

The debt ceiling—frequently asked questions



Overview

Any discussion should be prefaced by our belief that the likelihood of one or multiple technical defaults due to a protracted debt-ceiling debate is remote; that in the unlikely event there should be a technical default, it will be short-lived; and that upon resolution, investors and funds are likely to be unaffected. We further believe that, given evidence of preplanning, the Federal Reserve (Fed) would be prepared to step into the markets in order to calm them and ensure smooth and orderly functioning of the government markets. It also should be noted that no one, including us, knows what such a situation would look like—what we can offer is our opinion based on our research.

Past experience shows us that when push comes to shove, legislators will raise the debt ceiling in order to avoid a default. It has not mattered how cordial or fractious the relations are either between parties in Congress or between the legislative and executive branches. While some episodes have gone smoothly and other times they have been used to try and get a political advantage, eventually a resolution has been reached.

Frequently asked questions

What is the debt limit?

The debt limit is the total amount of money the United States government is authorized to borrow to meet its existing legal obligations, including debt held by the public and debt held by government accounts, such as the Social Security and Medicare trust funds.

Why was it created?

The debt limit evolved from the powers granted to Congress in Article 1, Section 8 of the U.S. Constitution: “*The Congress shall have Power ... To borrow Money on the credit of the United States.*” In a rare and perhaps unique development, congressional control of U.S. debt has taken on a simpler form over time as the government and its obligations have grown increasingly complex. In the beginning, and for more than a century, Congress approved individual debt issues

in detail, down to their interest rates and maturities. Over time, however, congressional approvals became gradually more general until 1939, when Congress created the first aggregate limit covering nearly all government debt and set it at \$45 billion.

How many times has the debt limit been increased?

From the first debt limit in 1939 through the end of 2018, Congress adjusted the limit 98 times. Except for a handful of declines in the 1940s and 1950s, all have been increases.

How does the debt limit get increased? Who makes that decision?

It starts with a bill, sitting on Capitol Hill, that is passed by both the House and the Senate and is signed into law by the president. For most of its history, the debt ceiling was simply raised from one number to a higher one, to allow for growth in the debt. In 2013, lawmakers took a different approach, suspending the debt limit altogether until a future date, allowing unfettered debt growth in the interim. When that date arrived, the debt ceiling was reestablished at the amount of debt then outstanding. The debt limit suspension/reinstatement structure has become the preferred approach, having been used in 2013 (twice), 2014, 2015, 2017, and 2018.

When does the debt limit need to be raised?

The U.S. typically operates at a fiscal deficit, spending more than it receives (usually through taxes) and borrowing the difference. When the Treasury’s cash balance is near zero and it has payments it is contractually obligated to make, it must borrow to fund the payments. If its outstanding debt is already at the legal limit, the ceiling needs to be raised to allow new borrowing. The Treasury can take steps, commonly known as extraordinary measures, to temporarily allow additional debt issuance even when it’s at the limit, but when those measures are exhausted, the limit needs to be raised to allow the government to meet its obligations. The point when the debt has reached the limit, cash is nearly gone, and extraordinary measures are exhausted is sometimes referred to as the *drop-dead date*.

What are the extraordinary measures at the U.S. Treasury department's disposal in order to prevent/delay a breach of the debt limit?

Because the debt limit restricts total U.S. government debt, including debt held by the public and debt held by government accounts (such as the Social Security and Medicare trust funds), the Treasury is legally able to take steps to reduce the debt held by government accounts, thereby allowing room under the limit for additional borrowing from the public. In this way, the Treasury is able to continue to fund the government's deficit operations for a number of months even after its total borrowings reach the debt limit. These steps, commonly known as extraordinary measures, include the following:

- The Treasury can suspend its daily reinvestment in the federal employees' Thrift Savings Plan G Fund, a retirement plan investing in special-issue overnight Treasuries that count against the debt limit. Not issuing Treasury debt to the G Fund frees up room under the debt ceiling. The G Fund is made whole (with interest) when the debt ceiling is eventually raised.
- The Treasury can suspend the daily reinvestment of the U.S. dollar balances held by the Exchange Stabilization Fund (ESF). Though the ESF is not a retirement plan, for debt-ceiling purposes the ESF suspension operates as the G Fund suspension does, by ceasing to issue overnight Treasury securities counting against the debt limit. Unlike the G Fund, however, the ESF is not eventually made whole for its lost investment opportunity.
- The Treasury also may alter the investment actions of two more employee benefit plans, the Civil Service Retirement and Disability Fund and the Postal Service Retiree Health Benefits Fund. In these cases, rather than suspending overnight investments, the Treasury's actions would affect the issuance of new securities and the reinvestment of maturities and interest on existing securities. As with the G Fund, the plans will eventually be made whole.
- Finally, the Treasury can suspend the issuance of State and Local Government Series (SLGS) securities, which are ordinarily issued to allow state and local governments to invest proceeds from their issuance of tax-exempt bonds. Because SLGS securities count against the debt ceiling, their suspension adds room under the ceiling.

How long are the extraordinary measures effective at delaying the binding debt limit? How much time do they buy?

The primary factor affecting the time value of extraordinary measures is the degree to which the U.S. government is operating in deficit. A larger deficit will burn through cash (and room under the debt ceiling created by extraordinary measures) faster. The other significant factor is the seasonality of the U.S. government's cash flows, especially around tax season in the spring. The Treasury typically makes large tax refund payments in February and March and then receives large tax payments in mid-April. Recent extraordinary measures executions unfolded in the following timetables:

	Start of extraordinary measures	Estimated exhaustion of cash and extraordinary measures
2011	5-16-11	8-2-11
2013	5-19-13	10-17-13
2015	3-16-15	11-3-15
2017	3-16-17	9-29-17
2018	12-9-17	2-28-18

Beyond the usual extraordinary measures, can the U.S. Treasury do anything to prevent/delay a breach of the debt limit, such as selling assets or prioritizing payments?

After the legal extraordinary measures have been exhausted, the Treasury, barred by law from increasing the nation's total debt, has only two options: increase its cash inflows or reduce its outflows. In theory, the U.S. could sell assets to raise cash. In a 2013 letter to Congress, then-Treasury Secretary Lew addressed the deficiencies of asset sales:

"Although the U.S. government owns other assets, such as gold, there are prudential or legal limitations on its ability to sell these assets. Selling the nation's gold to meet payment obligations would undercut confidence in the United States, both here and abroad, and would be extremely destabilizing to the world financial system. A fire sale of [other public] assets ... would be disruptive and would harm taxpayer interests. ... And, in any event, asset sales would not generate sufficient revenue to make an appreciable difference in when the debt limit must be raised. ... For these reasons, secretaries of the Treasury of both parties have concluded that asset sales are not a prudent or viable alternative to increasing the debt limit."

The Treasury also could give higher priority to certain types of payments, such as principal and interest payments on the debt, to ensure those are paid on time while other payments are delayed. To continue servicing debt by prioritizing those payments, the Treasury would roll over maturing principal by issuing new debt at auctions. As cash became available (for instance, from tax deposits), the Treasury would retain an amount necessary for upcoming interest payments and use any excess to pay other (non-debt-related) bills. The issues surrounding prioritization include:

- **Political risk.** Someone (an employee, a retiree, a Social Security recipient, a Medicare provider, a contractor, etc.) would be on the other end of delayed payments, and the combined objections would rise with each day or instance of delay. Depending on the size and duration of the missed payments, this also might soon flow through to the real economy, with people not spending money they didn't receive.
- **Technological capability.** Although Treasury officials have at times in the past publicly questioned their systems' ability to sift among the millions of payments the government makes per day on average, the transcripts from a debt-ceiling-related Federal Open Market Committee conference call on August 1, 2011, strongly suggested that the Treasury and the Fed had developed a contingency plan to prioritize payments.
- **Operational risk.** As indicated above, the Treasury and its fiscal agent, the Fed, had apparently worked through the technological issues to enable payment prioritization. If a debt-ceiling dispute persisted, requiring prioritization to avoid debt default, payment processing would be operating under nonstandard procedures, with a near-zero cash balance providing little room for error. This would be an environment with a higher risk of an operational error resulting in a missed principal or interest payment, for which there is no do-over.
- **Auction risk.** The success of a debt-prioritization policy is dependent on the ability of the Treasury to roll over maturing issues into new securities. Buyers of Treasury securities do so because they are considered the lowest-risk instrument available. In an extended debt-ceiling dispute where the U.S. is prioritizing payments and seems perilously close to missing one, it's easy to imagine risk-averse buyers stepping back, resulting in an auction failure and, in short order, a default.

Are the debt limit and a government shutdown the same thing?

The debt limit and a government shutdown are completely unrelated. A partial government shutdown relates to the budget process and occurs when Congress fails to appropriate funds for operating the government, while the debt limit only constrains the government's total indebtedness. It's entirely possible to have a budget dispute resulting in a government shutdown when the debt ceiling is suspended or far from binding, just as it's possible to have debt-ceiling issues in a fully appropriated government with no threat of a shutdown.

As a practical matter, the issues sometimes overlap, because budgetary decisions, of course, drive the government's need to borrow. If deadlines regarding the two issues happen to fall near each other, they are likely to be linked in congressional consideration. Another potential connection between the two issues is that if the government happens to be partially shut down as the debt limit becomes binding (that is, as cash and extraordinary measures are close to exhaustion), the shutdown reduces government outflows, potentially extending the time until the debt limit constrains. However, because a shutdown affects only *nonessential* government functions, which represent a small portion of outflows, a shutdown is unlikely to buy much time for the debt ceiling.

What impact, if any, does a prolonged debate on raising the limit have on the money markets?

Prior to the debt-ceiling-suspension era, the money markets reacted to the debt ceiling once per episode—when the debt outstanding approached the limit, cash approached zero, and extraordinary measures approached exhaustion. Leading up to that time, the Treasury typically reduced Treasury bill (T-bill) issuance, resulting in a relative shortage of T-bills, driving their yields lower. At the same time, as the market assessed the likelihood of nonpayment on particular Treasury securities, those instruments generally sold off. The specific securities deemed at risk were generally T-bills maturing in the several weeks after the drop-dead date, as well as Treasury notes and bonds, both those maturing in the same time period and those with interest payments due in that window. For example, if a payment late in October was considered questionable, investors might not only shun Treasury notes maturing then but also those maturing in April or October of future years, which would be due to receive interest payments that might be compromised.

The rates on other money market instruments, including government-sponsored enterprise (GSE) discount notes, were generally little changed, as they would be unaffected

by a payment delay on Treasury securities. As a result, at least in the threatened maturity window, GSE securities were considered to be of higher credit quality and often traded through similar-maturity Treasuries at lower yields.

When Congress changed its approach to raising the debt limit in 2013 by suspending it until a future date rather than merely raising it to a certain amount, it complicated and extended the impact on the money markets. This reflects the intersection of two factors, one being the requirement of debt-ceiling legislation that the Treasury have a cash balance when the suspension expires and the debt ceiling is reestablished equal to the amount it had on hand when the debt ceiling was suspended, and the other being the Treasury's desire to run larger cash balances as a matter of prudent policy. The former is a feature lawmakers devised to prevent the Treasury from issuing excess debt to build a large cash cushion before debt-ceiling reestablishment, which would extend the time the government could operate before the debt limit began to bind. The latter was a decision in May 2015 by the Treasury, aware of the risk of events that could cause disruptions to the broader financial system and the Treasury's auction capabilities, to begin holding a larger minimum level of cash, one generally sufficient to cover one week of outflows in the Treasury general account, subject to a minimum balance of roughly \$150 billion.

The money markets now react twice to a debt-ceiling episode, once as the Treasury reduces T-bill issuance to run its cash balance down as the end of the debt-ceiling suspension period approaches and then again months later as the real binding deadline, the drop-dead date, nears. The early reaction phase is due solely to the decline in T-bill supply, with none of the default concerns present, as extraordinary measures have not even begun to be used. This early T-bill drawdown was caused by the practice of suspending the debt limit and was magnified by the Treasury's large cash balance. The growing cash balance excluding these events has meant the drawdowns are starting from higher levels, increasing the market effect. The later market reaction phase, as the drop-dead date approaches, includes the angst that accompanies flirtation with default and is similar to episodes before Congress changed its approach to include a debt-ceiling suspension.

And would the same prolonged debate affect the administration's broader fiscal agenda?

The debt ceiling is entirely independent of the budget process, as discussed in the question above: *"Are the debt limit and a government shutdown the same thing?"* In addition, the question of a broader fiscal agenda is largely

a political one, with answers that would vary based on the party control of the various arms of government at that time. However, as noted above, if deadlines regarding the two issues happen to fall near each other, they are likely to be linked by lawmakers. Also, the resolution of a debt-ceiling dispute could affect the agenda in the future, as in 2011, when the law raising the debt ceiling also imposed the *sequester*, mandating automatic spending reductions in the future.

If the debt limit is not raised/suspended, and all extraordinary measures have been exhausted by the Treasury, will the U.S. government default?

If we get to the point that the Treasury has exhausted all extraordinary measures, explored any further measures, and simply run out of cash to pay the government's bills, then it is likely it would have to default. But what is meant by "default"?

The most likely answer is that it would mean a temporary delay in payments that come due—in this case, the payment of maturities and interest on Treasury securities. This is widely termed a technical default. One may ask, "How can that be if the Treasury can simply roll securities to make payments on maturing obligations?" At its simplest, the discount on T-bills and the coupon payments of Treasury notes and bonds do not count against the debt ceiling, nor do all bills, notes, and bonds mature on the same day. For example, if the Treasury has \$100 billion in maturing T-bills, it can roll that \$100 billion and remain under the debt ceiling. But it will receive only the discounted amount in cash from the auction—if that debt is issued at 1% yield to maturity, then the proceeds on the 1-year T-bills are \$99 billion. So, the Treasury will have a shortfall on reissuance of \$1 billion, which it will have to make up for using cash.

Similarly with coupons, the coupon payment must come out of cash, not maturing/rolling proceeds; this type of shortfall becomes even more acute if coupon payments for Treasury notes and bonds that mature sometime in the future also are scheduled for payment on or near a maturity date under a debt-ceiling crisis—that's just pure outflow from the Treasury with no partial recovery through a rollover.

So, getting back to the original question, even if the Treasury rolls maturing obligations, there will still be negative cash flow and eventually the money will run out. At that point, if no resolution raising the debt ceiling has passed Congress, the Treasury will have to cease making payments that are due. This would be the type of default we are likely to see, because no default provisions are contained in the Uniform Offering Circular for Treasury Securities. Because payments

must be made under the terms of the offering, the only recourse is to delay them until authorization to issue more debt is received. In this way, a default would differ from what we normally see in the financial world—there is no repudiation of debt, nor is there a way to erase debt under any sort of contract or bankruptcy law.

So, the bottom line is that we have no reason to expect the government will default on its obligations in the sense we traditionally know. The worst-case scenario is that it may have to delay a payment or two for a very short period of time, but the payment likely will be made.

Has the U.S. government ever defaulted on its debt?

The answer to that is sort of. During the debt-ceiling events of 1979, the Treasury delayed payments on a portion of three security issues following a contentious debt-ceiling debate and last-minute resolution. The issues affected were those maturing on April 26, May 3, and May 10.

According to the Congressional Research Service (CRS), the Treasury was unable to produce approximately 4,000 checks for holders of \$122 million in maturing securities in late April and early May 1979 (this occurred during a time when the Treasury still made some payments by check instead of Fedwire). While the Treasury attempted to attribute the payment delay to auctions that were postponed as a result of the delayed debt-ceiling resolution, the CRS points out that the legislation raising the debt ceiling had been passed on April 2, and at the time of the payment delay, the Treasury was actually \$32 billion below the debt ceiling; however, at the same time, the Treasury was in the process of relocating its operations and experienced an unexpected failure in its word-processing equipment. While all securities that were held in the Fed's book-entry system received their wires in a timely manner, those who had opted out received their payments beginning on May 14.

What would a default look like?

Answers to this question fall in the realm of pure speculation because we have very little concrete evidence upon which to base our opinions. Based on past experience, when push comes to shove, legislators will act as quickly as possible to raise or suspend the debt ceiling to allow the government to get back to business. For this reason, we think that in the unlikely event the government does go into technical default (that is, delaying payment on maturing securities), it would be for a very short period of time, affecting at most one or two payments. Neither side of the aisle wants to be the one that caused a government default.

From a market perspective, we can only speculate. During previous crises, securities that matured shortly after the drop-dead date experienced some stress, with investors by and large shunning their purchase and risk premia causing yields on those bills to gap out. Longer bills, however, were largely unaffected, and trading in those securities continued without discernible disruption. Under a default scenario, depending on whether the securities in question remain on the Fedwire (and we think that will be the case), we could see something similar happen. For further discussion on this topic, see the next section.

Finally, what will the investor look like after this is all over? While the Treasury is not required under either its offering circular or by statute to pay interest on delayed securities, the Treasury did make whole investors affected in 1979 following a class-action lawsuit that was filed against it, presumably to avoid further negative publicity; in addition, it also makes whole the G Fund under extraordinary measures. Given the depth and breadth of the holdings of U.S. Treasuries and the general view these are risk-free assets, we think the investor ultimately will be left unaffected after the resolution of any payment delay. In order to maintain access to capital markets—a necessity for a country running a \$20 trillion national debt—in the event of a payment delay, the Treasury may use these two precedents to make investors whole in order to mitigate any sort of risk premium or reduction in demand being associated with new issues.

What would happen to defaulted Treasury securities? Would they be transferable?

The transcripts of the Fed's 2011 debt-ceiling conference call show widespread support for Fed operations treating "defaulted Treasury securities in the same manner as nondefaulted securities ..." for purposes of "... outright purchases, rollovers, securities lending, repos, and discount window lending." This treatment would be the case so long as the default reflected a political impasse and not any underlying inability of the U.S. to pay, with the understanding that it reflected only a short delay in payment. The Fed continuing to treat defaulted securities as high-quality instruments could set the tone for the market's perception of them.

A defaulted security's transferability would seem to be dependent on its continued inclusion in the Fedwire system, on which Treasury security transactions are settled. Typically, a security automatically drops out of the Fedwire system upon maturity. In the absence of any notification otherwise, Fedwire would consider the security matured, whether payment was made or not. So long as the Treasury provided

notice of a payment delay on the day before the maturity date, the maturity date on the system could be updated to reflect the new maturity date, and the security would remain in Fedwire and remain transferable. In the absence of that notice, however, it would still represent a valid claim against the U.S., but it likely would be nontransferable.

Would all Treasury securities be affected by a default?

The Treasury's Uniform Offering Circular includes no provision for cross-default, where a default on one Treasury security would affect the status of all others. As a result, if the Treasury fails to make a timely payment on one Treasury security, it doesn't technically affect the status of other Treasury securities.

How would a default affect the repo market?

From an operational standpoint, defaulted Treasury securities, the specific issues that had suffered missed or delayed payments, would still be eligible for inclusion as collateral in repo transactions so long as they remained in Fedwire, the Treasury transaction settlement system. As a practical matter, lenders might be reluctant to accept such tainted securities as collateral unless higher haircuts, or margins, were offered. In addition, it's possible that lenders also could refuse to accept Treasury securities at risk of default as collateral, even if the Treasury had not yet missed a payment on any security. Because there is no cross-default provision for Treasury securities the vast majority of Treasury securities could continue to be used to collateralize repo transactions, at least operationally.

While the plumbing of the repo market thus likely would be unimpaired by a default and remain functional, the outlook for repo market conditions is less certain. A U.S. government default, even a temporary, technical one, could be highly destabilizing for the broader financial markets. Normal cash lenders in the repo market could well decide to remain more liquid than usual, preferring either to leave cash uninvested or to place it in the Fed's reverse repo program, which would provide the added layer of security that comes from having the Fed as the counterparty. With market participants faced with vast uncertainty, repo market rates could move substantially higher.

If the U.S. government were to default, would money market funds be required to sell defaulted securities?

Not necessarily. Under SEC Rule 2a-7, a fund is not automatically required to dispose of a security that is in default. A fund may continue to hold a defaulted security if the fund's board of trustees deems it would be in the best interest of the fund's shareholders. For example, such a decision may be made under a hypothetical scenario in which a fund's board believes any payment delay would be imminently resolved and an affected fund would receive its full maturity principal and interest. Under these circumstances, a board may find it is not in the best interests of the fund or its shareholders to sell a delayed security, especially if such a forced sale would lead to a trading loss for the fund and adversely affect the net asset value (NAV).

Would the U.S. get downgraded in the event of a default?

It's possible, depending on how long the delay is in making a payment. The U.S. has been downgraded only once in the past over a debt-ceiling crisis, and it would seem most likely to occur if a rating agency perceived that Congress lacked the political will or ability to prudently manage its fiscal responsibilities and that this lack of ability was permanent and irreparable.

Are we likely to experience debt-ceiling crises in the future?

Although former Treasury department officials who have had to manage the government's finances through debt-ceiling disputes likely would unanimously vote to abandon the debt ceiling altogether, and would be joined by many nervous investors, it's unlikely Congress would give up the lever of power it represents. It's partly the high likelihood of the debt ceiling resurfacing as an issue every one to two years that prompted the creation of this FAQ document, in the hope that it can be useful again and again.

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