July 6, 2020

VIA EMAIL TO: govsecreg@fiscal.treasury.gov

Department of the Treasury  
1500 Pennsylvania Ave., NW  
Washington, D.C. 20220

RE: Development and Potential Issuance of Treasury Floating Rate Notes Indexed to the Secured Overnight Financing Rate (Docket Number TREAS-DO-2020-0007)

Ladies and Gentlemen:

The Federal Home Loan Bank System, collectively the “FHLBank System”, consisting of the 11 Federal Home Loan Banks and the Office of Finance, has been issuing SOFR-indexed Floating Rate Notes (“FRNs”) in the U.S. fixed income capital markets since November 2018 and is pleased to have the opportunity to respond to the U.S. Treasury’s request for information (“RFI”) on SOFR-indexed FRNs. As a participant on the Alternative Reference Rates Committee (“ARRC”) convened by the Federal Reserve Board and the Federal Reserve Bank of New York and on the ARRC’s Floating Rate Notes Working Group, the FHLBank System has also provided feedback through those channels. We support the feedback provided by the ARRC, and through the Office of Finance, as fiscal agent of the Federal Home Loan Banks, have included additional observations on potential U.S. Treasury SOFR-indexed FRN issuance for your consideration below.

Before getting to some of the specific questions posed in the RFI, we provide some general observations:

- U.S. Treasury securities attract substantial amounts of global investment dollars from a wide array of institutional and retail investors. The U.S. Treasury’s decision with respect to SOFR-indexed FRNs will impact issuers, investors, and other market participants as U.S. Treasury securities are viewed as the pre-eminent, risk-free asset denominated in U.S. Dollars and typically benefit from more widespread adoption globally than any other fixed income security. Generally, what the U.S. Treasury decides with respect to SOFR-indexed FRNs and the features thereof will likely be viewed as the standard for SOFR-indexed FRN issuance that other issuers would be incented to adopt. Coalescence around the features selected by the U.S. Treasury and development of market conventions around those features are likely.

- Derivatives and futures markets will be impacted by the U.S. Treasury’s decisions with respect to SOFR-indexed FRN issuance given the hedging and trading typically associated with U.S. Treasury securities. Thus, the conventions the U.S. Treasury selects, should it decide to issue SOFR-indexed FRNs, will have impacts that extend well beyond cash investors and SOFR-indexed FRN issuers.

- One area where standardization of conventions may lag is the coupon calculation methodology. Many, but not all, issuers are currently employing simple averages of SOFR in the interest
payment calculation. Feedback from some investors in the agency SOFR-indexed FRN market indicates a preference that the U.S. agency issuers standardize their security conventions, although that has not occurred to date. If the U.S. Treasury were to employ compounded SOFR in the interest payment calculation, or some other methodology for calculating interest payments with SOFR as the reference rate, there could be, for a time, a bifurcated market for SOFR-indexed FRNs. Investors who desire and can accommodate compounded (or some other methodology) SOFR-indexed FRNs would acquire those securities issued by the U.S. Treasury. Investors who do not desire compounded (or some other methodology) SOFR-indexed FRNs or who are operationally unable to accommodate them would acquire the SOFR-indexed FRNs of issuers employing the simple average SOFR methodology. Although this is not overly problematic, as the fixed income securities market can support many different conventions for a wide array of fixed income securities, the U.S. Treasury is in a unique position to foster the development of an entire marketplace around SOFR-indexed FRNs.

- Should the U.S. Treasury decide to utilize compounded SOFR as the calculation methodology for SOFR-indexed FRNs, there are many ancillary effects for issuers, investors, vendors and other market participants beyond the potential for a bifurcated SOFR-indexed FRN market referenced above. Discrepancies in compounding methodologies across products, asset classes, and markets can result in operational and basis risks, create undue complexities, and require market participant education. Additional hedging tools may be required to mitigate the basis risks absent standardization. There are vendors who await a compounding standardization prior to embarking on necessary technological and operational changes to support compounded SOFR. Compounded SOFR, if it is ultimately the methodology preferred by the marketplace as a whole, presents unique challenges to all market participants that vary by the type of participant. A standardized method of compounding, which Treasury may facilitate should it decide to issue SOFR-indexed FRNs using a compounded SOFR calculation, would eliminate certain risks and impediments and could facilitate liquidity across a wide spectrum of the financial markets.

3. Security Structure

3.1 What are the primary considerations Treasury should evaluate when structuring a Treasury SOFR-indexed FRN? How would different potential security structures affect investment decisions by market participants, including with respect to activity in derivatives markets?

A: We believe that the U.S. Treasury should analyze the structure of SOFR-indexed FRNs issued by the government-sponsored enterprises (“GSEs”) and other financial institutions as an indication of investor preference on various SOFR-indexed FRN features such as reset, payment, and interest rate calculation methodologies, as significant market reconnaissance was employed by the various issuers and underwriters to tailor these security features to the broadest possible investor demand. A significant consideration, in our opinion, that the U.S. Treasury should contemplate when evaluating SOFR-indexed FRNs is the participation of money market mutual funds (“MMFs”) and the amount of weighted average life (“WAL”) any particular security will consume, since MMFs are believed to be the investors with the largest holdings of SOFR-indexed FRNs currently. A MMF governed by SEC rule 2a-7 under the Investment Company Act of 1940 calculates WAL on a portfolio of investments using each instrument’s final maturity date. Our experience is that, as MMFs approach their WAL portfolio limits, their ability to purchase additional longer-term SOFR-indexed FRNs becomes more
limited, which is reflected in their pricing/demand for any security. As the WAL on a MMF’s portfolio has a defined limit of 120 days, the U.S. Treasury should be cognizant of that limit, not only when choosing the features of a potential Treasury SOFR-indexed FRN to support the U.S. Treasury’s funding needs, but also with respect to other SOFR-indexed FRN issuers for whom MMFs are a significant investor base. A crowding out effect could develop whereby significant issuance by any one issuer of SOFR-indexed FRNs could hamper the ability of other issuers to access MMF liquidity vis-à-vis certain maturities of SOFR-indexed FRNs. With respect to derivatives markets, the FHLBank System believes many issuers prefer to closely align their debt securities with the conventions of the derivatives markets to facilitate hedging, hedge accounting, and risk management practices. We believe that Treasury SOFR-indexed FRNs, if issued, will become the bell-weather against which all other issuances will be benchmarked. Therefore, the U.S. Treasury should be cognizant of the hedging, hedge accounting and risk management practices of other issuers, investors, and dealers as well as the conventions in other established markets as it makes its choices for Treasury SOFR-indexed FRNs.

3.2 Some previously gathered feedback has suggested a 1-year final maturity for original issuance of a Treasury SOFR-indexed FRN. Is this maturity or another maturity preferable for a Treasury SOFR-indexed FRN? Please elaborate.

A: The FHLBank System has had success issuing SOFR-indexed FRNs across a range of maturities from 3 months to 2 years. To foster market development, a broad adoption of SOFR, and investor diversification benefits, the U.S. Treasury should seek to establish a full maturity curve for SOFR-indexed FRNs, potentially out as far as five or ten years, with initial issuance coming in one and two year maturities and then lengthening out as widespread adoption of SOFR-indexed FRNs occurs. By providing a full curve, market liquidity will be enhanced, investor diversification will be achieved, and other issuers will have a complete set of reference points, over time, against which their issuances may be benchmarked. The further out on the maturity spectrum the U.S. Treasury moves, the broader and more diverse the potential investor base becomes, and the more likely issuance from non-U.S. Treasury issuers is to be accepted at similar maturity points by investors. There are additional benefits to longer term consumer and business loans that would be created by longer-term U.S. Treasury SOFR-indexed FRN issuances as well. As such, the U.S. Treasury would achieve cost effective funding and promote the functionality and liquidity of the SOFR-indexed marketplace for the entire U.S. financial sector by providing as full a maturity curve as investor demand will support.

3.7 Should the index rate for a Treasury SOFR-indexed FRN reset daily, weekly, or at some other frequency?

A: As SOFR is a daily rate, aligning the reset convention and its publication seems sensible. To this point, the vast preponderance of SOFR-indexed FRN issuances has implemented a daily reset, to our knowledge. In this way, investing in a daily resetting SOFR-indexed FRN fairly well mimics the risks and returns of rolling overnight Treasury repurchase agreement investments, which can be beneficial to broad investor adoption. Given the significant participation of MMFs in FHLBank System SOFR-indexed FRN issuances, the daily reset feature allows MMFs to assign a weighted average maturity (“WAM”) of one day to the FRNs under SEC rule 2a-7. A MMF’s portfolio WAM is limited to 60 days under that rule, and thus a daily resetting FRN consumes the least amount of WAM for a MMF relative to a weekly or other frequency reset. Other investor types may not be as sensitive to the reset frequency as MMFs, although they benefit from the liquidity and demand provided by MMFs in SOFR-indexed FRNs as well. In addition, the daily reset aligns with derivatives market conventions.
and comports with many issuers’ desire to align debt securities and derivatives market conventions as we referenced above.

3.8 Should a Treasury SOFR-indexed FRN incorporate a lockout (i.e., last k rates for an interest period set at SOFR k days before the period ends), a lookback or “lag” (i.e., for every day in the interest period, use SOFR from k days earlier), or a payment delay (i.e., coupon and principal payments made k days after the end of the interest period) in its structure? If so, what values would be appropriate for each attribute? Please explain relevant considerations for these features.

A:

- Based upon discussions with a broad range of investors in FHLBank System SOFR-indexed FRNs, it is the FHLBank System’s belief that a payment delay is the least desirable of the features listed above. Ultimately, SOFR-indexed FRNs should closely mimic the economics of rolling overnight Treasury repurchase agreement investments.

- From the FHLBank System’s perspective, the solution that may be the simplest in the context of operational and calculation processes is the two-day observation period shift using the SOFR Index published by the Federal Reserve Bank of New York as the reference rate. Currently, the FHLBank System employs a one-day lookback on the daily published SOFR rate coupled with a two-day lockout prior to interest payments on its SOFR-indexed FRNs. This was in consideration of investors’ preference to be certain of the accrual and coupon calculation in advance of the payment date. This structure seems widely accepted within the investment community at this point. Additionally, the FHLBank System establishes a floor of zero percent on the daily reset of SOFR as well as the interest payment calculation of its SOFR-indexed FRNs.

5. Market Transition

5.1 What proportion of likely investors is currently operationally ready to purchase Treasury SOFR-indexed FRNs? For those investors that are not ready, what are the main impediments? How much lead time and investment would be required for additional investors to become operationally ready to purchase Treasury SOFR-indexed FRNs? Would any of the security structure choices mentioned in Section 3 above affect the operational readiness of likely investors?

A: The FHLBank System’s experience is that well over a hundred different investors have participated in our SOFR-indexed FRN issuances to date. Although MMFs hold the vast majority of FHLBank System SOFR-indexed FRNs outstanding, the FHLBank System’s experience has been that state and local municipalities, corporations, and some central banks have been participants as well. Municipalities, in particular, may be significant participants in a U.S. Treasury issued SOFR-indexed FRN given the risk-free nature of U.S. Treasury investments. Municipalities tend to have extremely conservative investment practices and many are restricted from participating in the repurchase agreement market due to the smaller relative scale of their investments, counterparty risk limitations, and the higher costs of setting up repo counterparty lines or tri-party custodial relationships. Treasury SOFR-indexed FRNs may offer these highly constrained investors with a cost-effective substitute to direct repo market exposure. Discussions with our investor base since 2018 indicate investors’ growing ability to operationally accommodate SOFR-indexed FRNs. One main impediment referenced by multiple investors is the lack of Treasury issuance of SOFR-indexed FRNs as a “market standard”. Many investors and vendors have cited this as a precursor to undertaking systems, accounting, and
other operational work required to operationally process and account for SOFR-indexed FRNs. Some investors have cited restrictions at their custodians in being able to handle these securities. The investors we have spoken to, across a wide segment of market sectors, all have cited lead times of several months to prepare operationally should significant changes to the types of SOFR-indexed FRNs the FHLBank System issues become necessary. This has most frequently arisen in response to our questions about using compounded SOFR for calculating interest payments. If the U.S. Treasury were to issue simple average SOFR-indexed FRNs, it is the FHLBank System’s belief that a large number of domestic institutional investors would have the operational capability to purchase SOFR-indexed FRNs given our experience. There is less certainty on our part about the readiness/ability of international investors or retail investors. In our experience, based on market surveillance exercises and not actual issuance, it is believed that compounded SOFR would be the feature requiring the most amount of lead time for the vast majority of investors to accommodate. We would also refer the U.S. Treasury to the vendor readiness assessment conducted by the ARRC. Some vendors expressed that three to six months would be required to support compounded SOFR. Vendors may be unwilling to invest in the technology and operational changes required until market conventions have been established and the data elements required are known.

5.2 To what extent would Treasury's issuance of SOFR-indexed FRNs advance the overall market transition away from U.S. dollar LIBOR? How would different market segments (e.g., FRNs, derivatives, business loans, consumer products) be affected by Treasury's decision to issue SOFR-indexed FRNs? What effect would Treasury's issuance of SOFR-indexed FRNs have on the overall market transition away from LIBOR beyond that caused by current issuance of SOFR-indexed FRNs by other issuers? Please provide specific details of the cause and effect relationships you expect.

A: We have gathered feedback from investors that frequently indicates that Treasury SOFR-indexed FRN issuance is one of the main drivers that will force more widespread adoption of SOFR in the investment community. It will also provide the impetus for vendors to modify their systems to support SOFR and address operational risks. As such, Treasury issuance of a SOFR-indexed FRN will greatly advance the market’s transition away from LIBOR. With significant issuances by the U.S. Treasury, which will be additive to the volume already supplied by the GSEs and other financial institutions, trading volumes in derivatives and futures markets referencing SOFR should grow. It is these markets that are believed to be necessary precursors to the development of forward-looking term SOFR rates, which could further the development of business loans and consumer products referencing SOFR, market segments that have yet to adopt SOFR widely. Business loans and consumer products may implement compounded SOFR before a prospective term SOFR rate is available. Should Treasury issuance of SOFR-indexed FRNs lead to certainty around SOFR conventions and term SOFR become available as a result, business loans and consumer products may transition away from LIBOR and progress to their expected final state earlier while minimizing litigation and operational risk and improving overall SOFR liquidity and adoption.
The FHLBank System appreciates your consideration of these comments and welcomes the opportunity to discuss further. If you have any questions about this matter, please contact the undersigned at (703) 467-3600.

Sincerely,

[Signature]

Randolph C. Snook
Chief Executive Officer
The Office of Finance, as fiscal agent of the Federal Home Loan Banks