November 1, 2005

Minutes Of The Meeting Of The
Treasury Borrowing Advisory Committee
Of The Bond Market Association
November 1, 2005

The Committee convened in closed session at the Hay-Adams Hotel at 3:00 p.m. Three members of the Committee, Keith Anderson, Susan Estes, and James Capra, were not present. Undersecretary for Domestic Finance Randal Quarles welcomed the Committee and gave them the charge. Office of Debt Management (ODM) Director Jeff Huther then proceeded to address the Committee.

Director Huther highlighted a few of the quarterly refunding charts released on October 31, noting that Treasury's borrowing in fiscal year 2005 was less than projected earlier in the year and that this is largely due to increased tax receipts and higher-than-expected SLGS issuance. He also noted the potential for volatility in Treasury's borrowing needs in the next few fiscal years, with estimated borrowing needs rising in FY2006. In addition, recent disaster related relief may create additional volatility in bill and coupon issuance in FY 2006. However, Director Huther highlighted the fact that such expenditure was within the expected range of Treasury forecast scenarios for FY 2006, and could be financed by increasing the size of bill and coupon issuance from their low current levels over the course of the fiscal year. He emphasized that Treasury had great flexibility in its financing needs during fiscal year 2006 even considering the appropriations bill.

A Committee member asked if Treasury knew why SLGS issuance was so high in the previous fiscal year. Director Huther stated that one of the primary reasons for increased issuance was the desire to lock in low interest rates and refinance existing levels of debt. He anticipated that such issuance would return to more normal levels in the coming fiscal year.

The Committee then addressed the first question in the Committee charge (attached) regarding potential adjustments to Treasury's auction calendar in order to accommodate the introduction of 30-year bond issuance. Director Huther presented a series of charts regarding calendar issues and changes, including the recommendation that the 30- year bond be included in the Quarterly Refunding semiannually and moving all 5-year note auctions to month-end. He noted that historically Treasury has not auctioned four coupon securities during refunding week and referred to a chart stating that such issuance could create excess risk for primary dealers which could lead to higher borrowing costs for the Treasury. Director Huther said that Treasury was currently planning on auctioning the 30-year bond be auctioned on a February/August cycle in 2006 with a dated date on the 15th of the month to ensure fungibility with outstanding bonds, and with a settlement date on the 15th of the month or the next business day if it were a weekend or holiday. He noted the importance that primary dealers placed on the

STRIPS market and stated that Treasury would aim to broaden liquidity in this market following the issuance of the 30-year bond.

In addition, Treasury was planning on moving all 5-year note auctions to the end of the month, with an end of month dated date and settlement date. The 5-year note would auction and settle in similar fashion to the monthly 2-year note. In addition, Treasury would announce the 5-year on the same date as the 2-year note, and auction the 5-year note one day after the 2-year auction. Given that 5-year TIPS and 20-year TIPS are auctioned at month end on a semiannual basis, the placement of the 5-year note at month end would, on a quarterly basis, result in 3 coupon auctions in a week. By moving the 5-year to month end, Director Huther stated that these month end auctions could garner greater interest from the investment community, provide additional liquidity to the market, and potentially lower borrowing costs while at the same time improve the management of Treasury's cash balances.

The Committee was asked if there are other issues Treasury should consider as a result of these planned changes in the calendar. In addition, Treasury asked if clustering issues during refunding week and the last week of the month were beneficial to Treasury, and if there were any tradeoffs of which Treasury should be mindful.

A majority of Committee members believed the adjustments to the calendar proposed by Treasury were prudent and reflected various market factors.

A Committee member noted that clustering securities allows Treasury to take advantage of Wall Street's marketing skills and helps in the overall underwriting process. The member also noted that the duration offered during the refundings did not look excessive. The same member noted that Treasury may want to consider its own exposure during refunding week and consider if issuing 10-year notes and 30-year bonds during the same week poses potential problems.

Another Committee member stated that the flexibility Treasury has shown in accommodating various securities may pose potential problems in the marketing of securities over the long run. Another Committee member countered this comment and stated that marketing had little to do with placement on the calendar as shown by the decline in when-issued trading. The member stated that the changes made by Treasury to accommodate various securities have not had an impact on borrowing costs. The member noted that an increase in when-issued trading would potentially indicate issues with Treasury issuance, placement, and marketing.

A Committee member noted that the 30-year bond should be auctioned such that it is fungible with currently outstanding STRIPS. Another member noted that having TIPS auctions during the same week as 2-year note and 5-year note auctions was not a problem because the securities were not necessarily substitutes and that their investor bases were different.

One Committee member suggested that auctioning three securities during the final week of the month may potentially be an issue given that employment numbers are released during that period. The member also noted that such issuance may be costly in December. Director Huther acknowledged this potential cost and stated this factor was considered in Treasury's issuance decisions.

Next the Committee turned to the second discussion point on the Committee charge on the proposed Treasury Securities Lending Facility and possible approaches to setting the borrowing terms so that it is only economically attractive during periods of protracted fails. Director Huther presented a series of slides on the factors that led Treasury to consider such a facility and the initial thoughts on a potential structure for a facility. The first few slides highlighted the costs to Treasury of periods of chronic fails including impaired liquidity in the cash markets, operational costs, and the potential erosion of benchmark status. He noted that these factors ultimately result in higher borrowing costs for Treasury.

The next few slides addressed other alternatives including reopenings or market based solutions such as "prompt delivery trades". Director Huther noted that Treasury had studied these alternative methods to resolve chronic fails and determined they were not suitable because of various factors including the lack of incentive to use such facilities, the reactive – rather than preemptive - nature of such methods, the uncertainty created by issuing the appropriate amount of additional supply, and the potential to introduce additional speculative components to securities prices.

The final set of slides presented by Director Huther showed preferred characteristics of the proposed securities lending facility as well as the possible incentives for using such a facility. The slides noted that such a facility would prevent settlement fails from occurring, ensure that additional supply was temporary, encourage market driven solutions to supply-driven imbalances, and be viewed as a lender of last resort option. Desired attributes include a non-discretionary, standing facility with unlimited supply on renewable terms. The price would be set at a penalty rate to discourage use unless the market was severely stressed. The facility would not be designed to address temporary needs, so the term would likely be greater than overnight. The slides also discussed potential incentives for using such a facility. Director Huther than asked members of the Committee for their thoughts on how such a lending facility should be designed and the risks of introducing such a facility in the Treasury market.

A Committee Member began the discussion by reviewing the minutes of the previous TBAC meeting in which members offered numerous and varied opinions as to the merits of the program, but expressed some reservations regarding the implementation and dynamics of such facility. The Committee member then asked if the Treasury was requesting further context on the facility.

Undersecretary Quarles responded by stating that Treasury wanted to hear what the views of the Committee were since the previous meeting and if the idea as a whole was a good idea.

A Committee member noted that the lending facility was potentially a departure from market conventions. He noted that delivery failures of Treasury securities are a market convention. He noted that the benefits that accrue to Treasury from the specials market versus the costs associated with chronic fails was difficult to define. Another member noted that the low rate environment was exacerbating chronic fails and that such a situation would clear as rates increased.

A Committee member stated that the fails situation was not simply a problem resulting from low rates, but the result of market trends in which Treasury supply was decreasing as an overall portion of the market. Given trends in foreign ownership, such supply related problems may become more frequent in the future.

Another member stated that if Treasury were to institute such a program, they should make the facility as simple as possible and create minimal impact on the market. The member suggested that the NASD and SEC should enforce the buy-in rule, and that Treasury should set up securities facility in tandem. Such a response would have minimal consequences.

A Committee member asked Treasury if it is Treasury's responsibility to enforce the buy-in rule. Director Huther clarified that the buy-in rule is enforced by the various self-regulatory organizations including the NYSE and NASD, and that Treasury can grant extensions. However, beyond this, the penalty for not responding to the buy-in rule was undefined.

In response, a Committee member stated that the facility appeared to be increasing regulatory burdens, and that instituting limits in markets generally encourages speculative behavior. The member stated that Treasury should allow market-based mechanisms to clear chronic fails.

A Committee member then asked if the ultimate benefit of such a facility should be to lower the cost of borrowing for tax payers. The Committee as a whole agreed. A Committee member stated that investors and market makers should also be taken into account when devising the appropriate penalty rate and term.

A Committee member asked the group if system limitations would prevent the implementation of a facility with a negative rate as the penalty fee. Several Committee members stated that their systems could not handle such rates, but that they would make the necessary adjustments if required by regulatory authorities. Another member stated that negative rates would not be necessary if the facility were set up on a term basis with a minimum term of 1 week. The term would act as the penalty in a similar fashion as the negative rates.

A Committee member returned to the point that chronic fails, regardless of the penalty rate utilized, were creating strains in other markets, including mortgages and corporate bond markets, and that implementing some type of backstop facility was prudent. Another Committee member stated that preparing for the worst case scenario was in Treasury’s interest, but that the current proposed facility was too restrictive and burdensome.

A Committee member asked if Treasury had ever experienced such a degree of fails when interest rates were above 4%. Director Huther stated that such a high degree of fails was not evident when rates were higher.

Undersecretary Quarles then asked the Committee if they felt that chronic fails were creating a cost for Treasury over time, and if a securities lending facility would be beneficial. A Committee member stated that he did not feel that the costs to Treasury over the long term were high. He stated that other methods to clear fails including persuasion from Fed officials and the Treasury were already working options and that an additional facility created greater ambiguity and potentially, speculative, activities.

Another member stated that a solution that was between large position reports and tapping an issue was optimal, but that the benefits of the proposed securities lending facility to Treasury were not readily apparent.

A Committee member noted that a backstop facility was required, but perhaps with less regulatory impositions. The member noted that some of the other alternatives – such as asking foreign entities to lend securities during periods of chronic fails – were not reasonable, and may reduce investor demand.

Finally, the Committee discussed its borrowing recommendations for the November refunding and the remaining financing for this quarter as well as the January – March quarter. Charts containing the Committee’s recommendations are attached. A Committee member suggested that, in the future, the borrowing recommendations would be presented in a calendar format rather than in table format. The Committee made some minor adjustments to its suggested financing tables, moving the 5-year note from mid month to month end in February 2006 and March 2006.

The meeting adjourned at 4:30 p.m.

The Committee reconvened at the Hay-Adams Hotel at 6:30 p.m. Three members of the Committee, Keith Anderson, Susan Estes, and James Capra, were not present. The Chairman presented the Committee report to Director Huther. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:45 p.m.

Jeff Huther
Director
Office of Debt Management
November 1, 2005

Certified by:

Ian Banwell, Chairman
Treasury Borrowing Advisory Committee
Of The Bond Market Association
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Attachments:
Link to the Treasury Borrowing Advisory Committee discussion charts
U.S. Treasury - Office of Domestic Finance

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – November 1, 2005

Calendar issues

Treasury is considering inclusion of the 30-year bond in the Quarterly Refunding semi-annually and moving all 5-year note auctions to month end. Treasury seeks the Committee's views on such an adjustment in Treasury's auction calendar. In particular Treasury solicits Committee input on the following questions:

- The clustering of auctions in refunding weeks increases market focus, potentially leading to higher demand, but it also increases the amount of risk market participants must hold, potentially leading to lower demand. How should Treasury evaluate this trade-off when considering where to place securities on the calendar?
- What is the potential impact of a February/August 30-year cycle on 20-year TIPS auctions?
- Are there any advantages to moving the 5-year note auction to month end only during 30-year auction months versus holding 5-year note auctions regularly at month end?
- Are staggered announcements of month end auctions preferable – i.e., consistent with current Treasury policy – or a single announcement of all three coupons?

Treasury Securities Lending Facility

Last quarter Treasury presented some preliminary thinking to the Committee on the need for a backstop securities lending facility to mitigate the risk of recurrent systemic fails. We will present some additional thinking on the potential negative implications of recurrent systemic fails. We seek the Committee's views on possible approaches to setting terms so that borrowing from the facility is only economically attractive during periods of protracted fails.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately $38.7 billion of privately held notes and bonds maturing on November 15, 2005.

- The composition of Treasury marketable financing for the remainder of the October– December quarter, including cash management bills.

- The composition of Treasury marketable financing for the January-March quarter.