TREASURY FLOATING RATE NOTES (FRNS)[1]

JANUARY 2014

On November 6th, the U.S. Treasury announced that the first floater issuance in history will take place on January 29, 2014. The FRN is the first new product that the Treasury has brought to market in 17 years (1997 marked the Treasury's unveiling of the TIPs). This paper describes the nature of what a FRN is and the implications for investors.

WHAT ARE TREASURY FRNs

A Treasury floating rate note (FRN) is a security whose interest payments fluctuate with the market (i.e. if rates rise the security's interest payment rise with them, and if rates fall the security's interest payment will also fall). The new FRNs will have a maturity of two years and pay quarterly interest. The FRNs will be indexed to the most recent 13-week Treasury bill auction High Rate, the most widely accepted discount rate in a Treasury bill auction. The Treasury will use the same auction process as for other marketable securities so the bidding process, the minimum and maximum purchase and award amounts, and the award methodology are all the same. The Treasury believes the introduction of FRNs will provide a number of benefits, including assisting Treasury in managing the maturity profile of the nation's marketable debt outstanding, expanding Treasury's investor base, and helping to finance the government at the lowest cost over time.

WHAT FRNS MEAN TO INVESTORS

In general terms, investors can expect a similar expected return / risk profile for Treasury FRNs as for Treasuries since T-bills reflect the reference rate; however, Treasury FRNs are expected to trade with a yield pickup due to liquidity, weighted average life extension, and a slightly different buyer base. Another differentiator between a Treasury FRN and a T-bill is that FRNs have a yield floor of zero and T-bills can (and have) had negative yields. One advantage of a Treasury FRN is that investors can get T-bill returns without rolling every 3 months, however, this benefit might be offset with less liquidity. In addition, Treasury FRNs can be a helpful tool to manage interest rate risk more efficiently. For example, if rates rise in the short-term, the duration of the FRNs will be significantly shorter than a comparable fixed-rate note and thus can shorten the overall duration of a portfolio. As most Treasury debt issues offer a fixed rate payment, this new floating rate option gives inflation-wary investors a way to avoid the constant T-bill rollover.

The longer weighted average life of the FRNs will put a limit on their use in money market funds due to the new 2a-7[2] rules. However, the weekly reset (most other floaters have one-month resets) and liquidity profile make them very attractive to taxable money market funds.

Outside of money market funds, it is difficult to know who the natural buyers of these securities will be.

[1] Source: Treasury Direct: Floating Rate Notes (FRNs). 16 December 2013. http://www.treasurydirect.gov/indiv/products/prod_frns_glance.htm
[2] The 2a-7 rules regulates money market funds to restrict their underlying holdings to investments that have more conservative maturities and credit ratings than those previously permitted to be held.

GENERAL MARKET IMPLICATIONS

In terms of cost for varying maturity options, issuing short-term debt is the cheapest possible option for financing the government over time. The maturity of Treasury FRN's is two years, which is longer than the maturity of T-Bills. The U.S. Treasury suggested it prefers to substitute Treasury FRNs for T-Bills in order to avoid the 'rollover' problem. Rollover occurs when the Treasury has to issue new fixed-rate T-Bills to pay for the old ones. The new Treasury FRNs will need to be rolled less frequently. Technically, FRNs will increase the weighted average maturity of the current marketable debt outstanding if they are a substitute for the issuance of T-Bills. In this case, the duration would still be tied to the underlying T-bill reference, so it would not have a material impact on the Treasury's interest rate risk.

CONCLUSION

Mercer views the launch of the Treasury FRNs as a valuable addition to repos, bills, and agency floaters and will complete the Treasury investment options.

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