Product Briefing – Floating Rate Notes

Floating rate notes (FRNs) are interest bearing securities that pay a variable coupon on a regular basis (usually quarterly). The coupon is usually a spread to a given margin relative to an interest rate index such as LIBOR (London Interbank Offered Rate) or Euribor. For example, the instrument may pay 3 month USD LIBOR +0.15% (15 basis points).

The instrument is economically equivalent to series of consecutive fixed term bank deposits, where the interest rate is reset on a periodic basis. The fixed percentage margin over the specified interest rate index is referred to as the quoted margin. The quoted margin is a function of the issuer's default risk relative to the interbank rate to which the interest payments are referenced. The better the credit rating the lower the quoted margin and vice versa.

- *FRNs pay a variable coupon referenced to an interbank rate such as LIBOR*
- *An investor receives LIBOR plus a margin which is a reflection of the issuer's risk of default*
- *FRNs derive their value mostly from changes in the market's perception of the issuer's credit risk*

FRN issuance is driven by the desire of the issuer to match their assets and liabilities. For example, banks will tend to be big issuers of FRNs (which will represent a liability) as the assets the bond proceeds are used to purchase will tend to pay a variable rate of interest (e.g. mortgages). This ensures that if interest rates change interest costs and income will move in tandem.

FRN investors will include many different entities:

- Bank treasuries with excess cash who are looking to match floating rate liabilities
- Central bank, retail investors and credit conscious fund managers will buy sovereign – issued FRNs
- Money market funds and corporates can earn an enhanced yield compared to alternatives such as cash and commercial paper