

January 22, 2013

Bureau of the Public Debt  
Government Securities Regulations Staff  
799 9<sup>th</sup> Street NW.  
Washington, DC 20239-0001

Re: Comment regarding the Sale and Issue of Marketable Book-Entry Treasury Bills, Notes, and Bonds 31 CFR Part 356, Docket no. BPD-2012-0002

To whom it may concern:

Goldman Sachs appreciates the opportunity to comment on the US Treasury's Advance Notice of Proposed Rulemaking on the *Sale and Issue of Marketable Book-Entry Treasury Bills, Notes and Bonds* ("the Proposal").<sup>3</sup> The Proposal seeks public comment on the potential issuance by the US Treasury of floating rate notes ("FRNs") and the design, terms, conditions and other features of such notes to enable the US Treasury to lower its borrowing costs, diversify its funding base and manage the maturity profile of its outstanding debt by issuing Treasury FRNs.

Determining the relevant index rate for Treasury FRNs is a key first step in the process. The Proposal considers two possible index rates: the US Treasury bill rate ("T-Bill") and the US Treasury general collateral overnight repurchase agreement rate ("GCF"). We include the Federal Funds rate ("Fed Funds") in our discussion, as we see it as a highly useful and workable alternative.

We concur with the view espoused by market participants that the FRN index rate should reference a liquid, traded rate with transparent pricing, and we recommend an index that will appeal to a broad range of investors, including 'real money' and relative value investors. In the post-crisis environment, three criteria are needed for an index to garner investor confidence: 1) the rate-setting mechanism of the index must be transparent, 2) the rate-setting process for the index must be robust, meaning that it cannot be distorted by a small number of market participants, and 3) the index itself must have a sufficient operating history and be considered sustainable. As we will discuss, the GCF index appears to be the better of the two alternatives favored in the Proposal, as the GCF most closely meets these three requirements, while also achieving the US Treasury's aims.

<sup>3</sup> See <http://www.treasurydirect.gov/Instit/statreg/auctreg/ANPR2012.pdf>.

On the first criteria, the transparency of the rate-setting mechanism, each of the three potential index rates would comply. For the Fed Funds rate and the GCF, the rate is a weighted average of actual trades that take place during the day. For the T-Bill, the relevant rate is the stop rate derived from the 13-week auction.

On the second criteria, the ability of a few participants to distort the rate, the analysis is mixed. While the GCF market is large and deep, at some \$650bn<sup>2</sup>, it includes a number of concentrated players who lend or withhold supply based on market levels. While we do not believe that any single counterparty could affect the rate by more than a few basis points, the market is nonetheless potentially sensitive to local, technical effects of supply and demand changes. The Fed Funds rate market is characterized by a limited number of transactions and participants. Given that this is a market for unsecured borrowers, it may become more credit-sensitive over time if the number of participants becomes increasingly limited as leaving excess reserves on hand at the Fed is currently a yieldier alternative. The T-Bills market, although liquid, is highly sensitive to supply. Any single auction price will be affected by the size of the auction, which is of course entirely determined by the US Treasury. Historical changes in T-Bill issuance have had significant effects on market investment dynamics, as well as on the derivatives markets that reference T-Bill rates. T-Bill rates may also be more sensitive to market perceptions of US government credit than the other two options, which could impact FRN valuations.

On the third criteria – that the index has a sufficient operating history and be considered sustainable – the results are also varied. While Fed Funds and T-Bills have substantial operating histories and projected longevity, the GCF index is relatively new, having been in operation for only two years.

In evaluating the cost to the US Treasury of using the Fed Funds, T-Bill or GCF indices, and in considering the breadth of potential investors in each, we reviewed several factors: investors' familiarity with each index, the breadth of investor demand for each index and the liquidity of the basis swaps markets (which will guide the market in pricing).

Because both the Fed Funds index and the T-Bill index have been used as reference rates for GSE floaters, investors should be comfortable with either choice. T-Bills were the benchmark rate for student loans in the 1980s and 1990s (until the Student Loan Marketing Association ("Salle Mae"), which was then a Government-Sponsored Enterprise, migrated away from T-Bills as its reference rate given the lack of market depth in Bills/Libor basis swaps). While GCF is less liquid than T-Bills, and has yet to be used as a reference rate in an FRN, we think the tight historical relationship between repo rates and Fed Funds rates should help the derivatives markets to develop quickly for the GCF Index.

Historically, Fed Funds, as an unsecured deposit, have traded a few basis points higher than the GCF. We expect one of the primary early buyers of Treasury FRNs will be money market funds, which actively purchase floaters today. Money market funds have greater capacity to purchase FRNs with a shorter Weighted Average Life ("WAL") due to legal restrictions which limit the overall WAL of the funds. Since these funds use the reset frequency of the index to determine the WAL, they should prefer GCF floaters

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<sup>2</sup> <http://www.dtcc.com/products/fi/ecfiindex/index.php>

because the rate will update daily; with T-Bill floaters, the rate cannot update more frequently than the auction of the 13-week T-Bill (which currently occurs every seven days).

Just as the US Treasury's fixed rate issuance is the basis for asset swap derivatives transactions, so too should there be demand for asset swaps of the US Treasury's new FRN program. In the case of Fed Funds, the derivatives market is already reasonably deep, and it is growing because of increasing attention to the cash collateralization of derivatives. Given that cleared swaps are discounted at the Fed Funds rate, using this index for Treasury FRNs should provide the greatest overall benefit to liquidity in the cash and derivatives markets. Additionally, money market investors are familiar with Fed Funds floaters, which have been a staple of GSE funding for many years. We would expect substantial and immediate demand for Fed Funds floaters from money market funds, as well as from bank liquidity portfolios.

In contrast, the swap derivatives market tied to T-Bills are illiquid, while the swap derivatives markets tied to the GCF are nascent. The US Treasury's reliance on a floating index is likely to encourage further development of a derivatives market for that particular index, whatever the choice, but the depth of related derivatives market activity remains to be seen, especially given the current depth of the LIBOR and Fed Funds derivatives markets. Using interdealer broker screens, Fed Funds/LIBOR swaps are 4bps wide. By comparison, T-Bill/LIBOR swaps are 50bps wide, and GCF/LIBOR swaps are not even quoted. In fact, though GCF futures are listed monthly out to two years, only the first 12 contracts have traded. Additionally, we do not believe that GCF/LIBOR swaps have traded with a maturity longer than one year. That said, when selecting between the GCF and T-Bills, we would still lean toward the GCF, as we anticipate that it will provide both the lowest cost to the US Treasury and the most market transparency, without linking US Treasury FRN rates to the dynamics of a specific T-Bill issue.

Despite the deficiency in observable swap markets, we can make a rough but reasonable estimate of where an *un-floored* US Treasury floater might trade relative to the various floating benchmarks. We first take the level of Fixed Coupon Treasuries as our baseline, and then adjust each by a theoretical mid-market swap level to estimate what the coupon might look like.

Maturity (years)	3ml (bps)	FF (bps)	Bills (bps)	GCF (bps)
2	-13.5	6.75	10.5	3.5
3	-12.75	8.5	11.5	5.25
5	-11.75	11.5	14.05	10.25
10	-3	21.38	25.75	22

Theoretically, all of the above coupons are equivalent. If the US Treasury were to swap each of these floating rate issuances into fixed rates all of the issuances would have the same yield. However, the US Treasury assumes the interest rate risk inherent in any of its issuances, be they fixed or floating rate. Thus the US Treasury must determine which of these floating rate issuances will command the largest premium, and which rate is most likely to stay low or trend lower over time.

Given that many short end rates are trading close to the zero bound today, the 0% floor that must be embedded in the Treasury FRNs for operational reasons may have meaningful impact on pricing. We expect that the Treasury FRN floor will be set based on the coupon rather than on any individual reset. Thus for the floor to be in the money, the rate would need to reset below the average spread for the duration of the reset period. By setting the minimum spread at zero, the US Treasury is ensuring that the floor for the FRN is never struck above zero on the index rate, further minimizing the value. Despite the US Treasury's efforts to limit the value of this floor, investors will retain its benefits and likely pay a premium (though not the full theoretical value of it) for the notes.

We think the floor on GCF will have the greatest value. Currently, the US Treasury does not allow negative stop yields on T-Bill auctions. While we expect systems changes to enable this functionality in the near future, we do not expect that T-bills would frequently stop at negative yields. Given our indicative spreads above, T-Bills would need to sustain a -10.5 yield for the floor to be in the money, while the GCF would only need to sustain -3.5 (in the case of a hypothetical two-year FRN). While we do expect that T-Bills would trade at negative yield before the GCF index would (investors would generally prefer T-Bills as an asset over repos), given the above spreads, the theoretical value of the GCF floor is greater since it is more likely to be struck closer to the money. Thus, we expect that over time, the GCF floater would help the US Treasury to attain the lowest cost of financing.

We also would like to convey our views on the optimal reset frequency, auction technique, issuance schedule, maturity and other features of the proposed Treasury FRNs:

First, a **daily reset frequency** is appropriate for any of the index options, although we do expect that the WAL on T-Bill floaters would be seven days, while the WAL for GCF floaters would be one day. The one-day lookback on rate reset as proposed by the Treasury is appropriate. In the case of forward settling trades, the market standard is to make an assumption on the rate resets and adjust the proceeds once the rates are known. Given that this is a manual process, we would recommend that if FRNs are traded for forward settlement, they trade on a dirty price (or proceeds) basis, which would require no such adjustment. We would expect quarterly interest payments regardless of the index choice. While technological advancements allow for a one-day lock-out period on the rate, we would recommend 2-3 days to provide for maximum operational clarity.

Second, we believe the **auction technique** described in the Proposal will result in the lowest cost to the US Treasury. In particular, this technique will give the US Treasury the ability to submit negative spread bids while setting the coupon with a spread of zero, which will result in an issue price above par. This will allow the US Treasury to maximize the richness of bids, while maintaining minimal value to the embedded floor. Additionally, we are comfortable endorsing bidding in increments of tenths of a basis point.

Third, we would recommend issuing floating rate securities on a **regular quarterly cycle**, with up to two **re-openings** in subsequent months following the original quarterly auction. We also recommend **mid-month settlements** for the FRNs. Although mid-month settlement means that the FRNs would not initially share the same maturity date as their fixed rate counterparts, we think the benefit to the repo

market warrants this choice. Month-end refundings tend to feature much larger gross and net settlements than mid-month, even in the case of quarterly refunding. For example, November 2012 featured \$72bn gross/\$9bn net new collateral on the 15<sup>th</sup>, and \$112bn gross/\$47bn net new collateral on the 30<sup>th</sup>. From the perspective of the functioning of the repo market, large collateral settlements should be spread over time, particularly when they correspond to quarter- or year-ends, when dealers face especially stringent balance sheet constraints. Adding a new product that settles on top of large net issuance on quarter-ends may reduce dealer and customer interest on those dates and affect liquidity. We believe that mid-month settlements, which correspond with tax payments, will also be attractive to corporate accounts, which may account for a significant amount of the demand for Treasury FRNs.

Fourth, we concur with the assertion in the Proposal that the deepest initial demand for US Treasury FRNs is likely to come from money market investors, who are limited to a two-year final maturity. However, as market participants gain comfort with the new US Treasury FRN, and as the interest rate environment changes, we expect demand for 3-, 5- and 10-year floaters to emerge. At a mature phase of the FRN program, we would expect to see one issue per month that would span the range of maturities over the course of a year. In order to maintain sufficient liquidity, we recommend issue sizes of no less than \$20bn in 2-year maturities. We think there will be greater demand for new issues than for reopening outstanding issues, particularly in the front end of the curve. As such, we recommend reasonably large issuance sizes (\$15-\$20bn), with smaller reopenings (\$8-\$12bn). As the program progresses, we would expect to see initial 10-year floaters with sizes of \$10bn, which could reach \$25bn after subsequent reopenings. The auction method for reopening described in the Proposal is appropriate, in our view.

Fifth, we do not see a need for the US Treasury to issue the floating rate securities in any form other than **book-entry form**.

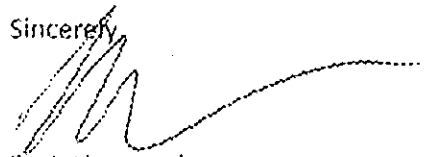
Sixth, making FRNs eligible as collateral for depository institutions that hold Treasury funds should add to the liquidity and transparency of the market. We would also expect these securities to be eligible for General Collateral repo, with haircuts identical to those of their fixed rate counterparts.

Seventh, we do not see a need to make floating rate securities Strips Eligible, nor do we anticipate any unusual tax consequences for these securities.

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We appreciate the opportunity to convey our views and would be happy to discuss any questions you may have. Please feel free to contact me at 212-902-1000.

Sincerely,



Beth Hammack  
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