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US Rates Strategy

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Should the Treasury (re)consider issuing a SOFR-FRN?

The Treasury's quarterly financing survey asked primary dealers about the merits of issuing a floating rate note (FRN) tied to SOFR. While there is strong demand for the Treasury's existing FRN, we are skeptical it makes sense to issue a SOFR-based security.

- Money funds are repo heavy and a short-maturity SOFR-FRN might be an attractive alternative investment for them if its yield is higher.

- But money funds account for most (70%) of the demand for the Treasury's existing bill floater. **A WAL-friendlier, shorter maturity SOFR-FRN might cannibalize some of this interest**.

- **The Treasury may have concerns about benchmarking its issuance to a rate it cannot influence as directly as the 3m bill rate**.

- **We wonder if it is efficient for the Treasury to use two different benchmark rates and payment structures for its floating rate debt**. Corporate and agency issuers have largely standardized payment structures since the Treasury last considered a SOFR-FRN.

- **Our sense is that the Treasury's renewed interest in the SOFR-FRN is mostly exploratory**. While the Treasury may wish to issue more short-maturity debt it is not clear that it will find significant incremental demand for a SOFR-FRN.

Reconsidering the SOFR-FRN

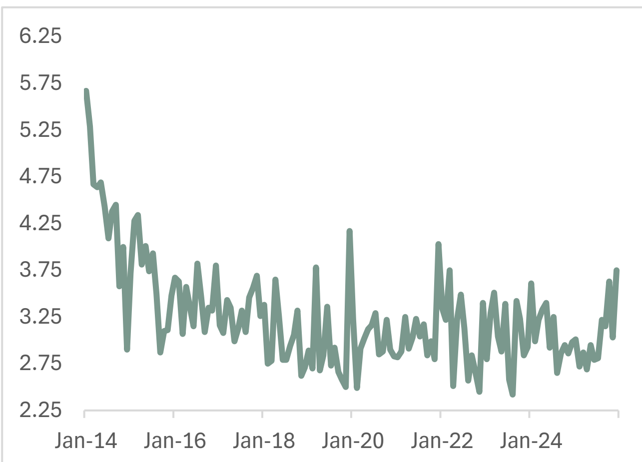
The Treasury proposed issuing a SOFR linked FRN in 2020. The market quickly argued for a short, 1y maturity floater that could help the transition from Libor. Corporate issuers would be able to model their own issuance after the Treasury's. However, the Treasury ultimately declined to become an "experimental" issuer. Instead, it argued that its choice of debt maturities and payment structures is meant to minimize taxpayer cost. Moreover, the Treasury has a successful, short-maturity FRN, and it was concerned that a SOFR-based instrument might cannibalize that demand.

The Treasury has been issuing a 2y bill floater since 2014. A new 2y FRN is issued quarterly with monthly re-openings. The auction determines the spread applied to the index rate. The index rate is the highest accepted discount rate from the most recent 3m bill auction. **As the 3m bill is auctioned weekly, the index rate changes once a week even though the security has a daily reset**. The choice of a bill index also means that the Treasury's security does not have lockout or lookback periods. Interest is paid quarterly.

Treasury FRN demand

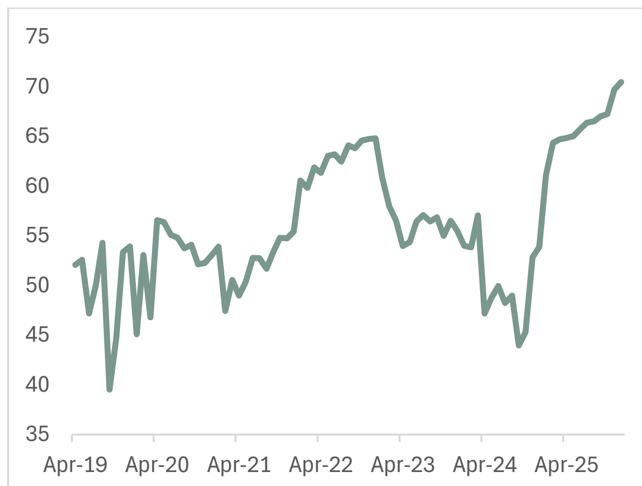
Demand for the Treasury's FRN is solid. **Its monthly auctions are on average 3x oversubscribed** (Figure 1). Auction demand was stronger in the security's early history, likely reflecting its novelty. This followed lengthy discussions about its introduction and structure over several years. **Most of the current auction interest comes from investment funds that typically purchase 60% or so of each month's supply**. While this category includes mutual funds, other data suggest that most of this bidding is from money market funds. **They held nearly $500bn (or over 70%) of the outstanding supply last month** (Figure 2). Money funds' appetite for the Treasury's FRN appears stronger in periods when interest rates are moving.

Figure 1: Treasury FRN auction bid/cover



Source: US Treasury, SMBC Nikko

Figure 2: Money fund demand (% outstanding)



Source: Crane's Data, SMBC Nikko

Although the index rate only changes once a week, the bill floater has a daily interest rate reset for money fund WAM and liquidity calculations. **As a result, it competes with overnight repo rates for space in money fund portfolios**. That said, 2a7 rules limit money fund portfolio WALs to 120d.[1] Since WAL is calculated to the final maturity rather than the interest reset, large holdings of the 2y FRN can chew up a significant amount of the fund's available WAL capacity. Thus, despite their attraction as a higher yielding repo substitute, 2y FRNs are typically less than 8% of aggregate money fund holdings. Money fund Treasury repo holdings are considerably larger (Figure 3).

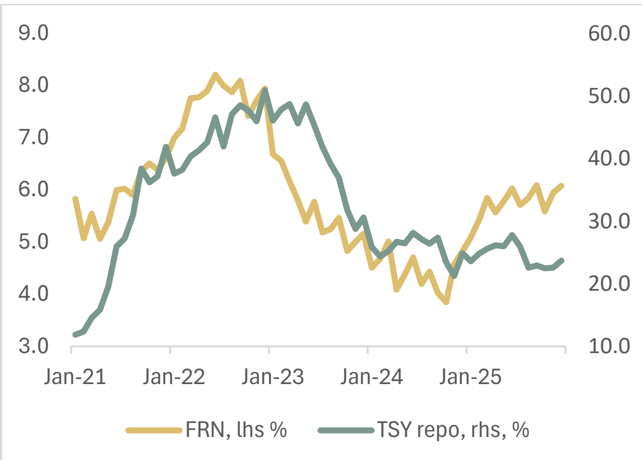
The WAL on money funds' FRN holdings is currently 350d although since 2019 it has ranged from 300-440d. We calculate the additional WAL 2y FRNs make on average to money funds overall portfolio WALs since 2021 (Figure 4). Currently, money funds' FRNs are adding about 30d to their aggregate portfolio WAL of roughly 90d. A security with a shorter final maturity would absorb less portfolio WAL capacity and might attract stronger money fund demand. Indeed, when the Treasury first proposed issuing a SOFR-FRN in 2020, there was keen interest for one with a one-year final maturity. We imagined a 1y SOFR-FRN could be issued in place of the 52w bill. Auction demand for the 52w bill is solid – since 2014, its average bid/cover ratio has been about 3.30.

[1] WAM weighted average maturity is calculated to the next interest reset date, WAL or weighted average life is calculated to the final maturity date.

Revisiting demand

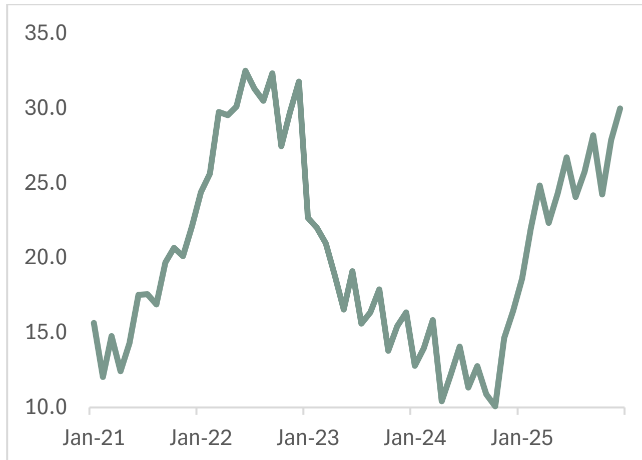
Since the Treasury last considered a SOFR-FRN, Libor has been replaced and corporations and agencies regularly issue SOFR-FRNs. As a result, the Treasury would be issuing into a ready-built market, with its own terms and payment structure. But would interest in a Treasury SOFR-FRN be stronger than in 2020?

Figure 3: FRN and repo holdings (% assets)



Note: The Treasury repo share includes RRP balances. Source: Crane's Data, SMBC Nikko

Figure 4: WAL contribution (d)



Source: Crane's Data, SMBC Nikko

The Treasury's renewed interest in a SOFR-FRN may be tied to a preference for issuing shorter maturity debt that could substitute for more costly term debt. Demand from money funds has already helped the Treasury increase bill supply to 22% of debt outstanding and close to its long-run historical average of 23.6%. If stablecoins take off, there may incremental demand from issuers looking to collateralize their coins with bills, repo, and, potentially, floating rate Treasuries. Moreover, money funds hold nearly $2trn in Treasury repo and depending on where a 1y SOFR-FRN trades, some of these balances might shift over.

That said, the Treasury faces two key issues related to the structure of the SOFR-FRN. **First, a new security should not compete directly with an existing one**. The Treasury already has a successful floating rate note that it has cultivated since 2014. Ideally, the introduction of a SOFR-FRN should not cannibalize the demand for the 2y FRN. And while it is possible that much of the demand for the new security will come from repo buyers, it will also likely come from money funds seeking more WAL-friendly securities. But it is unclear how much extra yield these securities might earn compared to overnight repo; agency SOFR floaters trade at very tight spreads.

Secondly, the Treasury would need to adopt the industry's issuance standards regarding payment structure and interest compounding. Because the Treasury is coming to market with a SOFR-FRN long after corporates and agencies have established frameworks, it would be a follower rather than a leader. As a result, the Treasury would most likely compound the daily average SOFR rate during the interest rate period. Likewise, it might consider a 2-5d interest rate lookback for calculating interest owed. We think it might be less inclined to adopt a lockout period where the interest rate is fixed for, say, the final two days of the quarter to ease the interest rate calculation. Since the 2020 discussion, the New York Fed has published daily compound average SOFR rates (at 1, 3, and 6m tenors) on its website.

The introduction of a SOFR-FRN would mean the Treasury uses two benchmark rates to calculate the interest owed on its FRNs. While changes in bill issuance affect SOFR, their effect is larger on bill yields. As a result, if the Treasury chose to it could shift the frequency or size of the 3m bill to push the rate applied on its bill floater lower. It would be harder to do the same for SOFR. And SOFR is sensitive to influences outside the Treasury's control such as dealer balance sheet capacity and the FICC's VaR margins. We think the Treasury may be reluctant to use an index over which it has more limited influence. The Treasury's auction calendar is already crowded and it is not clear where a new security might easily fit into the schedule. We assume the Treasury might want its SOFR-FRN to settle mid-month to avoid directly competing with the bill floater. That said, it is unclear if a new issue would add more to settlement pressure than simply increasing the size of existing offerings.

Beyond the mechanics of the SOFR-FRN there is a broader question. By issuing more debt at shorter maturities – particularly floating rate debt – will the Treasury save money for tax payers? **The Treasury's optimal maturity mix must minimize two opposing forces – expected debt service costs and their volatility**. At one extreme, the Treasury can concentrate all its issuance in bills and short-maturity floating rate notes to save on debt service costs as term premia typically increase with debt maturity. But this requires rolling over its (growing) outstanding debt more frequently. In turn, this increases the sensitivity of its debt service payments to changes in market interest rates. Alternatively, it can reduce this volatility by issuing only bonds although at a higher overall debt service cost given the term premium.

Our sense is that the Treasury's renewed interest in a SOFR-FRN is exploratory. We think the same issues that reduced its attractiveness in 2020 – demand cannibalization, choice of benchmark, and payment structure – likely have not changed enough to make a SOFR-FRN an attractive new Treasury security.

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