interest rate environment in determining what short-term instruments to purchase. The Funds have been minimizing exposure to U.S. Treasury securities maturing within the time frame the government would exhaust its borrowing capacity (X-date), originally thought to be in the mid-June to end of September time frame, with recent focus now on the first half of June. In addition, the Funds continue to hold significant other liquid assets, including overnight repo, and to have daily and weekly liquid assets well in excess of regulatory requirements.

Are the debt ceiling impacts the same for each First American Fund?

While all Funds will be impacted by expected market volatility as the U.S. approaches the debt ceiling, the direct impact to each Fund will differ depending on the composition of underlying assets. Treasury-only MMFs are most directly impacted, given their investment objective to solely invest in direct obligations of the U.S. Treasury (no repo). Treasury-only MMFs must rely on maturities and sales of securities to meet potential redemptions, while government and treasury obligations MMFs rely more on overnight repo to manage daily liquidity. U.S. government agency obligations (FHLB, Fannie Mae, Freddie Mac, Federal Farm Credit) held in government MMFs are not impacted by the debt ceiling and can continue to mature and issue debt without restrictions.

What is the debt ceiling impact on MMF yields?

Yields in the government-sponsored enterprise (GSE) and Treasury space are heavily influenced by Treasury Bill/Note supply and Fed policy. We anticipate some yield dislocations in Treasury and GSE issues as politicians navigate the Treasury debt limit. Treasury Secretary Yellen's potential debt ceiling X-date of as early as June 1 is impacting the short-end of the T-Bill curve. Current T-Bills maturing before June 1 are seeing increased investor demand and subsequently are trading at much lower yields than those securities maturing right after June 1. For Treasury and government MMFs, a significant portion of assets are held in Fed overnight repo, which as of May 3, 2023, paid a flat rate of 5.05%, and consequently, yield volatility is expected to be more limited.

How do the Funds' holdings of Reverse Repo Program (RRP) via the Federal Reserve Bank of New York work during a Treasury default?

Operationally, the Fed NY RRP parameters include a $160 billion per MMF maximum limit and a 12:15 p.m. CT trading deadline. RRPs are overnight with collateral backed by U.S. Treasuries priced daily at 100% margin. As of May 3, 2023, the offering rate for RRP was 5.05%. We have received no indications of a change to RRP operations in the event of a Treasury default.

Are RRP positions considered part of the scope of a Treasury default?

The Federal Reserve Bank of New York is the counterparty for RRP transactions, not the U.S. Treasury.

Is there an estimated number of days where First American Funds mitigation efforts in a default scenario stop working?

Portfolio managers may adjust Fund securities as the situation evolves, but the emphasis on minimizing exposure to potential defaulted securities and maintaining high liquidity will remain core to our investment approach.

Will a Treasury default result in a rating downgrade to First American Funds?

We do not anticipate a Treasury default will result in downgrades to MMF industry ratings in general. Fund ratings are based on several factors. It is important to note, even a downgrade of the U.S. Treasury and GSEs would not directly result in a downgrade to MMF's AAA rating. It is widely expected that the industry would hold impacted U.S. Treasury securities in the event of a default without immediate and widespread liquidations of impacted maturities.

Would a Treasury default change how First American Funds managed repo counterparty risk?

First American Funds credit process is based on rigorous fundamental credit analysis that seeks to understand historic and prospective credit risks throughout the market cycle. Portfolio managers and credit analysts will continue to update their outlook and views as markets evolve and will closely monitor events in this rapidly changing environment.

Would a Treasury default result in a stable constant NAV government MMF converting into a floating NAV MMF?

Government Obligations Fund, Treasury Obligations Fund, and U.S. Treasury Money Market Fund qualify as "government money market funds" under Rule 2a-7 of the Investment Company Act and seek to maintain a stable net asset value (NAV) per share of one dollar.

Investment securities held are stated at amortized cost (except for investments in other MMFs, which are valued at their most current NAV), and approximates fair value. Under the amortized cost method any discount or premium is amortized ratably to the final maturity of the security and is included in interest income. In accordance with Rule 2a-7 of the Investment Company Act, the fair value of securities held in the MMFs are determined using amortized cost, which is compared to prices provided by independent pricing providers.

If there is a Treasury default, will my account sweep instructions still be in effect?

Security investments in the Funds should not impact shareholder instructions to financial intermediaries. Ask your salesperson or visit your financial intermediary's website for more information.

In a Treasury default scenario, will transactions in the Funds occur as normal and be honored in full? Will there be a difference, or limit, between additional deposits and/or redemptions into the Funds?

Fund operations, including the general offering of shares of the Funds for redemption or purchase orders are not expected to be impacted by the events of the U.S. Treasury debt ceiling.

Will the Funds be closed to new shareholder accounts?

Information about purchasing or redeeming Fund shares is found in the Fund's prospectus. While the Funds reserve the right to reject any purchase order, suspend a shareholder redemption, and close a shareholder's account at any time, fund operations, including the general offering of shares of the Funds for purchase orders to new accounts is not expected to be impacted by the events of U.S. Treasury debt ceiling.

Sources

Federal Reserve, Transcript of Chair Powell's Press Conference, May 3, 2023

Moody's, Zandi, M. Yaros, B., "The Debt Limit Drama Heats Up," April 2023

The Hill, "OMB director says short-term debt ceiling extension possible," May 4, 2023

U.S. Department of Treasury, Bureau of the Fiscal Service

U.S. Department of Treasury, Secretary of the Treasury Janet L. Yellen to Congressional Leadership on the Debt Limit, May 1, 2023

Definitions

Basis Point (bps) is one one-hundredths of a percentage point. This term is often used in describing changes in interest rates. For example, if a bond yield increases from 7.50% to 7.88%, it has moved up 38 basis points.
Federal Reserve (Fed) is the United States central banking system. It is comprised of 12 regional central banks, known as the Federal Reserve Banks, which are owned by private banks. The Fed is governed by a seven-member Board of Governors, who regulates interest rates, availability of bank credit and sets other monetary policies such as legal reserve requirements for banks.
Government-Sponsored Enterprise (GSE) is a quasi-governmental entity established to enhance the flow of credit to specific sectors of the American economy. Created by acts of Congress, these agencies, through privately held, provide public financial services. GSEs help to facilitate borrowing for all sorts of individuals, from students to farmers to homeowners.
Treasury is negotiable debt obligation of the U.S. government, secured by its Full Faith and Credit and issued at various schedules and maturities. The income from Treasury securities is exempt from state and local, but not federal, taxes.
Yield is the income returned on an investment, such as the interest received from holding a security. The yield is usually expressed as an annual percentage rate based on the investment's cost, current market value, or face value.

[See next page for continued disclosure information.]

For Institutional Prime Obligations – You could lose money by investing in the Fund. Because the share price of the Fund will fluctuate, when you sell your shares they may be worth more or less than what you originally paid for them. The Fund may impose a fee upon sale of your shares or may temporarily suspend your ability to sell shares if the Fund's liquidity falls below required minimums because of market conditions or other factors. An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time.

Income from tax-exempt funds may be subject to state and local taxes and a portion of income may be subject to the federal and/or state alternative minimum tax for certain investors. Federal income tax rules will apply to any capital gains distribution.

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