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U.S. Could Be Pushed Into Debt Overload by the Treasury

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DURHAM, N.C. ([TheStreet](#)) -- Testifying before Congress in 1993, when interest rates were 7.5%, I advocated shifting some of the federal debt to floating rate debt. If the Treasury had shifted half of the debt to floating rate at that time, the U.S. would have saved \$2 trillion to date.

Today, however, interest rates are at, or near, historic lows. It is the wrong time to issue floating rate debt. This type of debt introduces unneeded funding risk.

Treasury Announcement

Traditional Treasury bonds have a fixed maturity, say 10 years, and a fixed coupon rate, say 2%. When you issue such a bond, you know exactly what the cash flow liabilities are: 1% every six months until maturity. Floating rate notes (FRNs) have a fixed maturity but variable coupon. An example is a bond that has 10 years to maturity but with a coupon that resets every six months to reflect the rate on a short-term Treasury bill. When FRNs are issued, the liability is uncertain because interest rates could rise or fall.

Many expected the Treasury to push forward with floating rate notes (FRNs) yesterday. They were originally proposed in February. See the [original report](#). While the Treasury still sees benefits in the issuance of floating-rate notes, a decision appears to have been deferred because of "a significant amount of feedback". See the Policy Statement.

The initiative appears to be coming from an industry group called the Treasury Borrowing Advisory Committee (TBAC). It stated:

"The Committee reiterated that its main goals in unanimously supporting FRNs were continued diversification of the investor base and average maturity extension through issuing floaters in lieu of shorter dated issuance. Furthermore, FRNs should lead to a reduction of term premium expense over time. While initial issuance should have final maturities of one to two years, eventually the Committee anticipates FRNs of longer final maturities." Read the [TBAC report](#).

This committee is populated with representatives from **JPMorgan Chase, Goldman Sachs, Morgan Stanley, Bank of America** and other banks.

The Case Against Floaters

When I made my testimony to the House Ways and Means Committee in 1993, floating rate issuance made a lot of sense. Interest rates were relatively high (7.5%). Indeed, if the Treasury had funded half of its needs with FRNs, \$1.9 trillion would have been saved (\$2.3 trillion taking the time value of money into account).

Today is different for two reasons.

Interest rates are at historic lows with the 10-year rate at about 2%. FRNs make sense if you think interest rates are heading down. It seems very unlikely that rates will stay at 2% for the next 10 years. The U.S. government's leverage is significantly higher today than in 1993. The federal debt is \$15.4 trillion and our GDP is \$15.5 trillion. When you have high leverage, you do not want to take extra risk on funding (the risk being interest rates going up). We have seen this movie played multiple times already -- in Europe.

The Case for Floaters

The TBAC minutes of May 1, 2012, state:

"The Committee again unanimously recommended that Treasury pursue an FRN program, citing the merits of expanding the investor base and providing a cost effective means of extending the average maturity." Read [the minutes](#).

There are three issues: bringing in new investors, cost effectiveness and extending maturity. Let me tackle each one.

New Investors

This is a weak argument. Essentially, the FRNs pay a coupon that reflects the Treasury bill rate. So why not just invest in Treasury bills? Treasury bills have been around a long time. The only difference is that you need to roll over the Treasury bills, say, every 90 days. However, this is routine and institutionalized. To be clear, there is no economic difference between the cash flows of investing in Treasury bills and investing in FRNs.

In addition, FRNs are not new. It is easy to create a FRN by buying a fixed rate Treasury and entering into a swap agreement (you pay the coupon to an investment bank and they pay you a floating rate). There is a very minor amount of counterparty risk. It is minor because you hold the bond. If there was a problem with the counterparty (which seems unlikely given the history of bailouts), your principal (the bond) is not at risk.

Cost Effectiveness

It is true that the short-term costs are less for FRNs than for fixed rate bonds. The Treasury bill yield is a fraction of 1 percent -- whereas the Treasury bond yield is 2%. So you save money immediately. However, it is not clear you save money in the end. Consider the choice between a 10-year FRN and a 10-year fixed rate Treasury bond. With the fixed rate bond, you are locked into to 2% for 10 years. With the FRN, the rate fluctuates. Maybe it is 1% but maybe is grows to 8% -- it depends on future interest rates and inflation. Who knows? This is exactly what I mean by funding risk.

Let's take a hypothetical example for perspective. Suppose the Treasury decided to fund half the federal debt with floaters. Currently, the average interest rate on the federal debt is 2.8%. This would lead to some immediate savings. However, what happens if rates jump -- which is not unreasonable given the Federal Reserve's balance sheet of \$2.8 trillion, or 19% of GDP. The savings would be wiped out if rates rose to 2.8% (which by the way, is roughly today's inflation rate). If rates go to 4%, then the government has to come up with an extra \$1 trillion to pay the extra interest they precommitted to. Do you think 4% rates are out of the question? I certainly don't.

The uncertainty about future interest service is what I call funding risk. The amount of cash needed is unpredictable. If interest rates rise, then extra interest service must come from: 1) higher taxes; 2) spending reductions; 3) more borrowing; or 4) printing money. Note that (4) usually causes rates to increase even more, leading to even higher service costs. (3) can have a similar effect.

Extending Maturity

Yes, FRNs extend maturity -- if they are replacing securities that have a shorter maturity. Suppose they replace Treasury bills. In this case, the interest rate risk is identical (both pay the Treasury bill rate). Suppose they replace fixed rate coupons. In this case, the interest rate risk changes. As rates go up, the FRNs become more expensive to service.

The Treasury's February 2012 document is a good read. They make the case that there could be some cost savings in minimizing the rollover risk. That is, instead of going to market every three months for Treasury bills, you commit for a longer period, say, two or five years. They also argue there is a modest term premium that could be captured.

If the FRNs are just two years to maturity, then not much additional risk is created. This is especially true today when the Federal Reserve is on record saying that rates will remain low through 2014. However, what makes me nervous is the phrase: "... eventually the Committee anticipates FRNs of longer final maturities."

I am in favor of extending maturities. The Treasury has extended the average maturity of the federal debt to about 63 months over the past three years. However, this weighted average maturity is no different than the average maturity in the 1990s -- when interest rates were much higher. It is best to extend maturity with fixed rate bonds -- not floating rate bonds.

Bottom Line

To me, the potential benefits to issuing FRNs are minor. However, the costs could be severe. In a different time, when the federal debt was a much smaller fraction of GDP, one could make the case to experiment with FRNs. However, today we face much greater risks.

You don't need to look far to see the risks created by relying on short-term funding. One of the major reasons that so many financial institutions needed to be bailed out during the crisis was that they were using short term funding. They faced rollover

risk as well as very high interest service costs. The same thing happened in peripheral countries in Europe. If they had locked in long term funding at fixed rates a few years ago, the crisis would have been mitigated. Instead, we are facing a 1.5 trillion euro rollover in 2012 at uncertain costs.

For the Treasury's plan, there is no rollover risk. However, there is interest service risk. Overall, the costs outweigh the benefits.

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