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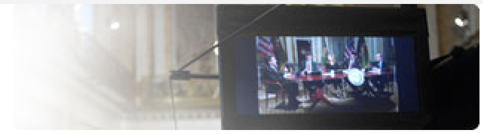

Minutes of the Meeting of the Treasury Borrowing Advisory Committee Of the Securities Industry and Financial Markets Association

8/4/2010

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August 3, 2010

The Committee convened in closed session at the Sofitel Hotel at 10:03 a.m. All Committee members were present. Assistant Secretary for Financial Markets Mary Miller, Deputy Assistant Secretary (DAS) for Federal Finance Matthew Rutherford and Director of the Office of Debt Management Colin Kim welcomed the Committee. Other members of Treasury staff included Fred Pietrangeli, Nathan Struemph, Alfred Johnson, and Veena Ramaswamy. Federal Reserve Bank of New York members Richard Dzina and Fabiola Ravazzolo were also present. The Chairman of the Committee introduced one new member, Ruth Porat.

DAS Rutherford opened the discussion with a presentation to the Committee that highlighted current fiscal conditions and financing needs. The presentation began with a review of the near term budget outlook and projections for the upcoming year. DAS Rutherford noted that the economy continues to grow at a moderate pace, with economic activity expanding at a 2.4 percent annualized pace in the second quarter.

He also stated that tax receipts continued to gradually improve, led by robust increases in the corporate figures. There was a brief discussion about the evolution of tax receipts following recessions. DAS Rutherford indicated that the recovery of the receipt base following the trough in GDP in the current recession was similar to previous downturns. However, he underscored that the economy contracted much more sharply in the current recession, leading to a lower base level of receipts. He noted that the Administration is expecting receipts to total 14.7 percent of GDP in FY 2010, below the 50-year average of approximately 18 percent.

DAS Rutherford explained that the Administration had recently released the mid-session review of the President's budget. The budget deficit for FY 2010 was revised down to $1.471 trillion, although the FY 2011 deficit was revised up to $1.416 trillion. Rutherford noted that primary dealer economists anticipate a smaller budget deficit for FY 2010 than the figures given by the Administration in July. The average deficit forecast from the primary dealers for FY 2010 is $1.351 trillion, $120 billion below OMB's forecast.

DAS Rutherford also suggested that the risks to the recovery have risen since the committee last met in May. As a result, Rutherford indicated that debt managers must remain extremely flexible to respond to changes in borrowing needs. He noted that there was still scope to continue to reduce auction sizes further, but that the reductions would likely occur at a more gradual pace. DAS Rutherford indicated that once these cuts are complete, Treasury will likely hold auction sizes constant for a period of time to assess the fiscal outlook.

Rutherford then discussed auction dynamics. Coverage ratios remain extremely high for bill, note, bond, and TIPS auctions. DAS Rutherford also highlighted that domestic funds have increasingly become more active in the Treasury market. There was a brief discussion on bank purchases of Treasuries. It was noted that banks have more than doubled their holdings of Treasuries in the past 2 years. This was largely attributed to weak loan demand, as well as potential changes surrounding liquidity requirements in upcoming bank regulation. Rutherford also noted that increased demand for duration has lead to an increase in STRIPS outstanding.

Director Kim then turned to the current state of the Treasury portfolio. Overall, the bills as a share of the total outstanding portfolio continue to fall. He noted that bills (including SFP) currently make up 22 percent of the portfolio, compared to the pre-crisis average of around 24 percent. The decline reflects the transition to coupon financing, as nominal coupons' share has risen to 71 percent. Treasury inflation-linked securities (TIPS) currently comprise 7 percent of the portfolio and issuance in this program will continue to steadily increase over the next year. For calendar year 2010, Treasury expects to issue between $80 and $85 billion in TIPS. Issuance will gradually increase again in 2011 as Treasury expects to increase the frequency of auctions.

Kim noted that the average maturity of the portfolio continues to lengthen. The average maturity of the debt currently stands at 58 months, directly in line with the average observed since 1980. Going forward, Kim indicated that the average maturity of the debt will gradually extend further, largely due to the fact that Treasury continues to hold monthly coupon auctions across the entire yield curve. However, he noted that any further extension will likely occur at a slower pace than what has been observed over the past year. Ultimately, he underscored that Treasury must retain its flexibility in order to respond to a range of financing scenarios.

Rutherford then briefly concluded with a few comments on the longer-term fiscal challenges facing Treasury. There was a discussion about the changes made to the President's 2011 budget in the mid-session review. One member asked about the macro growth assumptions underlying the Administration's forecast. Rutherford indicated that the real GDP growth assumption was approximately 4 percent over the next several years. Another member asked about assumptions regarding the extension of the 2001 tax cuts. Rutherford explained that the Administration used an assumption of eliminating tax cuts for those earners with income over $250,000, and that such an assumption added $37 billion per year to revenue. Additionally, he indicated that the bipartisan fiscal commission is currently working to identify policies to improve the fiscal situation in the medium term and to achieve fiscal sustainability over the long run. Rutherford noted that the Administration and Congress await their recommendations, which are due at the end of the year.

The committee then discussed projected auction sizes for nominal coupon securities going forward. It was noted that given constant levels of coupon issuance, Treasury has cut a cumulative $232 billion of annualized borrowing capacity when compared to April levels.

One member began by noting that given projected financing needs and uncertainty around the economy, the Treasury would probably need to stabilize coupon issuance by January 2011. The member noted that nominal coupon issue sizes peaked in early 2010 and held steady from February through April 2010. Further marginal issue-size reductions in nominal coupons could probably continue for the remainder of the calendar year, according to this member. Such a plan would still provide Treasury with capacity and flexibility to address unexpected financing needs, and also extend the average maturity of outstanding debt further.

A lively debate followed.

A member stated that given the fiscal and economic uncertainty going forward, it may be prudent to pause after some further gradual issuance-size reductions. The member stated that Treasury should consider making small reductions in 10-year notes and 30-year bonds. Other members agreed with the idea that 10-year notes and 30-year bonds should be cut slightly, with one member stating that the 10-to 30-year spread has widened and that there is a perception by some market participants that Treasury wants to extend its duration even though term premia appears to be elevated by some metrics.

Other members challenged this notion, suggesting that small marginal cuts in 10-year notes and 30-year bonds might not be considered to have a substantive purpose and that there was nothing to be gained from doing such cuts at this point. One member stated that given the long-run fiscal forecast, uncertainty about extension of the 2001 tax cuts, and absent any sort of credible fiscal plan for reducing government borrowing, cutting 10-year notes and 30-year bonds would be imprudent.

Ultimately, the Committee thought it was important for Treasury to maintain the flexibility to cut across the curve in the future. There was general consensus around the idea of pausing issue size reductions at some point in the future until more clarity forms around the economic and fiscal outlook.

A brief discussion followed regarding the optimal size of the T-bill market. One member stated that once bills as a percentage of the overall portfolio drops below 20 percent, dislocations and poor liquidity become more problematic in the bill market. Another member stated that if the Fed starts to reinvest cash flows from their MBS portfolio in the front end of the curve, shortages in the bill markets may be further exacerbated. Another member commented that bill issuance should be skewed more toward the short end of the bill curve to accommodate the demand from 2a-7 money market funds which are under new WAM constraints; many investment vehicles that money funds used to invest in are in shorter supply, including ABS paper and SIVs.

The committee next turned to the question in the charge concerning state and municipal debt markets and the ability of municipal issuers to access the capital markets. The committee focused its response on current market dynamics, including overall financing costs and strategies, as well as implications for the Treasury market and fixed income markets more broadly.

The presenting member began by describing general municipal market conditions, noting that the municipal bond market has grown dramatically over the past few decades, totaling $2.8 trillion at the end of 2009. The member noted that the municipal bond market has a higher average credit rating than the corporate bond market, which can be attributed to municipal taxing authority, low historical default rates and conservative debt profiles. Seventy percent of municipal bond holders are retail or retail equivalent buyers, including households, mutual funds, ETFs and money market mutual funds. Life insurers are large purchasers of taxable Build America Bonds (BABs), owning over 50 percent of many BABs deals.

The presenting member then went into a discussion on the municipal credit default swap (CDS) market, noting that the market is small and relatively illiquid. The market has only a handful of actively traded issuers, including the States of California, Illinois, New Jersey, Florida and Texas. As of the end of July, only 6 out of the top 1,000 CDS reference entities were state or local governments, and only $105 million of single-name municipal CDS was traded during the last week of July. In comparison, $144 billion of CDS was traded for the top 1,000 reference entities.

The member then discussed the MCDX index, which is an index containing 50 equally weighted state and local government and revenue issuers. The MCDX has approximately $3.8 billion of net notional outstanding, significantly below the $300 billion for the investment grade corporate index. The member noted that the MCDX is a poor indicator of perceived risk in the municipal market given that the index is subject to inconsistent market making and unpredictable investor participation.

The presenting member then went into a discussion of current cash market conditions and concerns going forward. It was noted that the largest municipal issuers have had continuous access to the market. This is evidenced by municipal issuance, which is at $232 billion year-to-date, a 13 percent increase from 2009. In absolute terms, municipal rates are at multi-decade lows. However, municipal bond yields remain elevated relative to Treasury yields. The yield on the Bond Buyer 11 index is currently 110 percent of Treasuries compared to a long-term average of 86 percent.

The member then discussed overall municipal market structure changes, highlighting the BABs program, which was introduced in 2009. Under the BABs program there has been $120 billion of taxable bond new issuance. The dramatic decline in municipal bond insurance was also highlighted. Five years ago, 50 percent of issuance was insured, compared to below 10 percent today. The member noted that the use of bond insurance is unlikely to return to previous highs given increased investor focus on the underlying credit quality of issuers as well as the health of the bond insurers.

The importance of the short-term market was also highlighted. Short-term offerings are generally used by issuers to smooth cash flow timing mismatches. They are used more frequently during recessionary times when budget deficits increase.

The presenting member then went into a discussion of current municipal market investor concerns. State budget imbalances are among the top concerns for investors. Although most states have balanced budget requirements, budget solutions are often one-time in nature and credible revenue and expense solutions are not evident for the largest general-obligation issuers. In addition, liquidity access and management was highlighted as a concern given roll-over risk for letters of credit for the variable rate market. Approximately $200 billion of letters of credit are maturating in 2010 and 2011, of which $30 billion may be difficult to renew. The result will likely be more restrictive terms, higher costs and less availability for lower-rated issuers.

The member then discussed the major risks to municipal issuers, which fall into two categories: market access and new issue pricing. In terms of market access, the member noted while a state GO default seems unlikely, if it were to occur, it would result in significant dislocation in the new issuance market. However, this risk is mitigated by a number of factors, including: state taxing authority, low debt/GDP ratios, low debt servicing costs, high debt payment priority, expense reductions, alternate sources of funding (asset sales, revenue stream securitizations), as well as rainy day reserve funds.

With respect to new issue pricing, the member suggested that municipal issuers would likely face higher financing costs if the BABs program is not extended. Other concerns included worsening credit quality of issuers and regulatory reform, which could affect banks providing letters of credit for variable rate issues.

The member concluded that in the near term the likelihood of a major default is low. However, a long-term deterioration in credit fundamentals is possible and funding costs are likely to increase.

The members then discussed the dramatic increase in municipal bond issuance over the last few decades. One member wondered how GDP growth over this time period had been affected by the sharp increase in municipal debt, where proceeds are typically used to finance state and local infrastructure projects.

The committee then turned to the third question in the charge concerning the drivers of demand for long duration fixed-income assets and the corresponding implications it may have on the gradual extension of the average maturity of Treasury's debt portfolio.

The presenting member began by noting that in contrast to the recent strong price performance in many financial assets, economic fundamentals have continued to weaken. Real GDP for Q2 came in lower than expected at 2.4 percent annualized pace. Both market consensus and the FOMC's Central Tendency Forecast for real GDP and inflation have declined. The subdued economic outlook and decline in inflation expectations have pushed out expectations for policy rate increases and driven yields lower across the curve.

The presenting member next discussed how changes in the mortgage market were affecting fixed income markets more broadly. The member underscored that the Federal Reserve holds 27 percent of 30-year agency MBS, which has altered the traditional hedging activity observed by mortgage investors. He also noted that capacity constraints are continuing to weigh on refinancing activities. It was concluded that agency MBS supply is likely to remain low for some period of time.

The member noted that one sector where supply is picking up is agency callable debt. At current rate levels, there is the potential that over $50 billion of outstanding agency debt will be called over the next two months, which would boost gross issuance and agency supply.

However, it was reiterated that Treasury still remains the dominant issuer in fixed income markets. Even if budget deficits decline in the next few years, Treasury will remain the major source of net supply in fixed-income markets.

The presenting member then discussed sources of demand in fixed income markets. It was noted that banks have been a strong source of demand for Treasuries over the past year. Corporate pensions continue to be a net buyer of fixed income despite low yield levels. Mutual Funds and ETFs have also seen significant inflows into fixed-income products throughout the crisis. It was noted that initially this was supportive of government issuance, but more recently, the low absolute level of yields has led some investors to pursue higher-yielding strategies.

The presenting member finished by noting that long-end demand continues to exceed supply. Treasury auctions continue to exhibit strong coverage ratios, and as a result, the member recommended that Treasury continue to lengthen the average maturity of outstanding debt.

The meeting adjourned at 11:45 AM.

The Committee reconvened at the Department of the Treasury at 5:35 p.m. All of the Committee members were present. The Chairman presented the Committee report to Secretary Geithner.

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 July through September quarter and the October through December quarter (see attached).

The meeting adjourned at 6:15 p.m.

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Matthew Rutherford

Deputy Assistant Secretary for Federal Finance

United States Department of the Treasury

August 3, 2010

Certified by:

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Matthew E. Zames, Chairman

Treasury Borrowing Advisory Committee

Of The Securities Industry and Financial Markets Association

August 3, 2010

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Ashok Varadhan, Vice Chairman

Treasury Borrowing Advisory Committee

Of The Securities Industry and Financial Markets Association

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Treasury Borrowing Advisory Committee Quarterly Meeting

Committee Charge – August 3, 2010

<u>Fiscal Outlook</u>

Taking into consideration Treasury's short, intermediate, and long-term financing requirements, as well as uncertainties about the economy and revenue outlook for the next few quarters, what changes to Treasury's coupon auctions do you recommend at this time, if any?

<u>Municipal Bond Market</u>

We would like the Committee to provide an update on state and municipal debt markets and the ability of municipal issuers to access the capital markets. Please provide detail on current market dynamics, and whether overall financing costs and strategies have changed.

How have these dynamics affected the Treasury market, and fixed income markets more broadly?

Demand for Long-Duration Assets

What are the forces that are underpinning demand for long-duration fixed-income assets? What factors should Treasury consider as the average maturity of outstanding debt continues to gradually extend?

Financing this Quarter

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

- The composition of Treasury notes and bonds to refund approximately $33 billion of privately held notes maturing on August 15, 2010.
- 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.

TBAC Recommended Financing Tables: Q4

TBAC Recommended Financing Tables: Q1