

INVITED EDITORIAL COMMENT

Treasury Floating-Rate Government Securities

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On January 29, 2014, after more than two years of extensive study and consultation with market participants, but with little fanfare, the U.S. Treasury introduced its first new security in more than 15 years. Its successful auction of \$15 billion in floating-rate notes (FRNs) was oversubscribed by a factor of nearly five and attracted a broad array of investors.¹

U.S. Treasury debt managers consistently reiterate the mantra “regular and predictable issuance,” to minimize the cost of borrowing.² Transparency is paramount. As a result, in 2011 the Treasury began consulting extensively with market participants, including Fidelity, regarding FRNs’ merits.³ The period of deliberation was quite long. During this phase, the Treasury needed to examine the potential costs, diversification benefits, and market demand for FRNs, to determine if FRNs would help the Treasury meet its objective of achieving the lowest borrowing costs over time.

One of the U.S. Treasury’s primary goals in issuing FRNs was to expand its investor base. A floating-rate instrument may have an added appeal to Treasury investors who are interested in limiting their interest-rate exposure. Additionally, two-year FRNs may be attractive to short-term investors, such as money market funds, that are unable to participate in two-year, fixed-rate notes. In fact, the Treasury designed the 13-week Treasury index and short reset period to appeal to these investors. The addition of FRNs to the Treasury’s current stable of nominal and inflation-linked securities gives investors a wider range of options, while simultaneously diversifying the Treasury’s existing debt portfolio.

Going forward, money market fund demand may increase as FRN liquidity deepens and the investor base

expands, particularly if rates begin to rise. However, money market fund participation will be limited by the FRNs’ two-year final maturity, as money market funds must adhere to portfolio-weighted average life limits.

To make room for FRNs, the Treasury lowered bill issuance. This strategy helps the Treasury continue to meet another objective: extending the average maturity of its outstanding debt. Since 2009, when the average maturity of the Treasury’s outstanding debt dropped to 49 months, the Treasury has made significant efforts to extend the average maturity of its debt. That maturity now stands at 66.7 months, well above the historical average of 58.6 months.⁴

We expect that these securities’ relatively longer final maturities will also limit the Treasury’s concerns regarding rollover risk. In November 2008, Treasury bills represented more than 30% of the Treasury’s total public debt outstanding. Today, bills represent slightly more than 12%.⁵ In essence, the current two-year FRNs provide the Treasury with a longer final maturity, while basing financing costs on a short-term rate.

From an investor’s perspective, FRNs have several unique characteristics to consider: the security’s reference rate, the rate reset frequency, and the final maturity. Some short-term investors, specifically money market funds, may need to limit their participation due to the two-year final maturity. However, these same investors may find the reset frequency an attractive feature. The FRNs float daily off of the index rate allowing money market funds to treat them as a one-day exposure from an interest rate perspective. Given the weighted-average-maturity limits for money market funds, investment managers may view FRNs favorably.

Furthermore, in certain interest-rate environments, such as one with rising rates, a weekly reset of a 13-week index may be more attractive for investors, as the rate resets into a steepening curve. From a risk perspective, investors must be aware that spread (or basis) changes to FRNs will have a larger dollar effect than those of most money market instruments, because of the longer initial final maturity.

The Treasury deliberated at length over the question of which reference index to use for its first floating-rate security. The Treasury wanted to use an index that would appeal to a broad set of investors but still be representative of the Treasury's current financing costs. The two reference rates that the Treasury considered were the 13-week Treasury bill auction rate and a Treasury general-collateral, overnight repurchase agreement (repo) rate. Ultimately, the Treasury decided that the 13-week bill rate—although self-referencing—was the best choice.

Some public commentaries have questioned why the Treasury would opt to issue FRNs at this point in the rate cycle, with rates near their all-time lows and likely to rise in the future. FRNs, like inflation-protected securities, can add to the uncertainty of future funding costs and make the Treasury's debt-portfolio management more difficult. Although this was probably a consideration, the Treasury was more likely to view its debt management from a longer-term perspective and across various interest-rate cycles. Furthermore, because two-year FRNs are a substitute for shorter bill issuance, it is unlikely that the Treasury sees these securities as a way to take on additional interest-rate risk. The longer tenor certainly reduces rollover risk.

But there are some caveats. The Treasury may not achieve its objective of lowering funding costs, given potential pricing differences between Treasury bills and FRNs. Investors may only commit to longer-dated Treasury FRNs, if they are more attractive than buying the underlying, shorter-dated, 13-week bill. In the first two auctions, FRNs have traded modestly cheaper to Treasury bills. This price spread between FRNs and Treasury bills could essentially blunt the benefits of issuing the new security. However, if the Treasury successfully broadens its investor base by issuing FRNs, the increased demand for Treasuries may offset the potential added cost of issuing FRNs.

The first FRN auction met several of the Treasury's stated objectives. Future issuance also has the potential to garner broadly based investor demand, to diversify the portfolio, and to limit concerns regarding rollover risk. The Treasury might want to further explore issuing FRNs with alternative features that could appeal to a larger set of investors. In its comment letter, Fidelity encouraged the Treas-

ury to consider a repo index as its reference rate, because repos are the baseline investment for the overwhelming majority of money market funds and are likely to be attractive to a larger contingent of that market. The Treasury could also choose to alter other features in order to boost demand. For example, issuing FRNs with a one-year final maturity might further entice money market funds, because they would get better treatment on their weighted-average life limits. As 2104 progresses, the Treasury will be able to better calibrate its objectives to meet investors' needs.

ENDNOTES

¹U.S. Treasury, Treasury Auction Results (two-year maturity reset daily based on Treasury bill rates), January 29, 2014. https://www.treasurydirect.gov/instit/annceresult/press/preanre/2014/2014_frn.htm

²U.S. Treasury Quarterly Refunding Overview, <http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Pages/overview.aspx>

³U.S. Treasury, Minutes of the Meeting of the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association, February 1, 2011. <http://www.treasury.gov/press-center/press-releases/Pages/tg1046.aspx>

⁴U.S. Treasury, Treasury Presentation to TBAC, p. 20., February 4, 2014. <http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Documents/Treasury%20Presentation%20to%20TBAC%20FINAL.pdf>

⁵U.S. Treasury, Treasury Presentation to TBAC, p. 40., February 4, 2014. <http://www.treasury.gov/resource-center/data-chart-center/quarterly-refunding/Documents/Treasury%20Presentation%20to%20TBAC%20FINAL.pdf>

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