GAO Highlights

Highlights of GAO-14-535, a report to the Chairman, Committee on Ways and Means, House of Representatives

Why GAO Did This Study

To continue meeting its goal of financing the federal government's borrowing needs at the lowest cost over time, Treasury began issuing a new type of security—a 2-year floating rate note (FRN)—in January 2014. The FRN pays interest at a rate that resets periodically based on changes in the rate of the 13-week Treasury bill (to which the FRN is indexed). GAO was asked to review Treasury debt management, including this product and other debt management issues.

This report (1) evaluates Treasury's rationale for introducing FRNs and (2) identifies the demand for Treasury securities from a broad range of investors to assess whether changes would help Treasury meet its goals. To address these objectives, GAO used Treasury auction data from 1980 - 2014 to simulate the costs of Treasury FRNs, reviewed Treasury documents, surveyed a non-generalizable sample of 82 large domestic institutional investors across sectors, and interviewed market participants and academic experts. (For the survey and results, see GAO-14-562SP.)

What GAO Recommends

GAO recommends that Treasury (1) track and report a measure of interest rate risk in its debt portfolio, (2) analyze the price effects of the difference between the term of the index rate and the reset period, (3) examine opportunities for additional new types of securities, such as FRNs of other maturities, and (4) expand outreach to certain market participants. Treasury agreed with the recommendations and said that they had already taken steps to begin implementing them.

View GAO-14-535. To view the e-supplement, click on GAO-14-562SP. For more information, contact Susan J. Irving at (202) 512-6806 or irvings@gao.gov.

June 2014

DEBT MANAGEMENT

Floating Rate Notes Can Help Treasury Meet Borrowing Goals, but Additional Actions Are Needed to Help Manage Risk

What GAO Found

Issuing floating rate notes (FRN) is likely to help the Department of the Treasury (Treasury) meet its goals to borrow at the lowest cost over time, extend the average maturity of the debt portfolio, and increase demand for Treasury securities, but it also presents risks related to changes in interest rates.

GAO simulated the costs of 2-year Treasury FRNs using historical Treasury auction data and found that interest costs of the FRNs were generally less than costs of fixed-rate 2-year notes, but could be either more or less than costs of 13-week bills, depending on assumptions about how investors price the FRNs. GAO also found that in rising interest rate environments, the FRNs may be more costly than these alternatives.

Multiple components contribute to achieving lowest cost financing over time: issuing FRNs is part of Treasury's approach to achieving this goal. GAO analysis identified a number of design elements that may affect how FRNs contribute to that goal. Treasury officials believe it is prudent for Treasury to extend the average maturity of its debt portfolio because the debt level is already high and is expected to grow. Relative to issuing shorter-term debt, 2-year FRNs will help Treasury extend the average maturity of the debt portfolio and thereby reduce the risk inherent in going to market. Because the interest rate on a FRN can change during the life of the security, FRNs expose Treasury to the risk of rising interest rates whereas fixed-rate securities of the same maturity do not. These shifts in risk are likely to be small because currently FRNs are expected to constitute a small proportion of Treasury debt. Although managing interest rate risk is an important aspect of Treasury's goal to borrow at the lowest cost over time, Treasury does not track and report a measure of the average maturity of the portfolio that captures the additional interest rate risk of FRNs.

One element of the design of the 2-year FRN—the difference between the term of its index rate (13 weeks) and the length of its effective reset period (one week)—is not typical for floating rate notes and creates tradeoffs in interest rate risks but also may result in additional demand for the product. The risks could affect the pricing of FRNs and raise Treasury's borrowing costs in environments of high and volatile interest rates. Treasury officials told us they examined design elements, including this difference, before issuing the 2-year FRN. However, Treasury had not analyzed how the difference may affect FRN pricing.

FRNs give Treasury debt managers additional flexibility by increasing demand for Treasury securities and by adding a new security that meets the high demand for short-term securities. Results from GAO's survey of a broad range of investors and interviews with market participants found that market participants likely will purchase Treasury FRNs primarily as a substitute for other Treasury securities, but they will also purchase the FRNs as a substitute for non-Treasury securities, bringing new and potentially growing demand to Treasury. To provide the lowest cost of financing the government over time, Treasury must consider investor demand for new and existing products. Survey respondents indicated an interest in FRNs of additional maturities and in other new Treasury products. Treasury currently offers many ways for market participants to provide input, but GAO's survey identified opportunities for Treasury to enhance input from some sectors—including state and local government retirement fund managers.