Minutes of the Meeting of the
Treasury Borrowing Advisory Committee
Of the Securities Industry and Financial Markets Association
August 4, 2009

The Committee convened in closed session at the Hay-Adams Hotel at 11:30 a.m. All Committee members were present. Deputy Assistant Secretary (DAS) for Federal Finance Matthew Rutherford and Office of Debt Management Director Karthik Ramanathan welcomed the Committee and gave them the charge.

The first item on the charge asked the Committee what adjustments to debt issuance, if any, Treasury should make in consideration of its financing needs in the short, medium, and long term. Director Ramanathan opened the discussion with a presentation to the Committee which highlighted current fiscal conditions and potential factors to consider in addressing these issues. The presentation began with a review of the growth in the budget deficit, and the relative magnitude of the deficit and the requisite financing in fiscal year 2009 versus previous years.

Director Ramanathan noted that Treasury had already raised about $1.4 trillion in marketable debt as of June 2009 versus $790 billion in all of fiscal year 2008, and was well poised to meet the balance of its financing requirements not only for the remainder of the year but also fiscal year 2010. Despite media reports to the contrary and an improving economic outlook, Director Ramanathan noted that the Office of Debt Management had issued over $6 trillion in gross Treasuries in the first 10 months of the fiscal year in a smooth and transparent manner.

Nonetheless, according to Director Ramanathan, the near term financing needs will rise as a result of weakness in the economy. The decline in federal receipts - down 18% over the same period last year – and the increase in outlays - up 20% over the same period last year – will create additional borrowing needs.

Director Ramanathan discussed the components of federal revenues in the current fiscal year versus last year, noting that corporate income taxes (which generally account for about 10% of total receipts) were lower by over 50% year to date, withheld individual income tax receipts and social insurance taxes (about 75% of total receipts) were lower by almost 6%, and non-withheld taxes (about 15% of total receipts) were lower by 30%. At the same time, individual tax refunds increased 22% versus last year, and may increase further next year as the economic stimulus tax reductions are realized next April during tax season. Because withheld taxes are the largest source of Federal income and generally lag in economic recoveries, the impact on the fiscal deficit will persist as the economy recovers.

In addition, outlays to the end of June were higher reflecting expenditures related to the Troubled Assets Relief Program and the Housing and Economic Recovery Act of 2008 as well as other financial market stabilization efforts. Director Ramanathan stated outlays would continue to grow to address the weak economy, with estimates of over $200 billion in such fiscal stimulus payments to be spent in the coming quarters.

DAS Rutherford then continued the presentation to the Committee, stating that Supplementary Financing Program bills would remain approximately constant at $200 billion to support Federal Reserve liquidity initiatives. In addition, cash management bills, which total over $300 billion, were slowly being transitioned into coupon issuance. As a result, coupon issuance will remain high with continued gradual increases in such sizes expected this year and next year.

DAS Rutherford also noted that bills as a portion of the debt outstanding were at about 27%, and were poised to decline as other securities gained as a portion of the portfolio. He noted that the decline in TIPS was a function of the rapid increase in nominal coupon growth.

DAS Rutherford then discussed Treasury's maturity profile, noting that the $72 billion in maturing debt and interest payments was the largest such refunding until February 2010. He noted that the decline in the average maturity of the debt has halted, and would gradually rise over time.

To close the presentation, DAS Rutherford noted that Treasury is cognizant that its borrowing needs are large in the short term, but by 2011-2013, such borrowing should result in economic growth and a better fiscal situation. At that point, a discussion followed regarding the best course of action for Treasury in the short, medium, and long term given its borrowing needs.

One member suggested that this was the first time in a while that no new securities or additions to the auction calendar seemed necessary. Another Committee member observed that the average maturity of new issuance was greater than the average maturity of currently outstanding securities, and this was noted as a positive move toward lengthening the average maturity of the portfolio.

Another member noted, in regard to market discussions in the past about a 4-year note, that this security is probably not necessary as the 3-year and 5-year securities carry that sector of the yield curve. The member added that it also would add nothing to average maturity.

The Committee agreed that no additional securities were necessary to address Treasury's borrowing needs.

The Committee went on to discuss issuance sizes and the capacity of the market to absorb additional supplies of Treasury securities. In response, one member suggested current issuance had been digested very well by the market despite comments by the press and market observers.

Another member observed that some recent auctions may have been characterized as "sloppier" than in the past, but these were in fact not poor auctions, particularly relative to offering amounts.

Several members stated that relative to negative expectations for the economic outlook six months ago, the auctions have gone much better than might have been anticipated. In general discussion, most members offered that offering amounts can increase for all nominal coupon issues.

Several members agreed that, if done gradually, the 2-year note could be increased to nearly $50 billion for each offering, the 5-year could reach $45 billion, the 10-year could go up to $28 billion with re-openings of $25 billion each, and the 30-year could move to $20 billion with re-openings of $17 billion. One caveat offered by a member was that upward ranges on the 7-year note should be taken more cautiously as Federal Reserve purchases of on-the-run 7-year notes distorts the market demand for the security.

A member suggested that the 2-year note might be offered twice monthly to increase offerings. This prompted the caution from another member that the market is comfortable now in underwriting the 2-year note issuance in the current inflation environment.

The Committee concluded that Treasury could address its borrowing needs with gradual increases in issuance sizes with its existing suite of securities.

The Committee then moved on to the second item in the charge concerning Treasury inflation-indexed securities. Specifically, Treasury asked the Committee if there were any changes to the TIPS program that Treasury should consider in order to improve TIPS market liquidity and maximize the diversification benefits of inflation-linked debt issuance.

The presenting member began the presentation by noting the original reasons given for issuing TIPS. Considering lowest cost over time, the presenting member noted that much of the criticism of TIPS has been based on ex-post cost measures which have shown a high cost. The presenting member also conceded that TIPS had not diversified the investor base to the point expected, but noted that some new investors to the asset class had recently been observed.

The presenting member remarked that lowest cost over time and the diversification of the investor base were not the only goals of the TIPS program. According to the member, the original individuals who introduced the program were keenly interested in TIPS as a real-time market estimate of inflation as well as being a way of having the government to monitor its fiscal balances.

The member then moved on to the next set of slides which discussed the changing investor base. Using internal estimates derived from experience with the asset class, the member estimated that 60% of the TIPS investor base is dedicated to the asset class while the remainder use TIPS for tactical trading purposes. Of those 60%, a large portion - far greater than nominal Treasury securities - are retail investors. The rest were mainly pension funds, endowments, central banks, and sovereign wealth funds. The member noted that these foreign flows were concentrated in short maturities (5 years and under) to avoid duration risk.

One member noted that pension funds were the source of large outflows from TIPS due to disbursement needs and the illiquidity of the alternative assets in their portfolios. This flow may re-emerge in the future.

The presenting member then turned to the recommended actions. The member stressed more frequent but smaller auctions and a commitment to 5 year issuance as being the most important to supporting the market. In addition, the presenting member suggested replacing 20-year TIPS with 30-year TIPS and increasing TIPS as a percentage of the portfolio. The Committee then discussed the presentation as well as the recommendations.

Members remained cautious about the product, citing past discussion of program's cost, but, given the government financing needs, did not recommend a reduction in issuance. Members did stress that TIPS remain more expensive on a LIBOR basis than the most expensive nominal security.

Another member countered that if the US experienced a period similar to that experienced in Japan in the late 1990's, TIPS could well prove to be cheap financing for Treasury.

One member thought that if central banks were increasing their involvement in TIPS they would be an important future player in the TIPS market.

Regarding changes to how TIPS are auctioned, members voiced no objections to smaller, more frequent auctions if Treasury could overlap them with short nominal coupons. One member suggested Treasury issue shorter duration TIPS. Another member suggested Treasury consider subscription issuance or reverse inquiry as a way of targeting the buy and hold investors which represent a diversification of the investor base.

Several members were concerned that after twelve year of TIPS issuance a liquid inflation swaps market had not developed and no other issuers had emerged. One member remarked that the issue was related to the choice of indexing to headline CPI rather than core CPI. The member said headline CPI was too volatile, too much of a play on commodities for the typical fixed-income investor and left the government effectively playing the commodity market rather than supporting long-term inflation hedging needs.

The Committee then turned to the recommendation of replacing 20-year TIPS with 30-year TIPS. Several members noted that the 20-year TIPS point was an anachronism of the auction calendar, noting that the 20-year TIPS introduction was at a time when there was no issuance of 30-year bonds. Other members underscored that such a movement would increase the amount of duration for market participants to absorb at auctions and potentially create a security which traded cheaper to the curve. On balance, it was suggested that moving 20-year TIPS to 30-year TIPS seemed like a reasonable course of action.

Additionally, several members found the behavior of TIPS in the second half of 2008 to be disconcerting. Members said TIPS illiquidity left investors with less than the safe government bond they thought they were buying. Another said that perversely investors ran from TIPS during a flight to quality. Another said flights to quality are really flights to liquidity, which TIPS lack. Members agreed that TIPS do not have the liquidity that typically characterizes government bonds.

DAS Rutherford asked the Committee what actions Treasury could take to show its commitment to the program. Several members stated that increased TIPS issuance could be considered, but for financing reasons and not for cost reasons.

The Committee agreed that given debt issuance needs, this was not the time to "cut" issuance, and to remain committed to the program, Treasury could once again publically affirm its commitment as well as move to 30-year TIPS security. It was noted that given the large financing needs which Treasury faced in the coming years, issuing additional TIPS to address those needs in addition to nominal issuance should be considered.

The Committee then turned its attention to the third item on the Charge regarding recent trends and volatility in Treasury markets, and their impact on liquidity in the cash and repo markets. Another Committee member gave the presentation.

The presenting member began by reviewing the economic landscape for Treasuries. The supply of Treasury securities is projected to remain elevated for sometime given the large projected deficits. The member further noted that the ratios of deficits to GDP have historically lagged economic recovery and as such, funding needs would remain elevated for a number of years, even after recovery begins and yields historically rise. The member noted that tax receipts can lag recoveries by as much as two years. Current debt-to-GDP ratios were well within long-term averages, there is still room to increase those ratios from current levels; relative to other sovereigns, the debt-to-GDP ratio in the US was relatively low.

On the demand side, the member noted that demographic trends suggest that the consumer is in the process of deleveraging, which would be a drag on growth but which also portends a return of savings rates to more historical levels of between 6 percent and 12 percent, from recent low levels of 0 percent to 2 percent. There is evidence that risk appetite is returning as measured by the tightening of credit spreads since January and financial assets have all become highly correlated. In addition, long-term inflation surveys have remained benign and stable. This has all occurred while Treasury has shifted borrowing from bills to longer-term coupons.

Mortgage credit availability remains very selective, and certain types of mortgage products, such as ARMs, which made housing very affordable over the last decade, are not available. Concerns are also growing over ARM recasts over the next several years and with $450 billion in ARM mortgages resetting, delinquency rates could rise substantially.

Higherunemployment rates have also contributed to an alarming rise in prime mortgage delinquencies, which are now four times higher than they were two years ago.

The presenting member then discussed interest-rate volatility. Both realized and implied volatility remained at elevated levels relative to historical norms, with long-term rate volatility significantly higher than front-end rate volatility. The negative convexity profile of the mortgage market has increased with the QE purchases but it is difficult to hedge the convexity in the current market. This is because there are no natural sellers of volatility left in the market, following the collapse of hedge-fund capital, despite overwhelming demand for volatility from mortgage servicers and originators; this has created a chronic structural net short position in the market place. The presenting member suggested that Treasury, if it wanted to be opportunistic, could potentially benefit from this demand for volatility by offering putable issues.

The presenting member then gave an overview of Treasury auctions. The member noted that bid-to-cover ratios have risen to record levels despite record issuance sizes, and foreign participation in auctions was rising and healthy. The presenting member stated that auction tails had increased but that phenomena was largely a function of auction size, and market events in the days leading up to the auction were a more significant driver of tails.

The presenting member noted that secondary market trading volume for Treasuries was falling despite increased supply due to declining balance sheets and decreased leverage ratios. The member stated that demand for TIPS appeared to be growing in relation to the Federal Reserve's policies. The member also noted that settlement fails have declined significantly following the introduction of negative repo trading.

Several members agreed that media reports were focusing too much on auction tails and statistics rather than realizing how effectively the increased supply had been digested.

Another member noted that private sector borrowing had yet to rise, meaning Treasury issuance would continue to be well absorbed.

Members agreed that Treasury needed to remain conscious of changes in risk appetite and investor participation over the next few years. However, given the liquidity of the market and the continued attractiveness of the United States as a destination for investment, Treasuries would remain a core component of portfolios.

The meeting adjourned at 1:00 PM.

The Committee reconvened at the Department of the Treasury at 5:45 p.m. All of the Committee members were present. The Chairman presented the Committee report to Director Ramanathan.

A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The Committee then reviewed the financing for the remainder of the June through September quarter and the October through December quarter (see attached).

TBAC Recommended Financing Tables: Q3

TBAC Recommended Financing Tables: Q4

The meeting adjourned at 6:15 p.m.

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Director, Office of Debt Management
United States Department of the Treasury
August 4, 2009

Certified by:

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Keith T. Anderson, Chairman
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
August 4, 2009

Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge – August 4, 2009

Fiscal Outlook

What adjustments to debt issuance, if any, should Treasury make in consideration of its financing needs in the short, medium, and long term?

Treasury Inflation Protected Securities

Treasury recognizes that financing at the lowest cost over time requires a diverse investor base. To meet these objectives, Treasury issues across the nominal and real yield curves. Are there any changes to the TIPS program that Treasury should consider in order to improve TIPS market liquidity and maximize the diversification benefits of inflation-linked debt issuance more generally?

Treasury Market Conditions

Discuss recent trends and volatility in Treasury markets. How has it impacted liquidity in the cash and repo markets?

Financing this Quarter

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

- The composition of Treasury notes and bonds to refund approximately $72.5 billion of privately held notes called or maturing on August 15, 2009.
- 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.