TBAC Discussion Charts

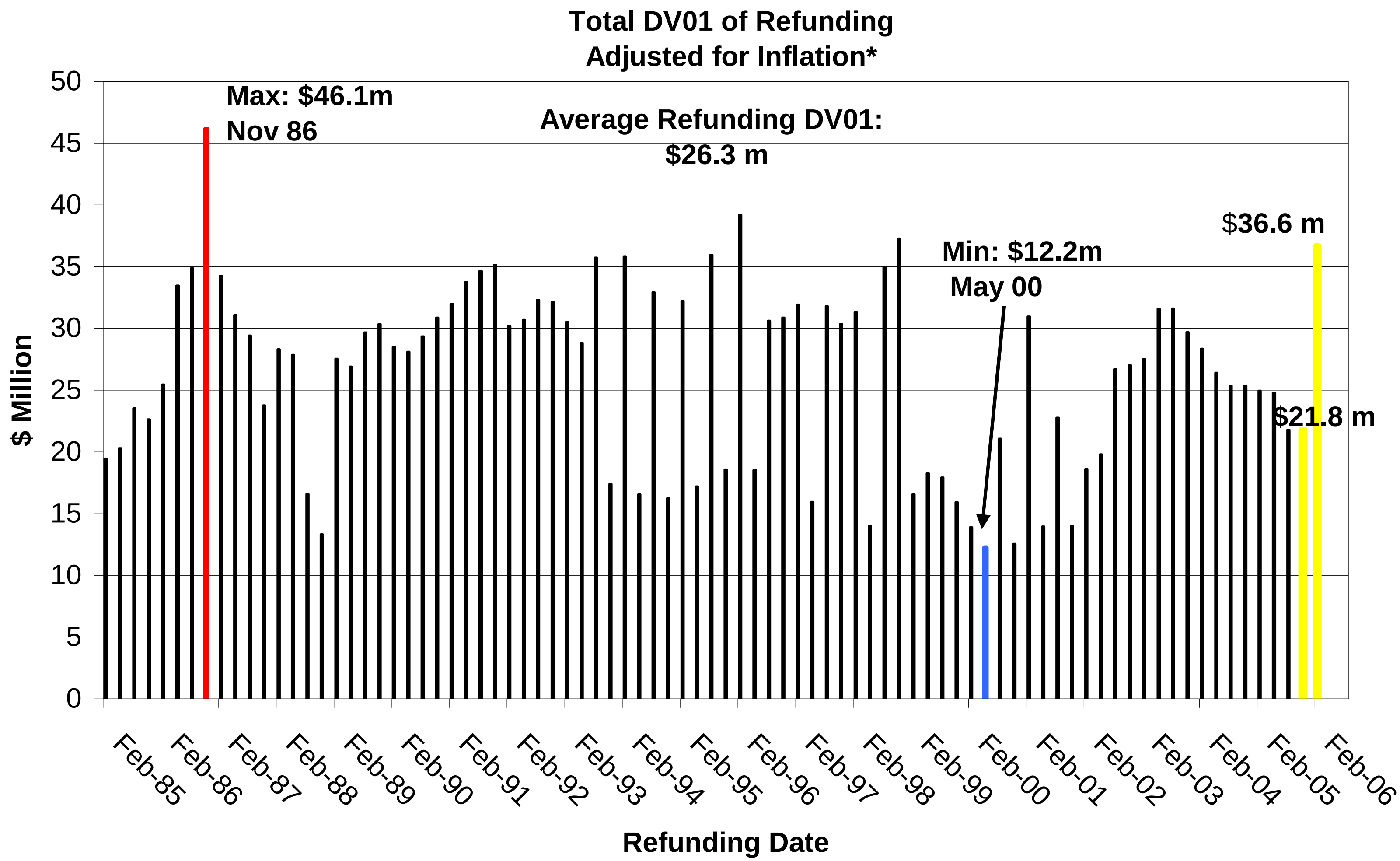
November 1, 2005

Potential Adjustments to Treasury's Auction Calendar

- Bring the 30-year bond into refunding week semi-annually; and

- Move <u>all</u> 5-year note auctions to month-end.

A Historical Look at Refundings' DV01



Nov 2005 forecast assumes 3,5,10 year issuance of $18b, $13b, and $13b, respectively.
Feb 2006 forecast assumes 3,10,30 year issuance of $18b, $13b, and $12.5b, respectively.

**Data adjusted to 2005 dollars using GDP deflator*

30-year Bond into Refunding Week

- Auction on February/August cycle in 2006 during refunding week;

- Dated date of 15^{th} to ensure fungibility with outstanding bonds; and

- Settlement on 15^{th} of month or next business day if weekend or holiday.

5-year Note to End of Month

- End of month dated date;

- End of month settlement; and

- Like two-year note, would settle first business day of next month if the end of the month is on a holiday or weekend.

Treasury Auction Calendar at Month-End

- 2-year also auctioned monthly at month-end as are semi-annual 5- and 20-year TIPS.
- Quarterly (Jan/April/July/Oct) this would result in 3 coupon auctions in a week, similar to refunding week.

Clustering Auctions

- **Pros**

  - Create liquidity event, garner greater market interest in upcoming auctions, increasing demand and potentially reducing borrowing costs.

- **Cons**

  - Concentration of issuance increases dealer risks – possibly resulting in lower demand and higher Treasury borrowing costs.

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?

- 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?

- What is the potential impact of a February/August 30-year cycle on 20-year TIPS auctions?

Coupon Auction Calendar With 5-year at Month End
September 2006 Hypothetical

Monday	Tuesday	Wednesday	Thursday	Friday
11	12	13	14	15 Settle 10-year
18	19	20 FOMC	21	22
25 Announce 2-year note Announce 5-year note	26	27 Auction 2-year note	28 Auction 5-year note	29
2 Settle 2-year note, 5-year note	3	4	5	6

Coupon Auction Calendar With 5-year at Month End
October 2006 Hypothetical

*** Note – movement of the 5-year TIPS auction to Monday which would regularly be held on Tuesday due to FOMC**

Monday	Tuesday	Wednesday	Thursday	Friday
9 HOLIDAY	10 Announce 10-year TIPS	11	12 Auction 10-year TIPS	13
16 Settle 10-year TIPS	17	18	19 Announce 5-year TIPS	20
23 Auction 5-year TIPS * Announce 2-year note Announce 5-year note	24 FOMC	25 Auction 2-year note	26 Auction 5-year note	27
30	31 Settle 5-year TIPS, 2-year note, 5-year note	1 Announce 3-year Announce 10-year	2	3

Coupon Auction Calendar With 5-year at Month End
November 2006 Hypothetical

Monday	Tuesday	Wednesday	Thursday	Friday
6	7 Auction 3-year note	8 Auction 10-year note	9	10 HOLIDAY
13	14	15 Settle 3-year note Settle 10-year note	16	17
20	21	22 Announce 2-year note Announce 5-year note	23 HOLIDAY	24
27 Auction 2-year note	28 Auction 5-year note	29	30 Settle 2-year note, 5-year note	1

More on a
Treasury Backstop 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 additional thinking on the 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.

Costs of Periods of Chronic Fails:
Ultimately Higher Borrowing Costs

- Impaired Liquidity in Cash and RP Markets
  - Loss of willingness to lend securities in the RP market
  - Reduced secondary market liquidity may lead to erosion of the liquidity premium Treasury receives for securities at auction
- Operational Cost of Resolving Fails
  - Manual handling of transaction
  - Cost of risk management of fails – oversight of counterparties
- Increased Regulatory Oversight
  - Cost of compliance, burden from increased scrutiny and reporting
- Loss of Price Convergence in Futures Market
  - Erodes usefulness for hedging resulting in loss of demand for Treasury securities
- Exposure of Participants to Credit Risk
- Potential Erosion of Benchmark Status

Alternatives to a Backstop Securities Lending Facility

- Voluntary market-based solutions such as "prompt delivery trades"
- Reopenings or other method of increasing outstanding supply (e.g., tap issue)

Characteristics of "Prompt Delivery" Contracts

- Facilitates trades with negative interest rates
- Only applies to the opening leg of an RP transaction – not the closing leg
  - Failure to have the security returned lowers the earnings to the lender of the scarce security
- Cannot motivate use without better certainty of supply

Characteristics of Reopenings and Other Methods of Increasing Outstanding Supply

- Permanent increase in outstanding supply
- Discretionary: Judgments by Treasury inherently subjective
- Uncertainty about the appropriate additional amount to supply
- Increases expectations that debt management policy will be tailored to accommodate the collateral market
- Treasury unnecessarily introduces an additional speculative component to securities prices

Characteristics of a Standing Nondiscretionary Securities Lending Facility

- Prevents settlement fails from becoming systemic
  - In place at the onset of chronic fails episode
- Additional supply is temporary
  - Increase in outstanding supply reverts to originally issued amount after resolution of fails episode
- Encourages market-driven solutions to supply-demand imbalances
  - If additional securities offered at a penalty rate, may facilitate market resolution of fails through the use of "prompt delivery" contracts at rates above the lending facility rate
  - Could encourage development of completely new solutions
- Requires incentives to compel use if securities offered at a penalty rate

Possible Incentives for Use of a Securities Lending Facility at a Penalty Rate

- Changes in voluntary market conventions regarding fails
- Changes to contractual requirements
- Changes to the regulatory regime such as a stricter buy-in rule

How Should a Lending Facility be Designed?

Issues:

- Should pricing, quantity or some other trigger be used that allows the facility to kick in?
- How will use affect trading of Treasury securities?
- How should rate, maturity and settlement be set?
- Do not want to encourage speculation exacerbating chronic fails
- Possibly viewed as favoring larger market participants who could wait for smaller firms to be forced to borrow securities at a penalty rate to clear fails (i.e. “winners curse”)
- May not clear fails in secondary market and could merely result in transferring fails to Treasury
  - This risk, however, is smaller than for private market participants because Treasury would be a fully secured lender