Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
Of the Securities Industry and Financial Markets Association
November 4, 2008

The Committee convened in closed session at the Hay-Adams Hotel at 10:40 a.m. All Committee members were present. Acting Undersecretary for Domestic Finance Anthony Ryan, Acting Assistant Secretary for Financial Markets Karthik Ramanathan, and Acting Directors of the Office of Debt Management Fred Pietrangeli and Steve Vajs welcomed the Committee and gave them the charge.

The first item on the charge related to Treasury's financing needs in the coming years as well as current and medium-term trends in the economic outlook. In particular, Treasury sought recommendations from the Committee on changes to the auction calendar. Treasury delivered a presentation to the Committee which highlighted current market conditions and potential factors to consider in addressing this issue.

Assistant Secretary Ramanathan stated that the exceptional marketable borrowing needs in FY09, which according to market estimates could approach $1.4 trillion and potentially vary by $500 billion, presented a unique set of challenges for Treasury. Nonetheless, even with the large financing need and the significant uncertainty around these estimates, Ramanathan noted that Treasury debt managers were positioned to address these needs within its current framework of adjustments to issuance sizes and the auction calendar.

Current credit market conditions remained volatile, and potential pressures on corporate and individual withheld tax receipts could increase Treasury's borrowing needs in FY08 and FY09, according to Ramanathan. He also noted that volatility across all markets remained elevated despite recent improvement, and that there was currently little risk appetite or available balance sheet among investors. In addition, economic fundamentals appeared challenging as measured by employment, home sales, and consumer confidence. At the same time, while flight-to-quality purchases of government debt was benefiting Treasury in the short-term, debt managers realize that they needed to be vigilant of a rapid improvement in broader financial market sentiment or conditions.

A recently provided market-based estimate of the deficit of $988 billion for FY09 is more than double the estimate released in July 2008 in the Mid-Session Review. Similarly, marketable borrowing needs are estimated to be double those of FY08. Lower corporate taxes and weaker withheld receipts in FY08 led to a decline in revenues for the first time since FY03. Meanwhile, outlays accelerated to their highest level since FY06, reflecting many of the measures that the government is undertaking to stabilize financial markets.

A number of initiatives undertaken by the Treasury, the Federal Reserve and the FDIC, to help stabilize financial markets, have pushed net marketable borrowing higher. In addition, reduced non-marketable debt issuance, large redemptions by the Federal Reserve related to the implementation of liquidity initiatives, the introduction of the Supplementary Financing Program (SFP), and expedited fiscal stimulus payments – all within a compressed time period - have necessitated the increased issuance of Treasury bills, cash management bills, and shorter dated nominal coupons.

In FY08, SFP bill issuance and redemptions by the Federal Reserve for liquidity purposes resulted in the Treasury's need to issue over $450 billion in additional bills and coupons. Moreover, state and local government issuance, for which net issuance was $58 billion in FY07, totaled a net *redemption* of $35 billion in FY08, and has continued this trend in FY09 with net redemptions to date of $10 billion.

Ramanathan noted that total cash management bills in FY09 year to date have totaled $475 billion including $330 billion for SFPs. This amount compares to $725 billion of CMB issuance for all of FY2008, including $300 billion for SFPs. At the same time, since the beginning of FY08, 2-year note and 5-year note issue sizes have increased $14 billion and $11 billion, respectively. Finally, in addition to increasing regular bills in FY08, Treasury introduced a monthly 52-week bill in July 2008. Bill and short-dated coupon issuance sizes stand at record levels. Despite borrowing across the curve, the average maturity has declined by three months in the last quarter.

Meanwhile, TIPS as a percentage of the overall portfolio has stabilized at 10 percent. Despite Treasury being the largest global issuer in the inflation-indexed sector, the sponsorship for shorter dated TIPS among investors is less enthusiastic than the sponsorship for longer dated TIPS and other Treasury products as evidenced by auction tails, cover ratios, and participation. Recent cost studies as well as investor participation statistics suggest that TIPS issuance, particularly for shorter-dated TIPS, has not reduced borrowing costs nor diversified the investor base, both of which were objectives at the start of the program.

Ramanathan noted that the breakeven rate on the most recent 5-year TIPS auction was negative 75 basis points implying higher costs versus nominal securities for Treasury as an issuer. Such a series of results in upcoming auctions would create additional costs for Treasury. Focusing on longer dated TIPS may be an approach to reducing effective costs, capturing a higher inflation premium, and increasing liquidity among benchmark TIPS instruments while at the same extending the duration of the portfolio.

Treasury's additional funding needs may need to be focused on other nominal coupon issuances beyond the short end of the curve. While the 2-year note to 5-year note sector raises cash in FY09, Treasury needs to be flexible beyond that time horizon as a result of the uncertainty regarding financing needs and due to the debt maturity profile of the portfolio. Treasury will continue to adjust issuance sizes in the front of the curve, but also look to

adjustments in the medium to longer dated sector of the existing curve to meet additional borrowing needs.

With these highlights, the Committee was asked for its views on debt issuance options and the optimal financing strategy given current projections and constraints.

A discussion followed with one member stating that Treasury was at a point where cyclical changes in borrowing needs were intersecting with secular changes in borrowing needs. Members noted that using bill financing to fund both the cyclical and secular changes was contributing to a shortening of the average length. A few members stated that net marketable borrowing could be as high as to $2 trillion in FY09, and Treasury needed to consider changes in auction sizes, auction frequencies, and also the offering menu.

Another member suggested that Treasury needed to be more transparent with some of the extraordinary measures being undertaken to assist financial markets, including insight into the asset structure of troubled assets being purchased by Troubled Assets Relief Program (TARP) This member stated that that it may be prudent to lengthen the average maturity in a manner consistent with the duration of the TARP assets.

A majority of the members however stated that extending average length at this point, given current cyclical and future secular shifts, may actually be desirable.

This spurred a discussion about whether Treasury should fund TARP purchases with special issuances. A member of the committee pointed out that Treasury had not matched liabilities with other past extraordinary expenditures such as wars or disaster relief. While members generally agreed that transparency around TARP was important, most members thought that issuing special liabilities, different from benchmark issues, was a more costly way to fund the extraordinary liabilities.

The Committee then turned to a discussion of how to fund the substantial borrowing needs facing Treasury. All members felt that Treasury should reintroduce 3-year notes, either on a on a monthly or quarterly basis, and that markets would not be surprised by the return of the 3-year note. Members debated whether the issue should be sold at mid-month or at month end as well as potential sizes of an initial offering.

A consensus developed that the issue should be a mid-month offering, with an initial offering size somewhere between the current offering sizes of the 2 year and the 5-year note. One member suggested that FDIC guarantees of bank debt for the next 3 years had the potential for creating a lot of congestion in the 3-year maturity sector. Other members pointed out that the FDIC guarantee would be rolling down the curve so that it should have minimal impact on Treasury 3-year issuance.

The Committee then suggested that Treasury add a second reopening of the 10-year note in the month following the first reopening, essentially creating monthly issuance of 10s. One

member stated that this change in the calendar would create large liquid 10-year issues and would assist in mitigating fails in the 10-year sector. Several members thought if Treasury introduced a second reopening that it should offer a large initial size, with scaled down first and second reopenings. Other members thought that, depending on borrowing needs, Treasury could auction a large initial size and more uniform second and third reopenings.

All members also felt that Treasury should expand the 30-year offerings, with varying opinions on implementation of this expansion. Most members felt it was sufficient to just offer four new initial bonds a year, one at each quarterly refunding. Other members suggested that Treasury should offer four new bonds with four reopenings in the month that followed the initial offering. One member thought that there was tightness in the current 30-year and the extra supply would benefit secondary market liquidity.

It was suggested that a reopening strategy would also reduce the duration and DV01 risk to the underwriting community by spreading supply across two auctions instead of one. One member suggested that Treasury consider monthly 30-year offerings via an initial offering once a quarter and 2 subsequent reopenings. This member stated that pension funds would potentially be willing buyers. In the end, it was the general view that Treasury offer four new initial 30 year bonds each year, and if the need arises, consider reopenings if financing needs warranted such a move. The Committee concluded that the 30-year bond frequency and size should be increased.

The Committee moved on to the second item in the charge concerning steps that Treasury could take to ensure efficient market functioning. Treasury outlined the existing cash and debt management tools available, including modifications to the Treasury Tax and Loan collateral provisions, the Term Investment option provisions, and the recently enacted authority to conduct Repurchase Agreement to a broad set of counterparties. These three programs provide means for Treasury to invest its cash balances in exchange for collateral in the form of securities. In addition, Treasury has other debt management tools including making adjustments to specific issues or to the auction calendar, as well as the ability to repurchase debt.

Ramanathan then raised the issue of the recent high level of settlement fails, and showed a chart that demonstrated that such episodes manifest themselves in periods of low interest rates. In particular, fails as of last week had decreased by nearly 70% since the reopenings which took place in early October, and Treasury's actions were well warranted.

While recent concerns by major securities lenders regarding counterparty risk have exacerbated the fails to deliver situation, addressing the core issue in light of existing market conventions is necessary. Changing market-trading conventions to eliminate the artificial price floor embodied in the master repo agreement and cash trading practices may provide economic incentives on both the demand and supply sides in a manner that will mitigate the prevalence of systemic fails.

Since November 2003, Treasury has repeatedly asked the private sector to address this issue proactively. On several occasions, market participants have emphatically stated that they

would resolve the situation without government intervention, but such steps have not been implemented. Treasury outlined several private sector steps which should be taken to resolve settlement fails including identifying pair-offs, bilateral processes between counterparties, cash settlement, and the initiation of negative rate repo trading.

The discussion turned to the recent unscheduled reopenings of four off-the-run securities in early October. The reopenings were taken to address borrowing needs. At the same time, the reopenings provided some ancillary benefit for improving liquidity in the Treasury market which was experiencing an unprecedented level of settlement fails.

A member acknowledged the successful steps which Treasury undertook in the midst of very large market dislocations, and commended the efforts of debt managers to address these issues quickly. The impact of these actions, according to this member, helped markets, and assisted in the resolution of certain dislocations.

One member pointed out that the reopening was not executed well but that it did help to fix fails, and that Treasury should consider being more opportunistic to take advantage of rich issues. Being opportunistic in this manner may help Treasury fund at low costs while also addressing the fails situation. Other members stated that certainty of supply was a hallmark of Treasury policy. A few members stated that such reopenings however would create a premium on Treasuries due to uncertainty of supply.

Another member asked the group if reopening issues was preferable to exchanging cheap off-the-runs for rich on-the-run issues via some sort of exchange offering facilitated by Treasury. Several members seemed to prefer the idea of targeting the demand side.

One member outlined a method of reopening issues where Treasury would offer certain dislocated securities on a routine basis on which the market could bid on. Treasury would reopen securities within the basket based on the best bids received. Over time, this could reduce the level of fails while providing low cost funding for the Treasury.

Another member cautioned that such a facility would encourage speculators to short issues in an attempt to guess which securities would be reopened. Other members questioned Treasury operational ability to implement such a program. Ramanathan concurred with both points and stated that such a program was operationally challenging.

Another member suggested that the behavior of holders of securities was adversely affecting the repo market and causing settlement fails. While this was a factor, several other members noted that dependence on a specific group of lenders without implementing potential solutions was not productive These members pointed out that there was little economic incentive to lend securities when general collateral rates stood at 20 basis points and the penalty for failing was zero basis points.

A member suggested that a negative rate of 200 or 300 basis points and margining of fails would create the correct economic incentives to cause holders of securities in low interest rate environments to lend securities again. This member suggested that market practices needed to change. Other members stated that attempting to force holders to lend was not feasible, and that industry efforts to prevent such problems need to be undertaken, particularly related to netting "daisy chain" fails and other issues.

Ramanathan stated unscheduled reopenings to fund the government would continue to be the exception, and that such actions were contrary to Treasury's policy of transparency, regularity, and predictability. Moreover, such actions had other less positive consequences. This reluctance to use unscheduled reopenings is consistent with a long-standing policy.

Ramanathan concluded the discussion by stating that the Treasury market must remain deep and liquid under all types of market conditions. The failure by the private sector to address the issues could result in the potential imposition of rules which would limit the overall efficiency of the Treasury market.

The Committee moved on to the third item on the charge dealing with credit market conditions and the impact of recent actions undertaken by the Treasury, the Federal Reserve and the FDIC. A Committee member was asked to deliver the presentation.

The presenting member began by noting that some financial market indicators suggest that financial markets have seen the worst and that credit market deterioration has at least stabilized, and may even be improving. The presenting member noted that swap spreads have narrowed from recent highs, both domestically and in Europe. In addition, commercial paper outstanding has started to increase, and the Federal Reserve has been very accommodating, expanding the monetary base by nearly 39 percent in recent months.

The presenting member also cautioned that while there are some positive improvements, markets are still showing signs of aversion to risk. Corporate and agency credit spreads are still high, default risk was elevated as measured by credit default swaps, and market volatility is still near record levels, reflecting a high degree of economic uncertainty.

The presenting member also highlighted some challenges including the high level of fails to deliver in the Treasury market which adversely impacts liquidity, the weakening balance sheet of the consumer, lending attitudes by banks as reflected by their hoarding cash, and asset allocations by investors away from risky assets. The presenting member concluded that it will take time for risk appetite to return to more historically normal levels.

After the presentation was completed, one committee member commented that this year was the first year that the Pension Protection Act was effective and that the recent substantial underfunding of pensions, related to the decline in equity prices, might create more financial market headwinds to the degree that companies will need to fund their pensions with cash.

The meeting adjourned at 12:00 PM.

The Committee reconvened at the Department of the Treasury at 6:00 p.m. All of the Committee members were present. The Chairman presented the Committee report to Acting Under Secretary for Domestic Finance Tony Ryan.

The Committee then reviewed the financing for the remainder of the October through December quarter and the January through March quarter (see attached).

A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:15 p.m.

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Karthik Ramanathan
Acting Assistant Secretary for Financial Markets
Director, Office of Debt Management
United States Department of the Treasury
November 4, 2008

Certified by:

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Keith T. Anderson, Chairman
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
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Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – November 4, 2008

Fiscal Outlook

Given Treasury's financing needs in the coming years as well as current and medium-term trends in the fiscal and economic outlooks, what are the Committee's thoughts on Treasury's debt issuance? What changes to the auction calendar do you recommend Treasury make at this time?

Treasury Cash and Debt Management Tools

Given the benefits of a liquid Treasury market and broad investor participation, what steps should be pursued to ensure continued efficient market functioning? Are there any other approaches to auctions, cash and debt management tools, and/or instruments that Treasury should consider?

Credit Market Conditions

The Treasury, Federal Reserve, and FDIC have undertaken a series of actions to strengthen public confidence in U.S. financial institutions and to foster the robust functioning of credit markets. Please discuss how these actions have impacted credit markets, what additional steps may be considered, and the implications of any current or additional steps on the Treasury market.

Financing this Quarter

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

- The composition of Treasury notes and bonds to refund approximately $54.9 billion of privately held notes maturing on November 15, 2008.
- 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, including cash management bills.