REPORT TO THE SECRETARY OF THE TREASURY

FROM THE

TREASURY BORROWING ADVISORY COMMITTEE

OF THE

SECURITIES INDUSTRY AND

FINANCIAL MARKETS ASSOCIATION

November 4, 2008

Dear Mr. Secretary:

Since the Committee's last meeting in late July, credit conditions have become more challenging and the outlook for the economy has deteriorated. Recent financial market dislocations and volatility are unprecedented and the resulting wealth destruction and heightened cost of capital will weigh on the pace of economic activity for a number of quarters. The unprecedented nature of the financial shock makes it difficult to forecast with any certainty the depth and duration of the recession.

Myriad policy action now being put in place will help to prevent an even more serious downturn than would otherwise occur. Monetary and fiscal policymakers' efforts to help recapitalize critical financial intermediaries, backstop key funding markets and stimulate economic activity through lower interest rates and other measures are positives. Nonetheless, the deleveraging process of both the financial and household sector has further to run.

Headline inflation is still elevated but is poised to slow notably. Commodity costs have plunged with the prices of some commodities down by more than half. Just as rising commodity costs lifted headline price statistics in recent years, the current decline in these costs will put downward pressure on inflation metrics in coming quarters. Meanwhile, core inflation also should moderate given sluggish economic activity and rising unemployment.

Federal Reserve officials have lowered the funds rate to 1% and the FOMC's latest statement indicated that policymakers are prepared to engage in further actions should circumstances warrant. Futures markets are discounting another reduction in the funds rate before year end. The lower policy rate and the volatility among risk assets has contributed to a marked steepening of the yield curve since the Committee last convened.

The spread between the two- and ten-year Treasury yield, for instance, has widened by about 100bp since late July.

Despite the creation of a myriad of facilities, direct capital injections into banks and numerous asset buying programs, credit conditions remain challenging and the outlook for the economy over the next year remains poor. The ongoing elevated nature of many money and credit market spreads underscore the still fragile nature of markets and likely have exacerbated the contraction in U.S. economic growth that is now underway.

The deterioration in the economy and financial markets has led to a commensurate decline in individual and corporate tax receipts. Tax receipts for the fiscal year ending in September 2008 declined by more than 5 percent from a year earlier and is the first decline since 2003. And while tax receipts registered a significant decline over the fiscal year, the outlays by the U.S. Government increased approximately 8½ percent over this same period.

Consequently, private forecasts expect the total deficit for fiscal year 2008 which ended on September 30 to be approximately $455 billion. And, projections for the fiscal year 2009 budget deficit are now very close to $1 trillion.

The deterioration in the budget deficit, combined with expenditures associated with the TARP, potential FDIC guarantees and expected additional stimulus spending have increased private forecasts for net borrowing needs by the U.S. Government for fiscal year 2009 to approximately $1.4 trillion. This forecast would grow further if the additional $350 billion TARP expenditures are approved by Congress within the fiscal year.

With those dramatic circumstances as a backdrop, the Committee tackled the Treasury's first charge which was to seek our advice on debt issuance over the coming quarters.

There was universal consensus on the Committee that the Treasury should announce major changes to its issuance calendar as soon as possible to insure that it can fund its obligations across the maturity spectrum.

The Committee strongly recommends a re-introduction of 3-year notes issued monthly in a size between those of the monthly issuance of 2- and 5-year notes. The Committee has long noted that this is the best choice for a new issue security, and financial market participants are widely expecting that this issue will be introduced.

Additionally, there was universal consensus on the Committee for the Treasury to increase the frequency of 10-year notes to a monthly schedule. Ten-year notes are a key benchmark issue and the market again is widely anticipating that monthly issuance is imminent.

There was also universal agreement on the Committee that the issuance of monthly 10-years notes occur with a quarterly new issue followed by two commensurately smaller re-

openings. For example, a November new issue of $20 billion followed by December and January re-openings of $15 and $10 billion respectively, or amounts determined by Treasury to be appropriate given financing needs and market acceptance. In this way, the Treasury will create large liquid benchmark issues that should serve as key benchmarks, and at the same time reduce the prevalence of delivery fails in the marketplace.

And, finally, the Committee also recommends that the Treasury increase both the size and frequency of 30-year bond issuance over the coming months.

Currently, the Treasury issues the 30-year bonds four times per year -- a new issue in one quarterly cycle followed by a re-opening the next quarter. The Committee was universal in its recommendation for increased size and issuance of 30-year bonds but was divided as to the exact schedule. About half the members recommended that the Treasury issue bonds eight times per year – a new issue quarterly followed by one re-opening the following month.

While remaining members recommended the Treasury follow the pattern of proposed 10-year issuance – a new issue quarterly followed by two commensurately smaller re-openings the next two months.

The Committee recognizes that these are significant changes to Treasury auction schedules but it is clear that the need for auctions is great and a specific path needs to be articulated to the market to ensure that the Treasury is able to achieve the lowest borrowing costs possible.

One member recommended that Treasury isolate and record the issuance and financing costs associated with the TARP and related "emergency" needs to distinguish them from the "core" financing needs of the U.S. Government. This member believes in so doing, policy makers will better control these costs.

In the second charge, the committee was asked for recommendations to enhance the ongoing efficiency of the U.S. Treasury markets in light of the significant increase in delivery fails. The nature of the broad investor participation in this market, coupled with recent pressures on U.S. and international financial markets, have presented some near-term anomalies in market functionality. Some of these anomalies have developed as a result of extreme volatility in other financial markets and will naturally be absolved with some form of return to normalcy, yet some proactive operational adjustments will serve to increase confidence in the market, as well as reduce overall borrowing costs for Treasury.

The acute desire to own risk less, liquid assets; i.e. Treasury securities has created extraordinary demand well beyond the existing available supply in the marketplace. Concerns related to money-market funds, the global banking system, and other "riskier" assets have been the primary driver of this flight to quality.

In addition, counterparty concerns on the part of the foreign owners of Treasury assets, which have been described as owning well over 50% of outstanding debt, has resulted in a greater reluctance to lend out these securities resulting in rampant fails in the repo markets. More over, the significant drop in rates, especially in the shorter-end of the curve, has made the cost of failing negligible creating little desire for short-sellers to close out their positions.

The committee believes that a balanced multi-pronged approach to dealing with these fails will significantly improve this market functionality. One member suggested that there should be a cost in the form of a penalty rate associated with fails in a low-rate environment. He suggested a fail-rate that could reach negative interest rates (as opposed to zero being the floor), which would allow the free market to determine the effective cost of the fail, and change the economics of securities lending. The member went on to suggest a margining charge for fails to reflect the credit risk associated with that fail activity.

The next part of this fail-directive would be a regular, coordinated tapping of outstanding issues. This clearly fits well with the aforementioned need for greater Treasury issuance. A number of proposals were mentioned to this end, such as frequent auctions of coupons as submitted to Treasury by the primary dealers. It was broadly felt that the announcement of new and scheduled re-openings of more “on-the-run” issuance would naturally improve the situation.

In summary, the benefit of this multi-pronged fail directive would be to mitigate the damage incurred from massive fails in particular on-the-run (and some off-the-run) securities, with the benefit being lower borrowing rates for Treasury across the curve.

Treasury’s third charge to the Committee was a fairly broad inquiry on the state of credit market conditions, the effects of previously announced actions and recommendations for further action.

One member gave a prepared presentation to the group which is attached to these minutes. In this presentation, the member reviewed the significant changes in credit conditions over the year and highlighted some of the recent improvements that have occurred as result of U.S. and foreign government actions and programs.

In particular, this member noted the healing that has occurred in the money markets and in the libor inter-bank markets.

The member also noted, however, that despite these tentative signs of healing that credit markets overall remain under severe stress and that credit spreads are very wide and little new issuance is occurring.

One member recommended that Treasury should consider entering into a swap agreement with FNMA and FHLMC to enable them to grow their mortgage portfolio without the need to issue new debt under their name. If the mandate for these GSE’s is to “grow for a

short period" and then to "shrink" then it doesn't make sense for them to issue additional paper given the ambiguity of their future mission and the wide spreads to Treasuries that their bonds trade in the marketplace.

In the final section of the charge, the committee considered the composition of marketable financing for the October - December Quarter to refund the $55.0 billion of privately held notes and bonds maturing November 15, 2008 the Committee recommended a $30bn 3-year note due November 15, 2011, a $20 billion 10-year note due November 15, 2018 and an $8 billion 30-year bond due November 15, 2038. For the remainder of the quarter, the Committee recommends a $37 billion 2-year note in November and a $40bn 2-year note due in December, a $30bn 3 year note in December, and a $27 billion 5-year note in November and a $28bn 5-year note in December, and a $15 billion re-opening of the 10-year note in December.

For the January - March quarter, the Committee recommended financing as found in the attached table. Relevant figures included three 2-, 3-. 5- and 10-year note issuances monthly, a 30-year bond in February followed by a re-opening in March, as well as a 10-year TIPs note in January, and a 20-year TIPs re-opening later that same month.

Respectfully submitted,

Keith T. Anderson
Chairman

Rick Rieder
Vice Chairman

Attachments (2)
Table Q4 08
Table Q1 09