April 17, 2012

Ms. Mary J. Miller,
Assistant Secretary for Financial Markets
Department of the Treasury
Bureau of the Public Debt
Government Securities Regulations Staff
799 9th Street NW.
Washington, DC 20239-0001

RE: Docket No. BPD-2012-0001
    Public Input on the Development and Potential Issuance of Treasury Floating Rate Notes

Dear Ms. Miller:

J.P. Morgan Securities LLC ("J.P. Morgan") is pleased to submit comments on the potential issuance of floating rate notes (FRNs) by Treasury.

We believe that FRNs are a useful debt management tool that Treasury should consider. In the long run, by striking a balance between the cheaper funding costs of short-term debt and the reduced rollover risk of long-term debt, and by taking advantage of the growing supply-scarcity in this segment of the fixed income market, we believe FRNs have a place in Treasury’s overall debt portfolio.

**Investor demand prospects**

We believe FRNs would potentially have two broad avenues of appeal for investors. First, Treasury FRNs could serve as an alternative for a range of cash substitutes that are increasingly in scarce supply. In addition, some investors such as state and local governments may view Treasury FRNs as a substitute for pooled government investments like government money market funds or short-duration government funds. Second, for investors unable to hedge duration, FRNs would provide an option to lower duration in rising rate environments while maintaining US sovereign credit exposure.

Regarding institutional investors specifically, we think Treasury FRNs could help meet their investment needs due to structural changes taking place in fixed income markets. First, due to Basel III rules, the share of short-term debt outstanding will likely decline as financial issuers term out their liabilities. In addition, FRN supply will also decline as the GSEs—a major issuer of FRNs in the past—continue to shrink. At the same time that supply of short-term debt is poised to decline, demand for such debt from money funds and banks is potentially poised to rise due to Basel III LCR provisions and money fund reform. Thus, we expect to see a supply-demand imbalance for high-quality short-term debt, at least in the medium term, which Treasury could seek to benefit from via FRN issuance.
Other significant money market investors not bound by rule 2a-7 may have interest in Treasury floaters as a substitute for low yielding bank deposits, money market fund shares, fixed-rate Treasuries and agencies, or other money market instruments. These investors include securities lending operations of custodial banks, the mortgage GSEs, and perhaps corporate treasurers.

Potential liquidity of FRNs in secondary markets

Initially, we think liquidity will probably be weak relative to comparable fixed-rate Treasury securities, but liquidity would likely improve over time. We would also expect FRNs to be considerably more liquid than TIPS due to the ability to hedge with interest rate swaps, which would allow FRNs/nominals to be synthetically swapped into each other. In contrast, swapping TIPS into nominals requires inflation swaps, which are far more illiquid than interest-rate swaps because of the lack of natural two-way flow in inflation risk, meaning that TIPS are ultimately the sole source of supply of this risk.

Liquidity would likely improve over time as the investor base expands. Initial buyers of FRNs are likely to be money funds and securities lenders; this base will likely grow with time as other investor classes obtain approvals and/or operational capabilities to invest in FRNs. However, since many investors have the ability to hedge fixed-rate US Treasuries, FRNs could provide relative value opportunities and incentive to invest in the product. In addition, the participation of index-driven investors could increase if FRNs are included in benchmark indices, and as they grow as a fraction of such indices.

We expect that Treasury FRNs will price only modestly cheaper than similar maturity nominal Treasuries on an asset-swap basis. The experience with Agency FRNs also supports this view. Under current market conditions, this suggests that a hypothetical par-priced 2-year Treasury FRN will need to pay a coupon of 3-month T-bills + 10-15 bp, or Fed funds effective + 10-15 bp.

Issuance of Treasury FRNs may also ultimately improve liquidity in the broader FRN market, as regular benchmark size Treasury FRN auctions might eventually serve as a benchmark for the broader FRN market, promoting liquidity in these markets.

Ideal structure for a Treasury FRN

Initially, we believe 1- to 2-year FRNs would be best since these maturities would most appeal to money market funds and securities lenders. As the product grows, we believe Treasury could issue up to 3- to 5-year maturities.

As for the choice of reference rate: between a choice of T-bills, GC repo, and Fed funds effective, we believe the Fed funds effective rate is the best choice for several reasons. First, we think using T-bills as the reference rate would not diversify Treasury’s funding risk. In a hypothetical market stress scenario where T-bill yields spike, extending maturities via FRNs would produce no benefits with respect to reducing rollover risk, since coupon payments would be based on the yield levels at which Treasury can issue bills in the open market. Thus, referencing bill yields will produce no rollover risk reduction, but will entail higher funding costs relative to a strategy
of simply rolling over short maturity Bills. Since the main case for FRN issuance is to reduce rollover risk, while saving on interest rate term premium, we think the case against referencing bills is strong.

On the other hand, GC repo and the effective Fed funds rate should provide greater rollover risk diversification. Between these two reference rates, however, we recommend the effective Fed funds rate because it has a highly developed derivatives market (the Overnight Index swap market) out to longer-term maturities, while GC repo currently does not. A developed derivatives market is important because it makes effective hedging of FRNs possible and should enhance liquidity in the product. In addition, the effective funds rate should be least affected by a hypothetical spike in Treasury’s funding costs, since it is an explicit target of monetary policy.

For the coupon payment frequency, we would recommend a monthly or quarterly coupon (with daily resets), since these are benchmark frequencies in the FRN market. As for whether to use daily compounding or the arithmetic average of the reference rate to calculate the coupon, we think either method is acceptable, since any bias in the coupon from compounding/not-compounding will be compensated for in the pricing spread. However, we do note that Agency FRNs typically use the arithmetic average of the reference rate to calculate coupons.

Potential operational issues

Anecdotal evidence suggests that while money market funds will likely have no significant operational hurdles, several major investor classes in the nominal Treasury market such as foreign central banks may not currently have the operational capability to invest in FRNs. These will need to be created over time, and is another reason why liquidity will likely be worse initially.

In addition, we recommend that Treasury floor coupon cash flows at zero. Reference rate observations do not necessarily need to be floored, but flooring each coupon cash payment at zero is likely to be an important characteristic for most investors.

J.P. Morgan appreciates the opportunity to comment on the potential for Treasury floating rate notes. If you have any questions about these comments, please contact the undersigned at christopher.p.wilcox@jpmorgan.com or (44-20) 7777-9695.

Sincerely,

Chris Willcox
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Head of Global Rates