April 18, 2012

Department of the Treasury
Bureau of the Public Debt
Government Securities Regulations Staff
799 9th Street NW
Washington, DC 20220

Re: March 19 Public Input on the Development and Potential Issuance of Treasury Floating Rate Notes

Ladies and Gentlemen:

RBS Securities Inc. ("RBSSI")\(^1\), welcomes the opportunity to comment on the proposal by the Department of the Treasury to issue Floating Rate Notes. We support the proposal to issue Floating Rate Notes and believe the program would provide diversification, extension of the average maturity of the debt, and would be met with robust demand.

**Request:** The Department of the Treasury is requesting comments on the potential issuance of a floating rate note. Treasury is particularly interested in comments concerning the demand for the product, how the security should be structured, its liquidity, and any operational issues that should be considered relating to the issuance of this type of debt. Treasury has not made a decision to issue floating rate notes. Treasury will continue to weigh the relative merits of issuing floating rate notes, and comments received as part of this Request for Information will serve as valuable input into this decision.

**Response:** RBSSI believes that there would be robust demand for a Treasury Floating Rate Note (FRN), and recommend that the Treasury issue FRNs in order to diversify its issuance, reduce rollover risk, and continue to extend the average maturity of its debt. We suggest that the Treasury begin with a 2-year maturity FRN, resetting monthly with a coupon paid monthly, and the reference rate being the 3-month bill or possibly the 4-week bill auction rate. Weekly resets may create operational burdens. Monthly coupons will suit money market and investors well. The FRNs should have a coupon payment floor of zero.

**Underlying demand:** The main benefit of these securities for investors is the convenience factor of being able to earn the US Treasury Bill rate over a significant period of time without incurring the inconvenience and transaction costs associated with rolling their short term investment every 3 or 6 months. The main benefit to the US Treasury is reduced rollover risk, but also some extension of debt maturity as FRN issuance will enable lower bill issuance. FRN issuance will also enable the Treasury to expand short end issuance if needed without a large corresponding increase in rollover risks. As bills as a % of issuance is at a low level historically, the risk of demand cannibalization from bills is limited.

- Demand from individuals is likely to increase in a rising rate environment, where the floating rate feature becomes more attractive (in comparison to regular issuance which may be less attractive if rates are rising very quickly). Household ownership of US Treasuries is low in comparison to other sovereign bond issuers (notably Japan and Italy), and FRNs provide a convenience that will be
appealing to retail investors. Due to the lack of widespread demand for savings bonds, these notes will give Treasury an opportunity to tap into retail demand more fully.

- Liquidity managers and short term Treasury-only money market funds are likely to be the main initial institutional investors, especially the latter, as these securities roll down the curve. Bank and non-bank custody, as well as escrow accounts would be natural holders as well.

- Appetite for Investment Grade (IG) corporate FRNs has been strong, which shows institutional demand may come from other sectors. In 2011 for example, IG FRN issuance was $145.35bn.

- The Government Sponsored Enterprises are likely to invest in FRNs if they yield more than the effective funds rate.

- State and Local governments, as well as some corporate cash managers, are likely to invest.

- Demand will also be strong due to regulatory developments (below).

**Regulatory developments:** Changes in the regulatory environment may increase demand for such securities. Estimates of the overall increase in demand for government debt to meet the new liquidity requirements in order to comply with Basel III range from $400 to $800bn. Money market funds are being encouraged by regulators to reduce the maturity of their holdings while banks are being encouraged to lengthen the maturity of their liabilities, creating a potential supply/demand gap for short-term instruments that Treasury floaters could fill. Most of the increased demand is likely to be for short maturity, highly liquid securities, whose risk weighting is zero. Another consideration is if Dodd-Frank unlimited insurance expires as planned on Jan 1 or if the FDIC imposes a surcharge on deposits over $250,000 for protection, some portion of ~$1.4tn in these overnight bank deposits may flow to FRNs.

On the other hand, some demand may be reduced if the FRN does not yield close to or above the Interest on Excess Reserves rate (commercial banks). Lastly, banks hold their Liquidity portfolios AFS or Available For Sale. Higher rates and lower Treasury prices will all things equal hit bank capital. FRNs are a good fit for these portfolios because they would diminish the accounting hits since prices would float or stay close to 0. FRNs could reduce balance sheet volatility for banks versus traditional Treasuries, under the new laws.

**Structure:** We envision a floating rate instrument, whose reset and reference rate are the same, e.g. a 3-month or 4-week reset with the 3-month or 4-week bill rate as its reference rate, preferring the 3-month due to lower volatility in 3-month bill rates. Some investors have expressed a preference for a reference rate based on the London Interbank Offered Rate (LIBOR) or an Overnight Indexed Swap (OIS) rate, but we do not recommend Treasury adopt a non-Treasury related reference rate. Treasury will not want to be subject to bank funding perceptions that influence LIBOR. Also, it is unknown how the OIS market or Fed Funds market will react when the Fed begins to exit the current extraordinary monetary policy regime. It should be noted however that institutional investor demand would be higher for an OIS based rate (partly due to the higher rate – 3-month OIS has averaged 6.3bps over 3-month bills since Jan 2009. Note however in the financial crisis, the spread between OIS and 3-month bills widened to more than 150bps, volatility the Treasury should avoid). We believe Treasury should use bill rates as their reference rate, although investors may require a higher spread to account for the lower nominal yields versus other reference rates.

Another option is to have the reference rate be tied to the GCF Repo Index. One issue with developing retail interest in the TIPS program was the complexity. Tying FRNs to GCF rates (or OIS) adds an unnecessary layer of complexity that would soften retail demand. In addition, using GCF as a reference rate subjects Treasury to seasonal swings and other pressures that may push General Collateral rates higher for technical reasons, as seen recently. Another issue is that GCF
rates do not have the required three year track record that ratings agencies require in order to rate money fund FRN holdings. Thus using GCF index rates as a reference would eliminate this segment as a potential buyer as they would not qualify as investments to hold for ratings purposes.

Lastly, we believe using bills as a reference rate provides the greatest possible breadth of potential investors for Treasury. The introduction of a new Treasury debt instrument is a significant and infrequent event. In our opinion the most important factor is a widespread investor base and a simple, well-known reference rate enables the product to be better understood and provides a reference rate that is liquid and transparent. Tying the rate to unknown or unproven indices would be counter-productive to the Treasury’s goals, especially considering the retail investor. Thus while there are advantages and disadvantages to all the proposed reference rates, including bills, using a bill as the reference rate is the most appealing.

Size: We believe Treasury can begin with issuance of $10bn/month, to increase over time as the market develops.

Maturity: Feedback from investors indicates an initial maximum maturity of 3 years. To begin, a 2 year maturity would be preferred, and if successful longer maturities can be introduced in the future.

Liquidity: Liquidity is essential for a new debt instrument and we expect liquidity will be good for this new program, aided by frequent resets as securities will be valued near par and dealers will be able to provide liquidity. This provides inherent depth that is in contrast to liquidity at the start of the TIPS program. As issuance proceeds and the program builds, liquidity will only increase. In addition, we believe basis markets for bills-OIS and bills-LIBOR will become significantly more active as hedging vehicles.

Minimum curve risk: Holders would not be exposed to the significant curve risks and pricing complexity associated with CMT-style floating rate instruments where there is a large mismatch between reference rate maturity and reset frequency. These were tried in Japan and France with mixed results. Frequent resets and coupon payments will also limit volatility.

Auction: Securities would be auctioned immediately following the bill auction where the new reference rate was set. Bidders would bid competitively to set a margin that would be added or subtracted from the reference rate set. The rate could be based off a single auction or an average of several bill auction results. We anticipate the margin would be ~10bps if priced off 3-month bills, given the match between the maturity of the reference rate and the time between resets. Auctions near the end of the month may increase attractiveness of the issue as the security will be near or at par – favorable for bank or cash managers.

Italian FRN auctions set the reference rate off the previous bill auction rate, then the Dipartimento del Tesoro sets the margin. We believe Treasury should allow this margin to be market determined to avoid a miscalculation or poor estimation that would harm the process and negatively impact long term demand, as well as increased transparency.

Sincerely,

William O’Donnell
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Head of U.S. Treasury Strategy

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