# REPORT TO THE SECRETARY OF THE TREASURY

# FROM THE

# TREASURY BORROWING ADVISORY COMMITTEE

# OF THE

# SECURITIES INDUSTRY AND

# FINANCIAL MARKETS ASSOCIATION

July 29, 2008

Since the Committee's last meeting in late April, credit conditions have remained challenging and the outlook for the economy uncertain. A myriad of actions on the part of the Federal Reserve and the Federal government have prevented the strains in credit and housing markets from undermining the U.S. financial system. Nonetheless, the ongoing elevated nature of many money and credit market spreads underscore the still fragile nature of markets and the lingering concerns about counterparty risk.

Considering the magnitude of the financial shock, economic growth held up relatively well in the first half of 2008 due in part to policymakers' efforts. GDP in the first six months of the year appears to have advanced by about 1½% to 1¾%. An improved net export position, joined with a boost to consumer spending in the latest quarter from tax rebates, contributed importantly to this performance. Yet, the economy's prospects ahead remain uncertain. The boost to household spending from rebates is temporary and will reverse later this year. Moreover, housing continues to be a drag through a variety of channels. The still notably unbalanced nature of housing supply and demand is sustaining downward pressure on home prices and related securities held by major financial intermediaries. On balance, the outlook for the economy will remain clouded until credit conditions improve and financial intermediation begins to function more smoothly.

Headline inflation remains elevated due to rapid price increases for food and energy. Softening economic growth is having a moderating effect on an array of other consumer prices, especially for credit-sensitive, large-ticket purchases such as household durables and motor vehicles. Core consumer prices continue to rise in a 2% to 2½% range. Chances favor some improvement in these measures amid tougher financial conditions, softer home prices and higher unemployment. Nonetheless, elevated costs for everyday commodities and their potential effect on inflation expectations, may sustain concerns about inflationary pressures.

Federal Reserve officials have lowered the Federal funds target to 2% and now view monetary policy as positioned appropriately given the outlook for growth and inflation. Futures markets

have oscillated considerably in recent months and currently anticipate a roughly quarter-point hike in the policy rate by year-end.

The economic slowdown coupled with several special factors has created a marked deterioration in the U.S. budget outlook and an increase in the net borrowing needs by the Treasury. The deficit for fiscal year 2008 ending in September is now expected to be in excess of $400 billion—a sharp increase from the previous year's deficit of $163 billion, and looking forward, most private forecasts for the FY 2009 deficit exceed $500 billion.

The deterioration in the fiscal situation stems primarily from the significant turn in tax receipts while outlays have remained elevated. For example, the year-over-year change in cumulative individual and corporate tax receipts through June have fallen 4.3% in 2008 whereas tax receipt growth for the same period in the three previous fiscal years ranged between +11% and +21%. At the same time, the increase in fiscal outlays at 6.6% for the last twelve months is similar to previous years.

Net borrowing needs by the Treasury has been further exacerbated by several factors including a large change in the demand for State and Local Government securities (SLGs) and the recent need for the FDIC to tap its funds at the Treasury

Pressures in the municipal bond market have significantly reduced the ability for municipalities to pre-refund and refinance their debt over the past year and has led to a redemption of approximately $30 billion of SLGs on a year-to-date basis. This compares to a net issuance of approximately $50 billion of such securities a year ago for a net swing of almost $80 billion. This change directly influences how much net marketable borrowing the Treasury must undertake.

And, lastly, the recent actions by the FDIC to take over several U.S. banks, including Indy Mac, has led to the need for the Treasury to borrow additional funds to meet the needs of the FDIC.

With this 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 a universal consensus on the Committee that given the marked change in net borrowing needs described above, and the prospects for further deterioration in the fiscal outlook, that the Treasury should increase the size and frequency of its current issuance calendar and consider adding additional issues over the near and intermediate term.

After much discussion, the Committee concluded that Treasury should consider moving to a monthly issuance of ten-year notes, to a quarterly issuance of thirty-year bonds and re-introduce a three-year note over the coming quarters to meet the growing financing needs of the U.S. government.

The Committee also discussed the merits of several alternative maturity issues but concluded that the Treasury should first focus on the above issues which have proven in the past to be well accepted by the marketplace.

In the second charge, the Committee was asked to address current conditions in the credit markets, including the perceptions of risk in light of previously implemented funding facilities introduced by the Federal Reserve, as well as the additional recent initiatives by the Treasury and Federal Reserve.

One member presented a comprehensive analysis of the aforementioned issues (attached), starting with a discussion of Libor vs OIS (Overnight index Swap) spreads. The analysis showed how the initial introduction of the TAF (Term Auction Facility) program in December '07 quickly improved funding strains into year-end, and was later enhanced by the increase in the TAF in early January, although global equity market volatility soon unwound some of this benefit.

Subsequent to this however, further TAF increases and the introduction of the TSLF (Term Securities Lending Facility) and PDCF (Primary Dealer Credit Facility) have reduced the term interbank premium in 1-month money, yet 3-month money remains persistently wide. The conclusion was that the growth in size of the TAF has had a tangible impact on Libor/OIS spreads, and that a 3-month TAF would further alleviate funding pressure.

The data shows that while early TAF results demonstrated strong performance, the results were much closer to interbank levels than OIS during March, while concerns that the Libor fixing process understated the true cost of borrowing in the interbank market.
The "stigma" associated with Discount Window borrowing may have contributed to the TAF trading like the interbank markets, as banks paid up to access money away from the Window.

The member notes that, while the TAF program was widely accepted and utilized, the TSLF was not as widely utilized at inception. The member felt that its execution in the form of a collateral swap, with a more restrictive collateral schedule, plus its being an auction for Treasury tri-party repo, not cash were limitations to its effectiveness. Yet, over the past few weeks, as MBS/Treasury repo spreads widened, the program became more widely utilized, and suggested the underlying confidence and potential easing of credit stress through this program having been in place.

The results of PDCF and Primary Credit Discount Window borrowings have shown that funding conditions in the dealer community have also improved, alongside of a perceived stabilization in the bank funding arena. The introduction of the PDCF had a clear and immediate impact on spreads once announced in March, yet it is difficult to assess the true impact of its presence today.

In addition, the member commented that the recent flight to quality buying in the wake of GSE uncertainty has seen T-Bill and Treasury repo richen once again, yet not back to the extreme

levels seen in March. The conclusion was that the Fed's liquidity provisions overall are having a tangible impact on credit conditions in the market.

The member went on to discuss the implications for Treasury of the volatility of global financial markets and the movement of investment allocations across asset classes. The re-distribution of Money Fund assets, re-allocations into Equities, as well as Treasury issuance levels will be critical drivers of demand for bills, as well as discount notes.

A number of members also cited other factors as having significant influences over bill and note pricing in the months ahead.

The Committee's third charge from the Treasury was to review the success of the TIPs market to date and to get our views on any suggested changes in issuance.

One member of the Committee prepared a presentation on the TIPs market in advance and presented his conclusion to the group. A copy of that presentation is attached to the release of these minutes.

This member noted that the total outstanding balance of TIPs is now almost $500 billion since first being introduced 10 years ago in 1998. TIPS have enjoyed a mixed history over those ten years both from an investor's acceptance and for the Treasury as issuer.

Interestingly, there has been almost no private inflation-linked securities introduced over this time and consequently, it is hard to appreciate how much of a "premium" TIPS have enjoyed by being backed by the full faith and credit of the U.S. government.

This member noted that private issuers have been reluctant to issue such securities because they view them as costly and they have been unable to receive hedge accounting treatment even when they may have an asset tied to inflation to hedge.

This member also believes that TIPs have proven very costly to the Treasury as a financing tool over their life. This cost is both a result of measured inflation being higher than the "break-even" level that existed at the time of their issue relative to nominal coupon Treasury securities of similar maturities and a result of the significantly reduced level of liquidity enjoyed by TIPs relative to nominals.

For example, a chart was presented that showed the average daily volume in the TIPs market is only about 2% of outstanding supply where nominal Treasuries have a daily turnover of closer to 14% of outstanding supply.

This member estimates that the cumulative cost of the TIPs program to the Treasury since inception, when comparing the total expense relative to nominal bonds issued at a similar time, approaches $30 billion with the bulk of that cost a direct result of significantly higher inflation than estimated by the markets "breakeven" level when issued.

This member and others were quick to point out that it is entirely possible that future "excess costs" might be negative—meaning TIPS prove cheaper to issue if future inflation moves lower over time than the break-even issuance levels. However, with a ten-year experience period to measure, TIPs have certainly not been an attractive form of financing for the U.S. Treasury to date.

Through discussion among various members of the Committee, there was a consensus that the Treasury should take this data as an indication that the TIPs program should at a minimum play a smaller relative role in meeting its future financing needs. In addition, as this Committee has opined previously, the Treasury should consider eliminating the 5-year TIPs issue. Its issuance should focus on longer-dated issues which better meet the needs of investors who are seeking to hedge the inflationary aspects of their liabilities, such as pension funds and selected insurance companies.

Lastly, one member noted that one of the original problems with TIPs, that still exists today, is that individuals must pay taxes on the total income of the security including the increase in principal that results from inflation while only receiving a coupon which is lower than this total income. This member pointed out that this structural flaw in the security has reduced its attractiveness and acceptance from inception.

In the final section of the charge, the committee considered the composition of marketable financing for the July-September Quarter to refund the $43.5 billion of privately held notes and bonds maturing August 15, 2008. The Committee recommended a $16 billion 10-year note due August 15, 2018 and a $10 billion 30-year bond due August 15, 2038. For the remainder of the quarter, the Committee recommends $31 billion 2-year notes in August and September, $21 billion 5-year notes in August and September, and a $12 billion re-opening of the 10-year note in September.

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

Respectfully submitted

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Chairman

Rick Rieder
Vice Chairman

Attachments (2)

Table Q3 08

Table Q4 08