Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
Of the Securities Industry and Financial Markets Association
July 29, 2008

The Committee convened in closed session at the Hay-Adams Hotel at 10:30 a.m. All Committee members were present. Acting Undersecretary for Domestic Finance Anthony Ryan and Office of Debt Management Director Karthik Ramanathan 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 the Committee's advice on whether the recent adjustments to the financing schedule provided Treasury with sufficient debt management tools to handle a wide range of budgetary and financing outcomes, or if additional adjustments should be considered.

To provide background, Director Ramanathan delivered a presentation to the Committee which highlighted current credit market conditions and potential factors to consider in addressing this issue. In particular, current credit market conditions remained volatile, and potential pressures on corporate tax receipts and individual withheld taxes could increase Treasury's borrowing needs in FY 2008 and FY 2009.

Director Ramanathan noted that marketable borrowing – i.e. borrowing from the public – is projected to total $555 billion in FY 2008 versus just $134 billion for FY 2007, and that this large increase warranted the Committee's focus.

The potential weakness in receipts as a result of the challenges facing the economy as well as reduced non-marketable debt issuance, large redemptions by the Federal Reserve in conjunction with its various liquidity initiatives, and expedited payments related to the fiscal stimulus package – all within a compressed time period - necessitated the increased issuance of Treasury bills, cash management bills, and shorter dated nominal coupons. Redemptions and outright sales by the Federal Reserve since the beginning of the fiscal year for liquidity purposes have resulted in the Treasury's need to issue over $150 billion in additional bills and coupons. Moreover, state and local government issuance for which net issuance was $58 billion in fiscal year 2007 versus total a net redemption of $10 billion in 2008 fiscal year to date.

Director Ramanathan also noted that total cash management bills in FY 2008 year to date total over $300 billion versus about $250 billion for all of FY 2007. At the same time, 2-year note issue sizes have increased $13 billion year to date and 5-year note issue sizes have increased $8 billion. In addition to increasing bills by over $200 billion this fiscal year, Treasury introduced a monthly 52-week bill in July 2008. Nonetheless, debt rollover and average portfolio metrics have changed modestly and remain within historical ranges.

Based on deficit projections from the recently released Mid Session Review, as well as estimates provided by primary dealers of $413 billion for FY 2008 and $422 billion for FY 2009, Director Ramanathan noted that 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 borrowing needs.

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

A Committee member began by asking about the average maturity of the debt, noting that Treasury had over the last year issued a significant amount of debt in bills and short to intermediate coupons. Director Ramanathan explained that the current average maturity was 56 months, well within the historical norms of the last 30 years. Treasury does not target an average maturity at this time, but feels comfortable with this measure being within historical norms as long as overall flexibility is maintained.

Another Committee member asked if the volatility in the cash balance was typical of prior years. Director Ramanathan replied that while cash balances maintain a seasonal pattern, the current fiscal year has seen more volatility due to many factors including liquidity intitatives, stimulus payments, unexpected outlays, and a decline in the growth of receipts.

The member pointed out that Treasury has benefited from the flight to quality, but needs to consider the situation in which credit market conditions improve. Several members stated that Treasury's issuance of bills was clear and transparent given its needs, and that at some point, the Federal Reserve would look to reconstitute its portfolio. As a result, Treasury's marketable borrowing needs would decline. Another member commented that the short to intermediate coupon sector has seen significant increases in issue sizes and that moving further out the curve was prudent.

Another member pointed out that there was a significant uncertainty in the fiscal situation posed by dislocations in the credit markets, the slowdown in the economy, supplemental expenditures, and the imminent need for large entitlement spending (Social Security, Medicare, and Medicaid, etc.). Given the recent increases in shorter term funding and the sizable projected borrowing needs going forward, the member believed that this may be the time to recognize that the borrowing needs were becoming more structural. This member continued by stating that Treasury should consider increasing its maturity profile using existing securities to meet these financing needs.

A discussion followed regarding the best method for Treasury to raise cash and reduce rollover risk. One member, noting the chart with the maturity profile indicated that there was room to add issuance that matures in the 2011 to 2013 region and also to add maturities in the 2019 to 2028 region. This member suggested adding 3-year notes or 10-year notes to more evenly distribute the debt profile..

Another member suggested that Treasury first consider issuing 10-year notes monthly, either through a double reopening or through new initial offerings of 10-year notes each month. This same member also suggested that Treasury offer new initial quarterly 30-year bonds, as opposed to the current practice of offering a combination of new and reopened 30-year bonds. Another member stated that there would be substantial demand for securities greater than 5-year in length from investors seeking to add duration. Several members stated that there may also be substantial demand for longer-term products, specifically 10-year notes, from accounts seeking to hedge mortgage duration.

A few members noted that the current 30-year auction cycle with an initial offering and reopening with accrued interest was unduly, and that Treasury should switch to original issue 30-year bonds. Director Ramanathan noted that Treasury moved to the current cycle of 30-year bond issuance to enhance liquidity in the STRIPS market by adding May/November maturity points, but that Treasury understood that such an adjustment may improve the debt maturity profile.

Alternative maturity points were discussed briefly by the committee. One member commented that previous issues of 4-year notes, 7-year notes, and 20-year bonds always traded at a discount. This member thought it would be costly to issue at those points or any “new” points outside of current points at this time. Another member stated that if Treasury were to increase 10-year and 30-year issuance, it could then reintroduce a 3-year to meet even greater than expected borrowing needs as well as to prevent average maturity from extending too far. Another member stated given the projected secular borrowing needs, Treasury should consider new liquidity points, including 50-year bonds or callable issues, but that such issuances we unnecessary at this point and prior to all of the other adjustments Treasury could make in their place.

A general consensus developed that Treasury should consider issuing 10-year notes with two reopenings instead of one reopening, and also move to new issue quarterly 30-year bonds. In addition, the Committee generally agreed that there was additional room in the front end of the curve to make modest increases in 2-year and 5-year notes, and that further deterioration in the fiscal outlook could be met by reintroducing the 3-year note or other such securities.

After finishing this discussion relate dto the fiscal outlook, the Committee moved on to the second item on the charge dealing with credit market conditions. The presenting member began by reviewing the history of the funding strains that were characteristic of recent credit market conditions. The member noted that LIBOR/OIS spreads were significantly more volatile and were trading at elevated levels relative to the historical trends. Similarly, credit default swaps for banks were trading higher. High volatility in LIBOR/OIS reduced investor confidence by creating strains in the repo markets, resulting in wider bid-ask spreads and less liquidity.

The Committee member then discussed the various Federal Reserve initiatives designed to enhance liquidity. The presenter began with the a discussion of the Term Auction Facility (TAF) noting that it had grown in size from $40 billion from its inception in December of 2007 to its current size of $150 billion. At the current size, bid-to-cover ratios were around 1, suggesting that some level of equilibrium had been reached. The presenting member suggested that while the TAF has been effective in reducing 1 month LIBOR/OIS spreads lower by over 60bps, 3 month LIBOR/OIS spreads remained elevated at 80 bps. The presenting member suggested extending the TAF to 90-days to complement the current 1-month TAF. The presenting member then provided background on the Treasury Securities Lending Facility (TSLF) and the Primary Dealer Credit Facility (PDCF) as well as their impact on Treasury issuance. The presenting member noted that Treasury Bills and Treasury repo have cheapened due to increased Treasury issuance and as a result of the initiatives of the Federal Reserve.

The presenting member then moved on to investor activity and sentiment. The presenting member noted the increase of assets flowing into money market funds. The member noted that a reconstitution of the SOMA portfolio could mitigate any significant improvement in market conditions, but that Treasury would be prudent in extending its portfolio. The presenting member also noted that GSE discount note issuance has doubled and that the Federal Home Loan Bank had provided $380 billion of funding in return for mortgage collateral.

After the presentation was completed, Committee members commented on the various issues related to credit markets. One member commented that tri-party best practices would be extremely helpful especially if it included a discussion on clearing agent responsibilities. One member suggested regulation in the repo market might prevent some of the fails. Another member remarked that if issues like rollover risk in tri-party repo were addressed, investor confidence would further benefit. Finally one member suggested that concerns in the repo market should be resolved before PDCF is eliminated.

The Committee then moved on to the second presentation to Treasury which focused on TIPS and trends in inflation. The presenting member begun by noting that while headline CPI should remain well above 5% for the rest of the year, it is expected to collapse to core next year even if oil were to increase an additional $10 from current levels. The Committee member then noted that most surveys related to inflation lacked any significant predictive power and tended to be reactive to current inflation.

The presenting member noted that even with $497 outstanding in the TIPS market, daily trading volume is estimated to be $8 billion, representing a daily turnover of total outstanding of about 2%. By comparison, average daily turnover in the $4 trillion nominal Treasury market is estimated to be nearly 14%. The member pointed out that TIPS seem to have reached a plateau in terms of trading volume despite Treasury's continued efforts to grow the market. The member also stated that the TIPS market appealed to "buy-and-hold" investors while the nominal market attracted many more traders.

The presenting member then stated that TIPS have been a good value to investors, helping them to diversify inflation risks in fixed income portfolios and to express views on realized and expected inflation. The key downside for investors is the illiquidity of the product. Moreover, liquidity does not seem likely to improve given the private sector's reluctance to issue inflation indexed securities. This reluctance on the part of private issuers to issue such debt reflects very high costs (and uncertainty) associated with such issuance, very little fundamental depth of demand, and FAS-133 hedge accounting related issues.

On the other hand, from Treasury's perspective, while TIPS have modestly diversified the investor base, there have been substantial associated costs. The presenting member developed a cost model comparing TIPS issuance versus potential nominal coupon issuance, and concluded that the aggregate cost of the TIPS program was over $30 billion. This cost reflects the fact that realized inflation has been higher than expectations.

The member noted that excess expense of the TIPS program compared to the equivalent amount of nominal issuance is 30% of the overall program expense this year. The cost for the lack of liquidity in TIPS makes up 22% of the excess cost, or approximately $1 billion a year. The presenting member viewed this cost as non-transient. The other 78% of the excess cost was related to the difference between realized inflation and expectations. The presenting member measured liquidity differentials by comparing TIPS and nominal asset swap spreads.

Finally, the presenting member stated that TIPS did not gain the same flight to quality bid that nominal securities did in the recent credit market tightening which in turn caused an increase in the cost of 5-year TIPS relative to the 10-year TIPS and 20-year TIPS. The Committee member concluded the presentation by stating that extending the average maturity of the TIPS portfolio was not so obvious given variable demand at the 20-year point.

The Committee generally agreed that an increase of average maturity in the TIPS program would be best accomplished by reducing or eliminating 5-year TIPS issuance. There was general agreement that given the excess cost to date and the non-transient liquidity premium of TIPS, inflation indexed secruties over the past 10 years have proven to be a less efficient funding mechanism given Treasury's objective of the lowest cost of borrowing over time. The Committee also reiterated its previous suggestion of moderating the growth of the program and eliminating 5-year TIPS issuance.

Director Ramanathan responded by stating that Treasury remained committed to the TIPS, but that a moderation in the growth of the program has occurred given the pace of issuance ver the past ten years relative to nominal issuance.

One member remarked that the lack of a swaps market for TIPS or any sort of liquid CPI-U NSA inflation derivatives market made the TIPS market unattractive to private issuers. This factor helped to explain why TIPS were currently a more costly financing vehicle for Treasury relative to comparable nominal issuance. Another member stated that many investors were not interested in hedging CPI-U NSA. The lack of an inflation derivatives market also prevented short sales of TIPS, which reduced trading volumes and helped explain why there was no flight-to-quality buying in stressed markets.

Another member stated that TIPS should not be considered a growth product in the Treasury debt issuance portfolio. The product was complicated to price, the return profiles were difficult to explain, and the tax treatment made it unattractive to many accounts.

Another member noted, however, that globally there was growing interest in inflation-indexed products, and that if inflation were to continue to rise, there could be additional demand for TIPS. One member suggested that much of that interest was driven by regulatory induced demand that required investors to hold assets that are inflation indexed.

To conclude the discussion, a member asked if another distribution mechanism should be considered for selling TIPS such as by subscription with a price determined by Treasury. Members recommended that Treasury maintain its auction disctibutin method, but study the alternative strategy further.

The meeting adjourned at 11:56 a.m.

The Committee reconvened at the Hay-Adams Hotel at 6:00 p.m. All of the Committee members were present. The Chairman presented the Committee report to Acting Under Secretary Ryan.

The Committee then reviewed the financing for the remainder of the July through September quarter and the October through December 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 6:20 p.m.

Karthik Ramanathan, Director
Office of Debt Management, United States Department of the Treasury
July 29, 2008

Certified by:

Keith T. Anderson, Chairman
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
July 29, 2008

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – July 29, 2008

Fiscal Outlook

Given Treasury's financing needs in the coming years as well as current and medium-term trends in the economic outlook, what are the Committee's thoughts on Treasury's debt issuance? In particular, we would like the Committee's advice on whether the recent adjustments to the financing schedule provide Treasury with sufficient debt management tools to handle a wide range of budgetary and financing outcomes, or if additional adjustments should be considered.

Credit Market Conditions

Treasury seeks the Committee's perspectives on the current conditions of credit markets. What are investors' perceptions of risk in light of previous actions by the Federal Reserve, including its introduction of various temporary facilities such as the Term Securities Lending Facility and the Primary Dealer Credit Facility, and additional recent initiatives by the Treasury and Federal Reserve? What are the implications for financial market investors, regulatory oversight, and market infrastructure, as well as their potential impact on Treasury market dynamics?

TIPS and Inflation Trends

In light of recent trends, Treasury would like the Committee's views on TIPS, particularly in regard to issuance of shorter-dated versus longer-dated inflation-indexed securities.

Financing this Quarter

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

- The composition of Treasury notes and bonds to refund approximately $43.5 billion of privately held notes maturing on August 15, 2008.
- The composition of Treasury marketable financing for the remainder of the July-September quarter, including cash management bills.
- The composition of Treasury marketable financing for the October-December quarter, including cash management bills.