

P I M C O

Via Electronic Submission

July 2, 2020

Mr. Brian Smith
Deputy Assistant Secretary for Federal Finance
The Department of the Treasury
1500 Pennsylvania Ave, NW
Washington, D.C. 20220

Re: Request for information on issuing a floating rate note indexed to the Secured Overnight Financing Rate; Docket No.: TREAS-DO-2020-0007

Dear Deputy Assistant Secretary Smith,

Thank you for soliciting public comment on the possible issuance by the Department of the Treasury ("Treasury") of a floating rate note ("FRN") linked to the Secured Overnight Financing Rate ("SOFR") Index published by the Federal Reserve Bank of New York ("FRBNY"). As you know, Pacific Investment Management Company ("PIMCO") is the largest active fixed income manager globally, managing \$1.78 trillion of assets as of March 31, 2020 on behalf of thousands of institutional and individual clients globally. We appreciate the opportunity to provide our thoughts on the development and potential issuance of a SOFR-linked Treasury FRN and do so in the capacity as one of the largest participants in the U.S. Treasury bond market. While we are happy to discuss potential demand and pricing, the focus of this written submission is on the security design and structure of the possible SOFR-linked Treasury FRN.

As it relates to the security structure and design of the SOFR-linked Treasury FRN, we believe the Treasury should broadly pursue an approach that promotes transparency, simplifies calculation, and reduces uncertainty surrounding cash flows. To this end, we believe several features should be considered for the potential Treasury issued FRN, including: 1) using a compounded average calculation for interest rather than a simple average; 2) avoiding a lockout feature; and 3) incorporating a 5-day lookback with a 5-day backward-shifted observation period. We expand on each of these issues below.

1) Interest on a Treasury SOFR-linked FRN should be calculated using a compounded average approach

As you know, the first SOFR FRN was issued in July 2018, and since then, U.S. agencies (e.g., Federal Home Loan Banks, Fannie Mae, and Freddie Mac) have issued about 86% of all SOFR FRNs by volume according to PIMCO estimates. Most of these issuances used a simple average of SOFR + spread. Issuers likely favored the simple average method, at least initially, because SOFR FRNs were a relatively new product and not all back-office infrastructure supported the more complex (at the time) compounded average calculation. However, despite the straightforward concept, the

simple average approach almost always requires customized (and cumbersome) calculations due to a combination of SOFR's publishing delay, the "lockout" feature, and market holidays.

Compounded average, the other method to calculate interest, became much simpler when the FRBNY began publishing the SOFR Index in March 2020, and we believe is generally a superior method. As you know, the SOFR Index is a total return index that reflects the daily compounded returns from investing at the SOFR rate overnight. To calculate the precise interest payment using the compounded average method and the SOFR Index, an investor first finds the percentage difference of the interest period start and end dates on the index, and then annualizes the rate to obtain the compounded SOFR rate. After obtaining the annualized SOFR rate for the interest accrual period, the investor adds the spread before calculating the final coupon payment with appropriate annualization (i.e., margin-exclusive compounding). We believe using the SOFR Index significantly simplifies calculation for both the issuer and the investors; indeed, there is no longer any need to track every daily SOFR rate, plus the SOFR Index takes into account holiday adjustments, compounding day weights, and rounding daily interest precise to the nearest 0.000001%. We believe that the compounded average approach, assuming the utilization of the SOFR Index and lookback and backward-shifted observation period (as described below), simplifies FRN interest calculation significantly and should be used.

2) A Treasury SOFR-indexed FRN should avoid the lockout feature

When assessing the relative advantages (and disadvantages) of a simple average versus the compounded average approach, the proverbial devil is in the details. Because the SOFR rate is published with a one business day delay, issuers cannot determine the precise amount of interest payment until the very same day of cash transfer. Traders often cannot determine the precise amount of accrued interest at the time of trade, since the SOFR rate for settlement date is not yet available. To cope with these complicating factors, many SOFR FRN issuers have adopted both 2-day lockout and 1-day lookback conventions along with simple average interest accrual. The 2-day lockout feature "locks" the rate on the third business day before the interest payment and duplicates this rate for the next two business days. Hence, issuers can prepare the precise amount of interest payment three days in advance.

A clear drawback of this approach, however, is that the lockout date may fall on month-end, when SOFR tends to spike (typically due to volatility in repo markets) and thus accrue interest for several days based on an unusually high rate. Compared with other conventions, we believe the lockout feature may cause the largest economic distortion, even if it is often negligible. Furthermore, a lockout is incompatible with the compounded average approach; because a lockout uses duplicated dates, the investor cannot use the SOFR Index to calculate interest accrual, but must instead perform customized calculations for each interest period. Based on our earlier preference for the compounded average using the SOFR Index, we believe the lockout feature should be avoided.

3) A Treasury SOFR-linked FRN should utilize the lookback feature, combining a 5-day lookback and a 5-day backward-shifted observation period

We believe that the lookback feature, when combined with a backward-shifted observation period, helps simplify interest calculation and minimizes economic distortion. The basic version of 2-day lookback is that Friday's interest accrual uses Wednesday's SOFR rate. Economic mismatch arises because FRNs accrue three days of interest on Fridays (using Wednesday's SOFR rate), but Wednesday's SOFR rate only accrues interest for one day in the SOFR Index.

In our view, the lookback feature alone is not compatible with the SOFR Index due to mismatch of day-weights. Recently, a handful of financial SOFR-linked FRN issuances featured a 2-day lookback with a 2-day backward-shifted observation period, meaning Friday's interest accrual period will still use Wednesday's SOFR rate, but only accrue interest for one day instead of three days. The backward-shifted observation period feature aligns the FRN's compounding day-weights with those used in the SOFR Index. The lookback feature must be accompanied by backward-shifted observation period to be eligible for using the SOFR Index.

Additionally, we believe a 5-day lookback and 5-day backward-shifted observation are better than the 2-day versions. A longer lookback period allows for several important things, including 1) T+3 and T+4 trades to pre-determine accrued interest at time of trade, 2) projection of precise interest amount 5 days before payment, and 3) additional time for international investors to determine cash flow and settlement. Although at face value, the 5-day mismatch between lookback period and interest accrual date seems like a long time, consecutive and continuous SOFR rates are used in the calculation; shifting the entire observation period ahead by five days in a stepwise manner causes a relatively small distortion compared with other conventions.

Concluding remarks

We support the Treasury's consideration of a new SOFR-linked FRN, and we think the most desirable set of features for such an FRN would include a compounded average approach by referencing the SOFR Index and would incorporate a 5-day lookback with a 5-day backward-shifted observation period. With this set of features, investors could independently and easily verify the precise interest amount with a handheld calculator and reasonable amount of effort. Better transparency regarding the inner workings of the Treasury SOFR-linked FRN should help reduce the illiquidity premium and could ultimately lower the cost of funding for the Treasury. We also believe the Treasury could help potentially increase liquidity in the SOFR cash and derivatives markets by issuing the first SOFR-linked Treasury FRN near the "Big Bang" scheduled for October 2020, when clearinghouses, such as the Chicago Mercantile Exchange (CME), plan to shift derivative discounting from Libor to SOFR. This Treasury issuance could set the stage and offer helpful guidance for additional new SOFR-linked FRN issuances from agencies, supranationals, and corporates.

Thank you again for your request for information on this important issue, and we look forward to engaging with you on this topic going forward.

Sincerely,



Marc Seidner
Managing Director
Chief Investment Officer of Non-Traditional Strategies
PIMCO



Rick Chan
Managing Director
Head of U.S. Interest Rate Strategies
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