



January 22, 2013

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

RE: 31 CFR Part 356, [Docket No. BDP – 2013-0001]

Citigroup Global Markets Inc. (“Citi”) appreciates the opportunity to share its feedback on the Advance Notice of Proposed Rulemaking¹ published by the Treasury concerning its Floating Rate Note (“FRN”) program.

Citi believes the floating rate notes will help the U.S. Treasury in its objective to borrow at the lowest possible cost. It will also diversify its investor base and allow the Treasury to exercise separate control over the maturity and duration of outstanding debt. Our main recommendation is that a FRN program indexed to the 13-week Treasury bill auction rate is preferable to a Treasury GC repo based index. We have attached more detailed comments below.

We would be happy to discuss these comments further, or any others aspects of the FRN program, with Treasury staff.

Sincerely,

Citi Rates Trading Representative(s)

¹ 31 CFR Part 356

Index rate

We believe there would be strong demand for FRNs indexed to either a Treasury GC repo index or the 13-week Treasury bill (T-bill) rate. However, we believe that a Treasury bill index is most consistent with the Treasury's objective to obtain diversified funding at the lowest possible cost, whereas, a repo index may have several significant drawbacks. The reasons why a repo based index may potentially be an inferior choice includes:

- 1. DTCC Treasury General Collateral Finance ("GCF") Repo Index reflects only dealers.** The DTCC Treasury GCF index is an average repo rate across dealer to dealer trades in the tri-party repo market. GCF rates are typically higher than rates in the broader tri-party market where end user investors, such as money funds, are active. This makes a GCF repo index less representative of an investable short-term rate for most end users, as opposed to a T-bill rate which investors can access.
- 2. Limited index history.** The DTCC Treasury GCF index history extends back to 2005 which does not include a full Federal Funds rate cycle. It is unclear the extent of historical data that would be available for an alternative tri-party repo index. Forming expectations of future index rates is a key step for investors evaluating investing in FRNs and since such expectations are often based on historical experience, the absence of a long history is a drawback. This is in contrast to the 13-week T-bill high rate at auction, which is readily available from 1960.
- 3. Technical factors affect repo rates.** Repo rates tend to be more volatile than T-bill rates measured at a daily frequency and can move dramatically higher or lower based on technical factors unrelated to demand for Treasury debt. For instance, the DTCC Treasury repo index moved 30bp higher in one day due to hurricane Sandy. A sustained move higher in repo could potentially result in the Treasury paying an interest rate on debt higher than that which is demanded in the market for T-bills. This could be viewed as inconsistent with the objective of minimizing funding costs.
- 4. Uncertain future market structure.** FRN investors will want to know that the index rate will be available for the life of the security, computed consistently and representative of the same notion of short-term borrowing cost. We see issues with a repo index on all of these counts. While we have no reason to expect tri-party repo volumes to fall, it is possible that unforeseen regulatory or market changes could cause increasing amounts of repo activity to move to bilateral or term repo agreements, neither of which would be captured in an overnight tri-party average rate. In fact, the recent decision to base FDIC

assessments on total assets has made bank entity intermediation of repo more costly. Only in an extreme and unlikely scenario would volumes shrink to zero and a tri-party repo index become unavailable. However, over the maturity of a FRN security it is possible that the market for tri-party overnight repo could become less liquid or not representative of the same dealer community. In this eventuality the Treasury would either need to modify the formula by which the index rate is calculated, accept that the rate no longer represents the same notion of short-term borrowing cost, or potentially both. This is in stark contrast to the 13-week T-bill rate where the Treasury can directly ensure that the auction process continues and remains substantially unchanged (ensuring availability and consistency of computation).

While we believe a T-bill index is preferable to a repo based index, it is not without its own drawbacks:

1. **Treasury control of index rate.** Some investors have raised concerns over using a T-bill index since the Treasury could seek to artificially lower the interest paid on outstanding FRNs by limiting new T-bill issuance, creating a scarcity of supply and driving down the 13-week auction high rate.
2. **Possibility of negative rates.** Since T-bill rates typically lie below repo rates, the 13-week T-bill auction high rate is more likely to be negative than a tri-party repo rate. While the presence of a zero percent rate floor for the index means this does not create an operational issue for the U.S. Treasury, the higher likelihood of a binding zero rate floor raises the value of the floor which could make valuation of FRNs based on a T-bill index more complex.
3. **Mitigate benefits of extending maturity.** One benefit of the Treasury extending the maturity profile of its outstanding debt is, if market conditions deteriorate, the Treasury does not need to roll over debt at potentially elevated funding costs. However, if the maturity extension is achieved through issuing FRNs tied to T-bill rates, new T-bills will need to be auctioned to set the rate and the existing FRNs may reset at higher rates reflecting poor financial conditions.

When balancing both options, we believe that the drawbacks of a repo index, particularly the questions surrounding the availability, consistency, and representativeness of the index, are more significant than those associated with a T-bill index. Even though there would be value to offering investors exposure to repo rates through a cash security, the drawbacks are sufficient to persuade us that the 13-week T-bill auction high rate is the best choice of index for a Treasury FRN.

If a repo rate is chosen as the index, we would recommend a broad tri-party rate that reflects all market participants rather than dealers only.

Payments conventions

We largely agree with the proposed payment conventions. In our view:

- An ACT/360 interest basis is desirable to be consistent with T-bills.
- Advances in payment technology will enable investors to handle interest payments with one day of notice.
- We expect these securities to settle next business day in secondary markets. Given this settlement convention, accrued interest will be known at the time of trade given a one business day prior determination date for the index. Unknown accrued interest on forward trades would not be problematic as we expect the security mainly to trade on a spot basis and securities that typically trade in forward markets, such as agency MBS, in general trade with an unknown accrued interest.
- Most existing floating rate notes pay quarterly interest, while the likely investors we have surveyed would prefer to receive quarterly payments.
- Either mid-month or end of month issuance would be a successful convention.

Minimum Rate and Spread

We believe a zero percent floor for both the daily index rate is important to many potential investors. This is especially true for 2a-7 compliant money market mutual funds that may be less willing to invest in a security that could possibly reset at a negative rate and create difficulties in maintaining a stable \$1 net asset value. If such a floor is provided, it is imperative that the US Treasury be able to issue securities at a premium to capture the value of the floor.

We think a minimum spread of zero would also be welcome by the market. However, it is important to note that this is only feasible if FRNs can be auctioned at a premium. If a repo index is chosen, we would expect spreads to be effectively negative, as repo rates tend to exceed T-bill rates. Negative effective spread would also result under a T-bill index if T-bill auction rates were expected to trend lower. In either scenario, the negative effective spread is only consistent with a zero stated spread, if the security trades at a premium.

Finally, we would like to note that while we do not recommend FRNs that allow negative index rates, we do think that such negative rates need not result in coupon payments made from investors to the U.S. Treasury. Rather, the Treasury could reduce the principal amount on which interest is paid, similar to how the principal value of TIPS is increased with inflation.

Auction Rules

We agree with the auction format described in the ANPR. In our view:

- A single price auction where spreads are bid is the appropriate format for offering FRNs.
- The .5bp increment used in T-bill auctions reflects the short maturities of these securities. The longer the maturity, the greater the price impact of each 1bp change in spread. Since FRNs will have longer maturities than T-bills, a .1bp increment, consistent with long maturity Treasury securities is appropriate.

- No problems would be presented by the Treasury stating principal and interest one day before issue rather than the day after auction.
- Bidding discount margins on re-openings consistent with secondary markets for other FRNs, is appropriate

Maturity

Since 2a-7 compliant money market funds are a likely source of demand for FRNs, and bearing in mind that they must keep weighted average life or unadjusted maturity of their portfolios to 120 days or less, there is in all likelihood, most demand for short-dated FRNs. We agree with the proposal to begin issuance with a 2 year maturity.

Offering size and reopenings

When the Treasury first issued TIPS, illiquidity likely caused them to trade at higher yields than would otherwise have been the case. We think FRNs will behave similarly when first issued, and that illiquidity, and hence borrowing costs, will be minimized by reopening existing issues rather than creating many smaller, less liquid issues. We would recommend a larger quarterly initial offering with smaller monthly reopenings.

Stripping

Interest strips created off of existing FRNs are not commonly traded and we believe that at this time there would be little demand for stripping Treasury FRNs. Stripping is most useful for long maturity Treasury securities as certain investors have targeted cash liabilities at long dates, which they wish to match with a target maturity asset. For shorter dated cash liabilities the T-bill market already provides targeted maturities. Stripping would exacerbate illiquidity issues by breaking up an existing issue into multiple, less liquid CUSIPs. However, as the program grows and if FRN maturities are increased, investors may see value in being able to separately trade interest and principal obligations. At that point the Treasury should consider making FRN strips eligible. A stripped coupon payment would be priced by using market implied future index rates to forecast the unknown coupon payment, which would then be discounted using a term structure model.