REPORT TO THE SECRETARY OF THE TREASURY FROM THE TREASURY BORROWING ADVISORY COMMITTEE OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS ASSOCIATION

April 29, 2009

Dear Mr. Secretary:

Since the Committee convened in early February, the contraction in economic activity has persisted, while financial conditions have remained restrictive. The fastest pace of economic contraction now appears to be in the past, but the economic outlook remains challenging. Policy efforts have helped to stabilize financial market volatility and, importantly, are beginning to unlock credit for high-quality borrowers. But the economy-wide cost of capital remains arduous, especially vis-à-vis the level of risk free rates. The difficult credit environment joined with ongoing financial sector delevering, considerable wealth destruction and rising unemployment are serious hurdles to a new economic expansion taking root in coming quarters.

Monetary and fiscal policy efforts are helping to curb the pace of economic contraction. Policymakers' efforts to restore the flow of credit to households and businesses, backstop critical financial intermediaries through capital injections and loan guarantees, and stimulate economic activity via quantitative easing, tax cuts and government spending are very helpful. Nonetheless, the necessary deleveraging of both the financial and household sector is considerable and has further to run. In this context, policy is a stabilizing, not stimulatory force.

Price pressures are receding rapidly. Headline inflation has turned negative for the first time in more than five decades and less volatile core inflation also is easing significantly. Multi-decade highs in unemployment and spare capacity are forcing businesses to price goods and services competitively or risk steep declines in profits. Weak labor market conditions – employers are cutting not only headcount, but also hours and compensation of workers still on payrolls – are sustaining the specter of deflation. Given elevated debt levels, such an outcome would be extremely problematic for the financial sector and real economy.

With the federal funds rate at its lower nominal bound, the Federal Reserve has embarked on credit and quantitative easing in an effort to improve financial conditions. Fed officials have committed to purchasing more than a trillion dollars of Treasuries, Agency mortgages and Agency notes to reduce the cost of capital. Meanwhile, the TALF program now underway is producing more favorable – but still elevated by historic standards – financing costs in the asset-backed securities market.

Treasury yields across the term structure have been range bound since the Committee met in February. Yields on the 30-year bond have risen as of late and are probing their highest level since Autumn 2008. With inflationary pressures scant, the rise in long-dated rates largely is a by-product of the Treasury's outsized funding needs in the period ahead.

Those outsized funding needs reflect the lackluster outlook for economic growth and the expansionary budgets being pursued by Congress and the Administration. Tax receipts are collapsing amid economic malaise. Revenue is down by nearly 14% in the first half of FY09 and April receipts are tracking their weakest level in years. At the same time, public expenditures continue to surge as automatic stabilizers (unemployment compensation, food stamps, etc.) kick in and the government plows resources toward stabilizing financial firms and domestic demand. In sum, fiscal outlays have increased by over 30% on a year over year basis.

Treasury's net borrowing needs likely will total about $2 trillion this year, a staggering one-seventh of GDP. Given the outlook for the economy, the cost of restoring a smoothly functioning financial system, and the pending entitlement obligations to retiring baby boomers, the fiscal outlook is one of rapidly increasing debt in the years ahead. While unlikely to materially affect real long-term interest rates today, such a fiscal path could force real rates notably higher at some point in the future.

Against this backdrop, the Treasury's first charge to the Committee was to solicit our advice and recommendations for issuance over the short, intermediate and longer term given the deterioration in the fiscal budget outlook.

There was universal agreement on the Committee that further expansion of the coupon auction calendar was needed to meet the growing projections for net borrowing needs and the goal of arresting the decline in the average maturity of the debt. The average maturity of the debt has shortened due to the increased proportion being met by bill issuance over the last year. The average maturity of the debt peaked at over 70 months in 2000 and declined to approximately 55 months in 2002. It held relatively steady for several years but fell sharply to approximately 49 months, or only 4 years, recently.

After some discussion, it was the Committee's conclusion that Treasury should incrementally increase the size of all coupon issues toward levels that the market could absorb and allow the Treasury to meet its financing needs over the short to intermediate term.

It is the committee's conclusion that the optimal level of issuance for each coupon maturity given today's market conditions and financing needs are as follows:

The 2-year and 3-year note should be increased incrementally toward a size of $50 billion and $40 billion monthly, respectively.

The 5-year and 7-year notes should be increased incrementally toward a size of $40 billion and $28 billion monthly, respectively.

The 10-year note issuance should be increased to $75 billion quarterly distributed among the initial auction and its two subsequent re-openings.

And, finally, the 30-year bond issuance should be incrementally increased to $45 billion quarterly distributed among the initial auction and two subsequent re-openings. The Committee is recommending that a second re-opening of the 30-year bond is added to facilitate this issuance.

The Committee believes that these actions will greatly assist the Treasury in achieving its objective of meeting its financing requirements at the best rates available over a long horizon.

Given the continued uncertainty over the economic situation and the potential need for greater financing requirements over time, the Committee also discussed several additional alternatives for Treasury.

The Committee discussed the benefits and costs of adding additional issues to its calendar including a 4-year maturity issue, and 20-year maturity issue and a super-long maturity such as a 50-year bond.

There was general agreement by the Committee that none of these additional issues would be helpful to the Treasury at this time, though each should be studied further.

Several members suggested that a twice-monthly issuance of 2-years, or a similarly popular issue, might be a better solution if needed than introducing a new security such as a 4-year note.

And, finally, the Committee discussed TIPs issuance and once again concluded that the Treasury would be ill-advised to increase the issuance of securities that historically and currently trade quite cheap to nominal issues. While many market participants and analysts enjoy the flexibility offered by TIPs, they have proven to be very costly to Treasury relative to nominal securities ex-post, as demonstrated in previous studies by TBAC.

In the second charge, the committee was asked to address a number of factors influencing Treasury issuance and the auction process. It was asked to consider factors such as the growth of issuance of agency, U.S. government or other sovereign-guaranteed or supranational debt as an impact on Treasury issuance, as well as the existing implicit factors impacting Treasury auction or issuance requirements, such as auction-timing, Fed actions/borrowing requirements, and the absolute demand for its burgeoning borrowing needs.

A member of the committee gave a presentation on all of these factors, highlighting some historic changes impacting Treasury issuance and demand. The member cited the very significant growth in global deficits, and the commensurate issuance requirements for several G7 countries suggesting some potential for competitive issuance over the coming months.

This increasing international supply dynamic is also up against some potentially changing demand dynamics. The Treasury has recently benefited from the demand from flows into bond funds. In addition, over the past few years trade surpluses in foreign countries have created tangible demand for Treasury product as countries chose to recycle those dollars. Treasuries will probably not receive the same favorable demand treatment from either source over the coming quarters. In addition, some supply from other quasi-government debt sources has created competition for those same dollars.

The member stated however, that the significantly changing fabric of the fixed income markets would mitigate some of these influences. Reduced borrowing patterns from other asset classes such as Mortgages, Corporate credit and the traditional GSE's will result in passive indexed investing becoming more heavily weighted towards Treasuries. Also, the Fed buying of Treasuries is creating at least temporarily, a real demand source for existing secondary issues.

The most critical influence in the Treasury market today however, is clearly the need for ongoing issuance related to the current and projected fiscal deficits and future refinancing requirements, plus the oncoming funding requirements for programs such as Medicare, Medicaid and Social Security. In fact, it is these secular financing needs for entitlement spending which once seemed so distant, that has many market participants concerned. The fear is that there may be little reprieve from cyclical financing needs once the economy improves, given the secular forces in front of us.

Faced with these issuance needs, the member suggested that the inevitable improvement in economic conditions would likely result in fewer inflows into Treasuries from the private sector, as well as from the Fed. This coupled with the potentially reduced demand for Treasuries from foreign sources could put medium to long-term pressure on interest rates.

With this in mind, the committee discussed the need for Treasury to extend the duration of the borrowing base to reap the benefits of an attractive rate environment today, coupled with the anticipation of a more expensive borrowing dynamic in the future. The committee reinforced some of the recommendations described earlier such as larger coupon note issuance, and a lesser reliance on the Bill sector in the near future.

The member provided some specific data and recommendations for auction activity such as the weaker performance of auctions on Mondays (larger tails and fewer indirect bids), suggesting that Treasury consider limiting only shorter maturity auctions to such days. The members also highlighted some recent Treasury price swings around the recent Fed buying, suggesting that Fed and Treasury seek to avoid overlapping issuance and purchases where possible.

In its third charge to the Committee, the Treasury sought our thoughts and opinions on the success of various actions taken by the authorities to ease credit conditions in the U.S. One member prepared and presented his thoughts on the issue and a copy of those exhibits and charts are attached to these minutes.

This member's conclusions are that government programs have, on balance, been very helpful in easing credit conditions particularly within the inter-bank lending markets and for many high quality structured securities.

The member highlighted the particular success of the Capital Purchase Program (TARP) and the TLGP program in easing bank and inter-bank financing markets as illustrated by the significant narrowing of LIBOR-OIS spreads.

This member also noted that the much maligned TALF program has, in fact, had a positive impact on high grade asset-backed securities including auto loans. This, in fact, was a view that was echoed by many on the committee.

Additionally, the member noted that the direct purchase by the Fed and Treasury of agency-backed MBS has also had a significant effect on the spreads and absolute yield of these securities. In addition, some new issue markets such as investment grade credit, high yield credit, and equity IPO's are showing improved activity and issuance.

While many of these programs have proved effective, the member also noted that the credit markets are far from normal and that for many borrowers such as those seeking commercial mortgages, home equity loans, and non-agency jumbo mortgages the markets are still fractured, if not effectively closed. Simultaneously, non-guaranteed financial issuance is growing, albeit only for a select few at this point.

In addition, several members voiced their concerns that while these programs have been helpful to date, that they are very concerned about the exit strategy by the Federal Reserve and Treasury when markets recover. One member highlighted that the Federal Reserve's purchase of Agency MBS far exceeds the net issuance in that market and while it may be having a very positive effect on rates today it might also create significant dislocations in the future.

In the final section of the charge, the committee considered the composition of marketable financing for the April to June Quarter to refund the $52 billion of privately held notes and bonds maturing May 15, 2009. The Committee recommended a $35 billion 3-year note due May 15, 2012, a $23 billion 10-year note due May 15, 2019 and a $15 billion 30-year bond due May 15, 2039.

For the remainder of the quarter, the Committee recommends 2-year notes of $42 billion in May and $44 billion in June, 3-year notes of $36 billion in May and $37 billion note in June, 5-year notes of $36 billion in May and $37 billion in June, 7-year notes of $27 billion in May and $28 billion in June, $21 billion re-openings of the 10-year note in May and June, and $12 billion re-openings of the 30-year bond in May and June.

For the July to September quarter, the Committee recommended financing as found in the attached table. Relevant figures included three 2-year, 3-year, 5-year and 7 year note issuances monthly, 10-year note and 30-year bonds in July followed by re-openings in

August and September, as well as a 10-year Tips note in July, and a 20-year TIPS re-opening later that same month.

Respectfully Submitted,

Keith T. Anderson, Chairman

Richard M. Rieder, Vice Chairman