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Department of Treasury
Bureau of Public Debt
Government Securities Regulation Staff
799 9th Street NW
Washington DC 20220

Re: Public Comment on Treasury Floating Rate Notes.

April 18, 2012

Dear Sir/Madam,

We are pleased to provide our comments on the proposed Treasury Floating Rate Notes. We do support the proposal as it should help diversify and lower roll-over costs for the Treasury over time. Please see pages 2-6 further for our specific comments to the questions posed by Treasury.

We would be happy to discuss any of our comments with the Treasury's staff in further detail.

Sincerely,

Priya Misra
Head of US Rates Research
Bank of America Merrill Lynch

Comments on the FRN program

1. Would FRNs attract new investors into the Treasury market for a sustained period of time?
    - We believe that the investor base will be drawn primarily from current investors in short dated Treasuries, particularly in the bill and short coupon maturity sectors. We see money market funds, short duration bond funds, central bank liquidity portfolios and security lenders as being the investors with the greatest demand.
    - In our view, there may be some demand from investors who currently buy agency floaters, of which there has been close to $100bn of issuance in the past year. The marginal cost to the agencies of a displacement by Treasury FRNs is expected to be very low, given the opportunistic nature of agency issuance.
    - We do not think the investor base for other floaters issued by banks, corporates or CMOs would be substitutable for Treasury FRNs due to the yield give-up.
    - New investors: Treasury FRNs may serve as a place-holder for corporate cash if the FDIC guarantee for non-interest bearing accounts expires in December 2012 as currently scheduled and the money goes back to government money market funds; non-interest bearing deposits grew by $572bn in 2011. Potential changes to money market fund regulations could also spur demand for direct holdings of Treasuries by corporates and other money fund investors. There could also be some Dodd Frank collateral demand, especially when the Fed begins normalizing interest rates.
2. Would a Treasury FRN help meet the investment needs of retail and institutional investors?
    - Institutional investors would be the primary buyers of FRNs; we expect relatively little direct interest from retail investors. Among institutional investors, money market funds would likely represent the biggest source of demand. Taxable money funds subject to SEC Rule 2a-7 had $2.4tn in assets under management at the end of 2011, of which more than $450bn (18.9%) was invested in Treasury bills or short-dated Treasury coupons. A portion of these holdings could be redirected toward Treasury FRNs, particularly given that the Treasury would likely reduce bill issuance in order to accommodate FRN issuance. Most money fund investors expect FRNs to be included in their 30% one-week liquidity bucket under Rule 2a-7.
    - Money fund demand for FRNs with maturities of greater than 1-2 years would likely be limited, given the constraints imposed by Rule 2a-7 on the weighted average life of money fund portfolios.
    - Other money market investors, including securities lenders, corporate treasurers, the housing GSEs, central banks, and state and local governments would also have an interest in FRNs as an alternative to existing money market instruments. These investors have sizable holdings of Treasury bills and coupons, money fund shares, repurchase agreements, commercial paper, GSE debt, and bank deposits. Depending on the pricing, a portion of these portfolios could be reallocated toward Treasury FRNs.
    - There might also be a role for FRNs as collateral for derivatives contracts, although the need for liquidity could be a limiting factor against widespread use.

3. How liquid would you expect FRNs to be in the secondary markets?

   - FRNs would likely be primarily a buy-and-hold product, with little secondary market trading.
   - There is no natural short base for FRNs, aside from dealer positioning, given the expected lack of price volatility. The lack of secondary market trading is also expected to lead to minimal on-the-run premium and a possible pricing discount relative to more liquid Treasury coupons.

4. What is the ideal structure for a Treasury FRN?

   a. What is the ideal final maturity for a Treasury FRN?

      - 1y and 2y maturity to start the program appears ideal. Given that a key reason behind issuing floaters is to attract the money fund investor base, the 1-2y sector would be most attractive. Nearly 90% of agency floater issuance and 60% of the corporate floater market is concentrated in the 1-3y sector of the curve. However, 2y helps to extend the average maturity (if it is offset by lower bill issuance).
      - We believe that SEC Rule 2a-7 restrictions on Weighted Average Life (WAL) of 120 days should be amended to exempt Treasury FRNs since these rules were put in place to limit credit risk (which Treasury FRNs would not have). Moreover, Treasury FRNs would not have duration risk if they the reference index is a 1-day rate. Such an amendment to Rule 2a-7 would allow money market funds to own more Treasury FRNs without negatively impacting their WAL ratios.

   b. What are the pros and cons of using the following reference rates for a Treasury FRN: Treasury bills, a Treasury general collateral-based repurchase agreement ("repo") rate, and the federal funds effective rate? Are there any other reference rates that merit consideration?

      - **Treasury general collateral repo rate:** Using the GCF repo rate index, which is a weighted average interest paid each day on general US Treasury Collateral in the inter-dealer repo market.

        a. Positives:

           - Actual transacted market, and represents the true funding cost for banks and dealers against Treasury collateral
           - Fed can intervene in the triparty repo market via repos and reverse repos

        b. Negatives:

           - Uncertainty of the behavior of the GC rate in different scenarios for Fed policy. For example, GC rates could decline notably if the Fed begins another round of QE or rise sharply when the Fed drains reserves through reverse repos as part of its eventual exit strategy.
           - The lack of a mature derivatives market linked to this index. The NYSE/LIFFE is creating a GCF linked futures index, but it remains to be seen how successful the product will be.
           - Even the GCF index is far from being ideal. GCF only accounts for a small portion of GC traded (we estimate 10%).

- **Fed funds/OIS:** the dollar weighted average rate on overnight trades in the brokered fed funds market with a 1 day look-back (i.e yesterday's fed funds effective)

  a. Positives:

     - Existing floater market tends to be off effective fed funds (1 day look back).
     - There is an OIS swap market as well as fed funds futures and basis markets.
     - Fed effective tends to be more stable than GC repo.
     - The Fed's main policy instrument is the fed effective rate (although the Desk normally intervenes in money markets through the triparty repo market). To illustrate the primacy of the fed effective in Fed policy, there have been large spikes in repo rates recently where the Fed did not intervene because fed effective remained within the 0-25bp target range. Aside from its tools to add or drain reserves, the Fed retains the ability to control the funds rate accurately by adjusting IOER (currently 25bp).

  b. Negatives:

     - The fed funds market is a very thinly traded market because of the high level of excess reserves currently. The primary sellers of fed funds today are Fannie Mae, Freddie Mac, and the FHLBs. Their size is expected to diminish over time, which would likely reduce fed funds activity further unless the Fed conducts operations to significantly reduce the quantity of excess reserves.
     - The index measures only bank funding costs

- **Treasury bills:** A FRN that references another Treasury rate is not ideal because it is a self-referencing rate and thus does not diversify the Treasury's funding cost risk. In addition, the lack of a regular reset date for bill yields, the vulnerability of individual bill yields to technical forces, and dependence on the bill auction schedule are also negative factors for using bill rates as the index.
- **Alternative indices:** The Treasury may also want to consider the fed funds target rate (IOER in today's policy environment) as a reference index. This would address some of the uncertainty around where fed funds and GC repo will trade relative to the target rate.

c. What would be the appropriate coupon payment frequency of a Treasury FRN?

Quarterly: Existing agency floaters with overnight indices are most often paid quarterly. The liquidity and attractiveness to investors of the 3m bill maturity also highlights the attractiveness of quarterly payments. While there could be some investors who prefer monthly payments (for money market funds), or semi-annual payments (for short-duration funds), we would not advise the Treasury to issue on multiple payment frequencies. 3 months is the best compromise. This would require a quarterly average of the reset rate.

5. What changes to trading, settlement and accounting systems would be needed to accommodate FRNs?

    - Some central banks will need to adjust their trading systems to allow for floaters.
    - The SEC should consider exempting Treasury FRNs from the Weighted Average Life calculation for Rule 2a-7.

6. Are there any other operational issues that Treasury should be aware of when deciding on whether to issue FRNs?

    - Auction procedures would need to be changed to allow bidding using yield spreads off the index instead of yield levels.
    - Trading levels are likely to be quoted in discount margin instead of yield levels.
    - Need for a zero floor on the coupon rate (to prevent a negative coupon payment).
    - Allow FRNs to be strippable. This would bring some interest in trading the strip with the fed fund/GC future.
    - Issuance schedule: We recommend a regular issuance schedule with Dutch auctions. Preferably monthly auctions, new issue at refunding and reopened twice after (allows for 4 new CUSIPs/year with reasonable size).

7. Given the above considerations, are FRNs a useful debt management tool that Treasury should consider?

   There are several positive factors from a debt management perspective to issuing FRNs.

    - **Helps fund a higher deficit than previously thought:** At unchanged current issuance levels, we project a mismatch of $180bn. This arises due to higher deficit projections with the extension of the payroll tax cut, unemployment benefits etc, and accounts for the increase in bill issuance from early this year. FRNs would help plug some of this deficit, and would reduce pressure to increase issuance at other points on the curve.
    - **Reduce roll over risk while extending average maturity:** One of the primary objectives of the Treasury over the last few years has been to extend the weighted average maturity of the outstanding stock of public debt in order to reduce rollover risk. FRNs would allow the Treasury to term out the public debt (assuming that FRNs replace issuance of shorter-maturity bills rather than issuance of coupons with similar final maturities) while possibly capturing the low funding costs of bills. For example, issuing $240bn of debt over 2 years using 2y FRN's would increase the Treasury's average monthly rollover needs by $10bn/month while issuing it through 3 month bills would increase rollover needs by $80bn/month. However, floaters will likely only be a small proportion of total Treasury debt, which reduces the benefit.
    - **Avoid paying high term premium:** A major cost the Treasury incurs in extending out average maturity by issuing fixed rate debt is the incremental term premium associated with moving out the curve. Forward rates have systematically over-predicted the future evolution of short term rates, primarily because the curve has had positive term premium. This issue has been exacerbated in recent years by the zero lower bound on the fed funds rate. By indexing interest payments to a floating short term rate, the Treasury can avoid locking in higher forward rates and thus can reduce its interest expense by an amount equal to the embedded term premium. Although term premium currently

is low, over the longer run the Treasury would likely save taxpayer money through this program given the systematic bias in forward rates.

- **Broaden investor base:** Capturing a larger domestic demand base is another reason we think the Treasury should issue FRNs. Money market mutual funds and other domestic investors would likely be a large source of demand for floating rate notes, particularly because a large part of the high quality short end floater market is currently dominated by the housing GSEs. Given that agency debt outstanding is projected to decline in coming years, we believe this is an opportune time for the Treasury to target this investor base. Further, the Treasury would also wish to capture the boost in demand for short-duration high-quality collateral under Dodd-Frank swap clearing.

We see 2 negative factors behind issuing FRNs:

- **Doesn't help as much to increase average maturity of debt:** The Treasury should be striving toward increasing the interest-rate duration of its issuance. FRNs are short-duration but longer maturities, and thus reduce rollover risk, but are still exposed to higher costs from rising interest rates. In the event of tighter monetary policy by the Federal Reserve, and possible shifts in global current account imbalances that would adversely affect Treasury demand, the Treasury should be trying to lock in long fixed rates now.
- **Costs of illiquidity:** As a general principle, the Treasury should minimize the number of issuance points and strive to have fewer, larger issues, subject to maximum auction sizes that can be tolerated by the markets. Given the success of current auction sizes, and even of larger coupon auction sizes of 2008-2009, we aren't near those auction size maximums, and thus have spare capacity within the existing coupon/bill/TIPS auction system. The problem would probably emerge only when the deficit is declining if FRNs draw issuance and liquidity away from the bill and short coupon sectors. This is an unlikely situation currently.