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July 6, 2020

Department of the Treasury
Government Securities Regulations Staff
799 9TH St. N.W.
Washington, DC 20239-0001

VIA E-MAIL

Re: Docket No. TREAS–DO– 2020–0007, Development and Potential Issuance of Treasury Floating Rate Notes Indexed to the Secured Overnight Financing Rate

Dear Ladies and Gentlemen,

Federated Hermes is grateful for the opportunity to provide feedback on the request for information on the development and potential issuance of treasury floating rate notes (“FRNs”) indexed to the Secured Overnight Financing Rate (“SOFR”).

We welcome the Treasury’s consideration of issuance of SOFR-indexed floating rate notes. As background, Federated Hermes is one of the largest investment managers in the U.S. with \$605.8 billion in managed assets as of March 31, 2020, including \$451.3 billion of liquidity products. With holdings of Treasury securities of approximately \$185 billion in these products as of May 31, 2020, we feel that there will be robust demand for a product of this type, and that it can be issued in such a way as to result in a liquid market while at the same time being consistent with Treasury’s goal of providing the lowest cost of financing for the U.S. government. To date, we have been active buyers of Treasury bill-based FRNs across our government products, to include Treasury only portfolios, Treasury and repo portfolios, and agency money market funds. We expect to find SOFR-indexed FRNs to be an attractive investment for these funds as an alternative for repurchase agreements, as well as increased participation from prime money market funds where Treasury bill-based floaters do not have a significant presence. We also expect local government investment pools to find a SOFR-indexed offering to be an attractive investment to fill required Treasury allocations.

2. Pricing and Liquidity

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

For the same reasons that the 13-week T-bill FRN has aided in Treasury debt management by providing an attractive investment alternative for cash investors at an advantageous cost, we would expect the introduction of a SOFR-indexed security to result in similar benefits.

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.

Our expectation would be that there should be a premium for Treasury issuance relative to similarly-structured FRNs offered by the GSEs, estimated to range over market environments between 3 to 10 basis points depending on the maturity, outlook for rates, and other technical factors in the market. We would expect the issuance cost of SOFR and Treasury bill-based FRNs to be relatively comparable over time, although factors such as overall financing needs and interest rate outlook may favor one index relative to the other in certain environments.

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.

Investors may be willing to adjust discount margins at auctions for Treasury SOFR-indexed FRNs if upward pressure on certain “stress” dates were expected to continue. However, as outlined in more detail below, action by the Federal Reserve to reinforce the resiliency of the repo markets, along with changes as to how regulatory compliance is calculated has reduced the prospect of significant upward pressure on these dates.

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 T-bill FRN? Please elaborate.

There has been a great deal of attention on the repo market, and SOFR, since the extreme volatility in the funding markets experienced last September. At that time, a confluence of events led to repo rates spiking to over 5% for the traditional Treasury and agency backed repo that money market funds engage in. Since then, the U.S. Federal Reserve (the “Fed”) has taken extraordinary steps to mitigate some of the factors that led to this spike in rates, including the provision of liquidity to market participants through temporary and permanent open market operations. The coronavirus pandemic led to substantial dislocations in a variety of markets in March, and the Fed again took unprecedented action across a variety of fronts to restore market functioning, including measures aimed at ensuring that the liquidity of the funding markets remained intact.

We believe that, even after the Fed’s tools are returned to their toolkit, the new “normal” for the Fed will be to engage in temporary open market operations on an ongoing basis. As a result, our expectation is that the day to day volatility of SOFR will remain quite low, including

over those trading sessions typically thought of as pressure dates. Because of the technical nature of Treasury bills, with yields on issuance in this sector having the potential to be greatly influenced by supply and demand shifts, and as a result of the safe haven nature of this market, we view Treasury bill-based FRNs as having a greater degree of basis risk than SOFR-based FRNs, and potentially greater variability in financing costs for the Treasury as a result.

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.

We would anticipate SOFR-indexed FRNs to eventually reflect the same liquidity profile as Treasury bill-based FRNs, and follow the same trajectory in development as with when Treasury bill-based FRNs were introduced in 2014. Although less liquid than the direct Treasury bill market, we would characterize the eventual secondary market trading as being comparable to that of short-dated Treasury coupon securities.

3. Security Structure

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?

As an overarching comment, liquidity is likely to be enhanced if the security structure is consistent with the developing market convention for SOFR-based issuance by GSEs.

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.

The ideal market would be one in which both 1 year and 2 year maturity FRNs, for both SOFR and Treasury bill-based indices, would exist. The robust size of government liquidity universe of investors would provide support for varied issuance, as the motivations for owning different maturities and index types would differ by product type. For example, a 1 year SOFR-based FRN may have more appeal to a prime money market fund, whereas a 2 year SOFR-based FRN may offer relative value to a government money market fund. Similarly, while a 2 year Treasury bill-based FRN has been a valuable addition to Treasury and repo portfolios, funds that limit investments to Treasury securities only may have more capacity for a shorter-duration instrument. That said, the introduction of both a new index and multiple maturity points is likely not practical in the current environment. With that in mind, a 1 year SOFR-based FRN would be an attractive complement to the current 2 year Treasury bill-based FRN, offering potential yield enhancement to repurchase agreements depending upon market pricing, while still affording the Treasury a low cost alternative to the longer-dated Treasury bill FRN.

3.3. Is a quarterly issuance frequency with two re-openings 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?

Yes, a quarterly issuance frequency similar to the existing 13-week T-bill FRN seems appropriate.

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

SOFR-indexed FRNs should be issued mid-month, to avoid congestion with the month-end issuance of Treasury bill-based FRNs.

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?

While we could accommodate either simple or compounded average, the compounded average would be preferred and more in line with how the market for SOFR is developing.

3.6 What coupon frequency should be used for a Treasury SOFR-indexed FRN? Note that the existing 13-week T-bill 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?

To avoid price dislocations and potential liquidity impacts, coupon frequency should be no less frequent than quarterly.

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

We would prefer a daily reset.

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.

We would prefer a one-day lookback, and a lockout period of 2 days before the end of a coupon period.

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?

We are comfortable with the FRBNY's data contingency procedures for the publication of SOFR; reference to said procedures should be sufficient.

We appreciate the opportunity to express our views on the potential SOFR-based Floating Rate Note, and view the issuance of such a security very favorably. In addition to our thoughts outlined above, Treasury's issuance of SOFR-indexed FRNs will help to advance the transition of the cash market away from LIBOR, by improving the liquidity of SOFR FRNs as a whole and through the demonstration of government support for the recommended replacement of LIBOR. Please feel free to contact us if you have any questions or require additional information relating to our comments.

Yours very truly,

Deborah A. Cunningham

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