



Department of the Treasury
Bureau of the Public Debt, Government Securities and Regulations Staff
799 9th Street N.W.
Washington, DC 20239-0001

RE: Docket No. BPD-2012-001
Public Input on the Development and Potential Issuance of Treasury Floating
Rate Notes

Treasury Strategies is pleased to offer its comments on the proposal from the Department of the Treasury to issue floating rate notes that offer a periodically reset indexed-based rate. The rationale behind such an instrument is that the market demand for such securities will expand the potential buyers of treasury notes and lower the all-in cost of borrowing for the US government.

In providing its comments, Treasury Strategies is drawing upon its position as the leading global consultancy to corporate treasurers and the providers who sell payment and liquidity solutions to treasurers. Through our quarterly cash briefings, we regularly monitor the supply and demand of corporate and institutional cash in the US and Europe.

While Treasury Strategies sees merit in the proposal to issue floating rate notes (FRNs), we also have concerns about the potential disruption such an instrument could have upon private-sector offerings, should these instruments become successful. Offering investors new cash flow structures would presumably expand the base of investors who would otherwise lack the scale to use derivatives or other financial instruments to transform current treasury offerings to their desired liquidity, index and maturity characteristics. For example, investors who currently lack the scale to secure a floating rate, extended maturity instrument often turn to banks, which offer money market demand Accounts and, for corporate clients, earnings credit rates. Both of these products implicitly recognize the term nature of the funds while offering a rate that is reset periodically to reflect prevailing market conditions.

We believe the nature of the index could be problematic, given the central bank's role in setting interest rate levels and monetary policy. Such an index could potentially be self-referential, thus unwittingly driving significant market volatility.

From the perspective of Treasury Strategies' financial institution clients, we believe the most important element in the design of an FRN product is the reset frequency. Presumably, at reset, the price of the FRN will move back to par. A daily reset threatens to cannibalize bank demand deposits, sweep accounts, and other short-term liquidity structures. Ultimately, that would deprive banks of a stable funding source. On the other hand, a quarterly or semi-annual reset could make the FRN ineligible for certain investors such as money market funds.

From the perspective of our corporate clients, it is important that you design the instrument such that it will qualify under accounting standards for treatment as cash and cash equivalent.

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Our specific responses to the questions posed in the request for comment are below.

1. *Would FRNs attract new investors into the Treasury market for a sustained period of time?*

Floating rate notes would presumably be popular, because they would provide a variable rate of return to investors that do not want exposure to term interest rates. Based on Treasury Strategies' quarterly cash surveys, we believe that corporate and institutional investors are currently meeting their demand for such instruments through banks – primarily through short-term deposit instruments and sweeps, and secondarily via money market mutual funds. Because the US government represents sovereign risk and investors are concerned with the financial health of banks, it is likely that a material portion of bank deposit and sweep balances would flow out of banks into the FRNs. Further, the demand for FRNs would intensify once the unlimited deposit insurance guarantee on non-interest-bearing accounts expires at year-end. In a recent conjoint study conducted by Treasury Strategies, corporations over \$500 million in revenues exhibited the greatest demand utility for low credit-risk deposits – this demand utility far outweighed interest rate. For this reason, we believe FRNs would be popular, diverting money out of banks and into the US Treasury.

2. *Would a Treasury FRN help meet the investment needs of retail and institutional investors?*

Yes, as indicated by our research referenced above, FRNs would meet the needs of investors for a low-risk, floating rate instrument.

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

The liquidity of FRNs would depend upon several factors – the integrity of the rate, the safety and soundness of the US federal government, and the depth and liquidity of the secondary trading market.

It is instructive to note why the auction rate securities market failed. Despite prevailing claims to the contrary, Treasury Strategies correctly identified auction rate securities as an illiquid instrument that should not be treated as a cash-equivalent instrument. While the rate-resetting feature of auction rate securities gave investors a variable rate instrument, the underlying assets were long-term in nature, the secondary market for these securities was shallow (and dependent upon the underwriters) and the index parameters were complex and non-transparent. In point of fact, the credit condition of these instruments was generally strong, but the liquidity of these instruments was nearly non-existent.

For this reason, it is critical that prior to issuing FRNs, the government determine how the secondary market will work. Under what mechanisms can investors “put” the FRNs back to the US Treasury in exchange for cash? In a liquidity crisis, the FRN market could theoretically “seize up” as investors flee to more liquid instruments. Secondarily, the index must be reliable,



transparent, and not contain any punitive mechanisms for investors (as was the case with auction rate securities where defaulted auctions often resulted in lower interest rate yields). This issue is particularly problematic in that the index would logically be based on rates set directly or indirectly by the US government.

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

- a. *What is the ideal final maturity for a Treasury FRN?*
- 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?*
- c. *What would be the appropriate coupon payment frequency of a Treasury FRN?*

Investors would prefer notes with short-term maturities – e.g., 30 to 90 days. Such a maturity level would satisfy investor desire for liquidity. From Treasury’s perspective, it may desire a longer-term maturity, for purposes of funding stability and reduced cost of securities issuance. The government could offer multiple maturities to the market and let the market vote with “their wallets.”

The reference rate is problematic. Probably the worst U.S. reference rate that could be used would be the Fed Funds rate because it is not a market rate (consider that private sector overnight borrowings are conducted at rates **below** the Fed Funds rate). There is an understanding by investors that the Federal Reserve will set Fed Funds rates to drive policy, rather than to reflect market conditions. As a result, the use of a rate such as Fed Funds – even with a haircut – would lead to massive levels of arbitrage and massive market volatility. For example, if the Federal government were to offer corporate investors a 25 – or even 10 or 15 – basis point rate of return today for sovereign floating-rate notes with strong liquidity, the most sophisticated corporate investors would shift massive levels of cash into such notes, given their preference for low risk.

Treasury-based notes would work, but the formula for the rate would have to recognize the unique nature of these notes and their difference, in reduced liquidity or different rate structure, from the reference rate securities. For example, a two-year FRN could be set with a rate that resets each 90 days at a rate that represents the implied 90-day T-bill rate, plus a premium to reflect the reduced liquidity of the FRN.

Because any rate haircut would imply a dynamic knowledge of investor preferences and implied value, such indices would – at times – represent “bargains” to investors and at other times would fail to appropriately compensate investors. This could cause investors to move in and out of FRNs aggressively.



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

Without further details as to the settlement mechanisms and index structure, it is difficult to address this question. Many sophisticated risk management systems are capable of modeling, monitoring and settling instruments with the characteristics proposed.

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

The greatest risks to this proposal are not operational, but are financial, given the proposal's potential disruption to financial market flows.

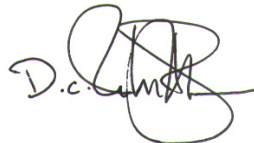
7. *Given the above considerations, are FRNs a useful debt management tool that Treasury should consider?*

Treasury should consider FRNs, because such instruments offer the potential for greater liquidity and lower borrowing costs. However, Treasury must be cognizant of the risk that these notes would "crowd out" current private sector instruments. In particular, FRNs could exacerbate a banking crisis by providing a low-risk cash-equivalent instrument to substitute in place of bank deposits. During a credit crisis, it would be reasonable to expect that funds would flow out of bank deposits into FRNs, triggering liquidity events and possibly a sequence of bank failures.

For this reason, FRNs must be seen as a policy tool, with the supply carefully monitored to avoid crowding out private sector instruments.

Please do not hesitate to contact us if you would like us to clarify or amplify our comments.

Sincerely,



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