

Morgan Stanley

July 2, 2020

Via email to the Department of the Treasury at: govsecreg@fiscal.treasury.gov

Subject: Docket number TREAS–DO–2020–0007

Regarding: US Department of the Treasury Request for Information on the Development and Potential Issuance of Treasury Floating Rate Notes Indexed to the Secured Overnight Financing Rate

Morgan Stanley is pleased to respond to the Department of the Treasury's request for comments on the possibility of issuing a floating rate note (FRN) indexed to the Secured Overnight Financing Rate (SOFR) published by the SOFR Administrator, currently the Federal Reserve Bank of New York (FRBNY). Please find below our answers to each of the questions posed by the above referenced request for information.

1. *Market Demand*

Question 1.1 Which types of investors would be the primary buyers of Treasury SOFR-indexed FRNs? Would Treasury SOFR-indexed FRNs attract new investor types or additional demand from existing Treasury investors?

- *Morgan Stanley expects that primary buyers of Treasury SOFR-indexed FRNs would be similar to the current primary buyers of T-Bills & Treasury FRNs and would likely include money market funds, central banks, public sector entities (e.g., municipal and state entities and government agencies), retail investors, and corporates.*

Assuming the possibility of a 1-year or 2-year maturity, how would the tenor of a Treasury SOFR-indexed FRN affect demand?

- *Morgan Stanley believes that the 1-year tenor of a Treasury SOFR-indexed FRN would have the highest demand. Money market funds, perhaps the largest single investor type for SOFR-indexed FRNs, are likely to prefer the shorter 1-year tenor because they perceive the shorter tenor as a more efficient product to manage the weighted average life of their portfolios. If, however, Treasury's objective is to appeal to the broadest spectrum of investors, then the 2-year tenor may appeal to a wider and more varied group of investors, such as corporates.*

Question 1.2 Please estimate annual demand for Treasury SOFR-indexed FRNs. Would demand be greater for a shorter tenor? How would potential growth in issuance of SOFR-indexed FRNs by other issuers affect long-term demand for Treasury SOFR-indexed FRNs?

- *As noted in 1.1 above, Morgan Stanley anticipates that money market funds would likely be the largest single investor type for SOFR-indexed FRNs and that they would likely prefer the shorter tenor to better manage the weighted average life of their portfolios. Morgan Stanley also believes that increased volumes of SOFR issuance by other debt issuers (that is, other than the Treasury) would likely serve to further broaden the investor base that is interested and capable of investing in Treasury SOFR-indexed FRNs.*

2. Pricing and Liquidity

Question 2.1 Would introducing a Treasury SOFR-indexed FRN help Treasury finance the government at the lowest cost over time? Why or why not?

- *Morgan Stanley is of the view that SOFR-indexed FRNs are likely to have stronger demand than 2yr T-bill FRNs and that such Treasury SOFR-indexed FRNs may lower Treasury costs over time. SOFR-indexed FRNs would also diversify the options for investors seeking short term interest rate products thereby reducing government costs over time. When evaluating FRNs on a forward looking basis, Morgan Stanley believes that SOFR-Indexed FRNS would be an attractive investment for investors due to its shorter weighted average maturity, which would most likely make the SOFR FRN the most in demand US Treasury floating rate security, decreasing the costs to finance the government. Tbills will likely remain the most liquid fixed or floating rate US Treasury product due to their simplicity and large investor base, and would probably remain the cheapest financing option for the government.*

Question 2.2 How would you expect a Treasury SOFR-indexed security to price relative to a comparable maturity 13-week T-bill FRN security? How would this pricing vary across the economic cycle and interest rate environments? Please provide pricing estimates.

- *Morgan Stanley believes that the SOFR-indexed FRN will trade at a premium to the 13-week FRN due to the shorter weighted average maturity. We anticipate that the SOFR indexed security would trade at a premium in economic cycles where the U.S. interest rate curve is upward sloping. Moreover, given the potential for volatility in the repurchase agreement market within the current low rate/flat yield curve environment, Morgan Stanley believes that SOFR FRNs may ultimately have more demand than the current FRNs.*

Question 2.3 SOFR has risen significantly for certain short time periods, such as around some ends of months, quarters, and years. To what extent would such patterns, if they continue, affect

the interest cost for Treasury on a SOFR-indexed FRN, the interest payments of which would be based on a SOFR averaged or compounded rate over a longer interest accrual period? To what extent would investors be willing to bid lower discount margins at auctions for Treasury SOFR-indexed FRNs in expectation of such patterns continuing? Please elaborate.

- *Recently, volatility has been muted in short term interest rates, thus Morgan Stanley does not foresee a large impact to pricing if this trend continues. If investors expect continued periods of volatility, it is likely that they will pay a premium to realize the additional yield. Please see response to 2.4 for a discussion of our expectations during periods of volatility.*

Question 2.4 During the global financial crisis, repurchase agreement rates were persistently higher than Treasury bill rates. More recently, during the COVID-19 outbreak, liquidity in Treasury and other markets (including repurchase agreement markets) exhibited signs of stress. How would potential future periods of market stress affect SOFR? In a potential future period of market stress, how might interest costs for Treasury differ between a Treasury SOFR-indexed FRN and the 13-week Tbill FRN? Please elaborate.

- *Morgan Stanley expects SOFR-indexed FRNs to perform well during periods of volatility because investors would seek exposure to price movements, while 13 week T-bill FRNs would likely be less sensitive to such volatility. During such periods, the added ability to incorporate yield due to funding increases may also attract additional investors to Treasury SOFR-indexed FRNs. We anticipate that the incremental expense to Treasury related to these products during periods of market stress would likely be negligible because the additional interest expense should be mitigated by increased demand as investors seek exposure to the aforementioned funding volatility.*

Question 2.5 How liquid would Treasury SOFR-indexed FRNs be in secondary markets? Please compare the expected liquidity of Treasury SOFR-indexed FRNs to Treasury bills, the existing 13-week T-bill FRN, and off-the-run short dated coupons.

- *Over time Morgan Stanley expects SOFR-indexed FRNs to have increased liquidity vis a vis the 13 week T-bill FRNs and the off-the-run short-dated coupons. T-bills, however, will likely remain the most liquid product available to Treasury. Morgan Stanley does not anticipate secondary market liquidity issues with respect to SOFR-indexed FRNs.*

3. Security Structure

Question 3.1 What are the primary considerations Treasury should evaluate when structuring a Treasury SOFR-indexed FRN? How would different potential security structures affect investment decisions by market participants, including with respect to activity in derivatives markets?

- *Morgan Stanley believes that markets will generally benefit most from an issuance structure that closely mirrors the derivatives market.*

Question 3.2 Some previously gathered feedback has suggested a 1-year final maturity for original issuance of a Treasury SOFR-indexed FRN. Is this maturity or another maturity preferable for a Treasury SOFR-indexed FRN? Please elaborate.

- *Consistent with our feedback set forth above, Morgan Stanley believes that an initial issuance of a 1-year maturity would appeal to the largest single component group of the investor pool, which is money market funds as they seek to manage the weighted average life of their portfolios.*

Question 3.3 Is a quarterly issuance frequency with two reopenings appropriate for a Treasury SOFR-indexed FRN, similar to the existing 13-week T-bill FRN? What factors should Treasury consider in making this decision?

- *Morgan Stanley believes that the quarterly issue with two reopenings is appropriate but Treasury should ensure that the initial single issue is large enough to sustain liquidity. Past experience suggests that if the initial offer is not large enough it will have difficulty sustaining liquidity.*

Question 3.4 When during the month should Treasury auction SOFR-indexed FRNs? When should auctions settle?

- *Morgan Stanley does not believe that auction timing or settlement would have a material impact on demand for SOFR-indexed FRNs, provided that auction timing and settlement should not occur at month end. Morgan Stanley would encourage avoiding month end settlements since money market fund liquidity may be impaired during month end periods thereby potentially reducing demand.*

Question 3.5 Should interest on Treasury SOFR-indexed FRNs be calculated based on a simple average or a compounded average of SOFR? Should Treasury consider indexing the security to an average rate based on SOFR, such as those recently published by FRBNY as administrator for SOFR? If so, what would be the optimal averaging period for a SOFR-indexed FRN?

- *Morgan Stanley believes the SOFR indexed FRN should be structured with an interest calculation compounded in arrears, in order to align with the derivatives market and facilitate hedging by market participants of their SOFR-indexed FRNs. Ideally, for consistency, the compounded in arrears SOFR used should correspond with the SOFR compounding definition set forth in ISDA's 2006 Definitions. . If a simple average calculation methodology is, instead, utilized by Treasury, Morgan Stanley believes that*

such approach would have take-up in the market, but please see 3.8 below for discussion of matters that Treasury may want to consider.

Question 3.6 What coupon frequency should be used for a Treasury SOFR-indexed FRN? Note that the existing 13-week Tbill FRN pays coupons quarterly. Would a semi-annual, or other coupon frequency be preferred? When during the month should coupon and principal payments be made?

- *Morgan Stanley believes that SOFR-indexed FRNs should have quarterly coupon payments and principal payment at maturity, similar to Agency FRNs and the current 13 week T-bill FRNs.*

Question 3.7 Should the index rate for a Treasury SOFR-indexed FRN reset daily, weekly, or at some other frequency?

- *To ensure that SOFR-indexed FRNs appeal to the broadest spectrum of investors, Morgan Stanley believes that the index rate should reset daily. Morgan Stanley believes this reset frequency is preferable because it is the simplest to employ and will operationally allow for the broadest possible investor base.*

Question 3.8 Should a Treasury SOFR-indexed FRN incorporate a lockout (*i.e.*, last k rates for an interest period set at SOFR k days before the period ends), a lookback or “lag” (*i.e.*, for every day in the interest period, use SOFR from k days earlier), or a payment delay (*i.e.*, coupon and principal payments made k days after the end of the interest period) in its structure? If so, what values would be appropriate for each attribute? Please explain relevant considerations for these features.

- *Morgan Stanley believes the SOFR indexed FRN should be structured to pay interest quarterly, have a daily index rate reset and an interest calculation that is compounded in arrears. With respect to interest periods other than the last one, Morgan Stanley suggests a 2 day payment delay. With respect to the final interest period, Morgan Stanley would propose using a 1 day lockout approach. This 1 day lockout would utilize the SOFR rate from 2 days prior to the payment date for the interest calculations associated with final 2 days of the final interest period. This would allow the final interest amount and principal to be paid at contractual maturity/on the call date without delay.*
- *Morgan Stanley has utilized the above structure in respect of its SOFR FRN issuances but acknowledges that the “lockout” methodology may present operational complexities for some investors. Utilizing a simple average, rather than a compounded in arrears calculation, may be less operationally demanding and therefore more feasible for certain investors. As noted in 3.5 above, if a simplified interest calculation methodology is*

selected by the Treasury, Morgan Stanley believes that there would be market demand for such approach.

Question 3.9 In light of FRBNY's data contingency procedures for the publication of SOFR, what contingency measures should Treasury consider incorporating into the terms of a SOFR-indexed FRN if SOFR, or an average rate based on SOFR, is temporarily unavailable or revised?

- *If the SOFR rate is temporarily unavailable, Morgan Stanley believes Treasury should adopt a contingency that utilizes the SOFR rate as of the last U.S. Government Securities Business Day for which such rate was published on the New York Federal Reserve's website. Morgan Stanley supports use of the fallbacks to SOFR set forth in the Floating Rate Note LIBOR fallback language published by the Alternative Reference Rates Committee in circumstances where a Benchmark Transition Event has occurred (as defined therein).*

4. Existing 13-Week T-Bill FRN

Question 4.1 If Treasury decides to issue SOFR-indexed FRNs, what, if any, changes should Treasury make to the existing 13-week T-bill FRN issuance program?

- *Morgan Stanley believes that SOFR-indexed FRNs and the existing 13-week T-bill FRNs can initially be issued in parallel but that the SOFR-indexed FRN will likely have higher demand over the long term.*

Question 4.2 Should the Treasury issue FRNs indexed to both indices, or should Treasury consolidate FRN issuance on a single index?

- *Morgan Stanley is of the view that, in the short term, it is possible to use multiple indices in the issuance of FRNs but, in the long term, SOFR will likely have more demand.*

Question 4.3 If there is not sufficient demand for both Treasury FRNs to coexist, which index would generate the greater long-term demand and better meet Treasury's issuance objectives? Please elaborate.

- *Please see our response to 4.2.*

Question 4.4 Should Treasury consider issuing 13-week T-bill FRNs with a 1-year final maturity? How should the decision regarding issuance of Treasury SOFR-indexed FRNs affect this possibility?

- *Morgan Stanley believes it would be most effective to focus on SOFR-indexed FRNs in the 1 year tenor, as they would be the most appealing to a majority of active investors and*

crowding the issuance space with additional products may diminish potential incremental liquidity.

5. Market Transition

Question 5.1 What proportion of likely investors is currently operationally ready to purchase Treasury SOFR-indexed FRNs? For those investors that are not ready, what are the main impediments? How much lead time and investment would be required for additional investors to become operationally ready to purchase Treasury SOFR-indexed FRNs? Would any of the security structure choices mentioned in Section 3 above affect the operational readiness of likely investors?

- *Based on Morgan Stanley's feedback from potential investors in SOFR-indexed FRNs, as well as our own operational readiness, modest prior notice would be needed for an initial issuance. Most firms are currently capable of trading SOFR indexed notes or require a modest amount of additional work to become operationally ready. This is because many potential investors are operationally able to transact in Agency SOFR floating debt. Please see the views articulated in Section 3 (Security Structure) above regarding our views of the optimal basis for the issuance of Treasury SOFR indexed FRNs to foster the broadest base of investors to be operationally ready in the shortest time period.*

Question 5.2 To what extent would Treasury's issuance of SOFR-indexed FRNs advance the overall market transition away from U.S. dollar LIBOR? How would different market segments (e.g., FRNs, derivatives, business loans, consumer products) be affected by the Treasury's decision to issue SOFR-indexed FRNs? What effect would the Treasury's issuance of SOFR-indexed FRNs have on the overall market transition away from LIBOR beyond that caused by current issuance of SOFR-indexed FRNs by other issuers? Please provide specific details of the cause and effect relationships you expect.

- *Morgan Stanley believes that Treasury's issuance of SOFR-indexed FRNs is a fundamentally important milestone in the overall transition away from U.S. dollar LIBOR. The impact may most directly be in the floating rate corporate debt market where SOFR issuance standards going forward may likely mirror the conventions adopted by Treasury. Morgan Stanley also believes that Treasury's issuance of a SOFR-indexed FRN may improve liquidity in the SOFR-based derivatives market, as there will likely be greater demand by investors for hedging products related to these notes. For lending markets, we view Treasury's issuance of SOFR-indexed FRNs as an important means to increase market familiarity with SOFR, which should provide a benefit for the overall transition even if lending markets adopt different SOFR conventions than Treasury.*