Minutes of the Meeting of the Treasury Borrowing Advisory Committee of the Securities Industry and Financial Markets Association July 31

August 1, 2018

The Committee convened in a closed session at the Hay-Adams Hotel at 9:00 a.m. All members were present. Counselor to the Secretary Craig Phillips, Deputy Assistant Secretary for Financial Markets Clay Berry, Deputy Assistant Secretary for Federal Finance Laura Lipscomb, Director of the Office of Debt Management Fred Pietrangeli, and Deputy Director of the Office of Debt Management Nick Steele welcomed the Committee. Other members of Treasury staff present were Chris Cameron, Dave Chung, Tom Katzenbach, Dave Monroe, Peter Phelan, Brian Smith, Renee Tang, and Brandon Taylor. Federal Reserve Bank of New York staff members Nathaniel Wuerffel, Susan McLaughlin, Rania Perry, and Jake Schurmeier were also present.

Counselor Phillips opened the meeting by announcing the fourth and final report in a series on the administration's core principles for financial regulation, a response to Executive Order 13772 issued in February 2017. The report, "Nonbank Financials, Fintech, and Innovation," identifies improvements to the regulatory landscape that will better support nonbank financial institutions, embrace financial technology, and foster innovation.

Next, Phillips discussed various changes to the Committee, including introducing the newest member, Deirdre Dunn. He then welcomed Beth Hammack to her new role as Chair and thanked Jason Cummins, the outgoing Chair, for his esteemed leadership. Phillips also thanked Stuart Spodek for his leadership as Vice Chair and noted that Dan Dufresne will take over as Vice Chair at the next meeting.

Phillips then thanked outgoing Deputy Assistant Secretary Clay Berry and Deputy Assistant Secretary Laura Lipscomb for their dedicated service and commitment to the Treasury Department. Phillips wished them well as they transition out of their current responsibilities. Phillips also announced that Brian Smith will become the new Deputy Assistant Secretary for Federal Finance.

Phillips then discussed outreach efforts around a policy for potential public dissemination of secondary market transaction data for Treasury securities collected through FINRA's TRACE. Phillips outlined the diverse set of market participants canvassed and noted that over the next quarter Treasury will be continuing outreach and evaluating feedback received. For instance, some market participants have commented that data gaps should be addressed before considering a public transparency policy, such as requiring reporting by depository institutions. Other participants commented that delays and capped trade sizes should be considered, analogous to public dissemination of other securities currently reported to TRACE. Finally, Phillips noted that Treasury staff continues to analyze and clean the TRACE data, using findings to inform policy considerations, and that no decision regarding public transparency has been made at this time.

Next, Director Pietrangeli provided an overview of the fiscal situation. Pietrangeli noted that year-to-date FY 2018 receipts increased by 1 percent year-over-year, led by a $78 billion increase in non-withheld taxes and a $33 billion increase in withheld taxes. The gains were partially offset by a $51 billion decrease in corporate taxes, which is a decrease of 20 percent. After calendar adjustments, outlays increased by $123 billion over the same timeframe, which is an increase of 4 percent. Notable increases included $57 billion for Treasury, which is mostly attributable to higher interest on the public debt. Other increases included $40 billion for the Social Security Administration related to an increase in the number of recipients and a higher cost of living adjustment compared to last year, $35 billion for the Department of Defense, $16 billion for Health and Human Services related to higher Medicaid expenditures, and lower overall receipts from the government-sponsored enterprises. Finally, as a result of the treatment of advanced refundings in the Tax Cut and Jobs Act, non-marketable borrowing from state and local governments has declined.

Pietrangeli then acknowledged that projections by the Office of Management and Budget and the Congressional Budget Office indicate borrowing needs will increase over the next few years. Treasury's projections provide an estimate of the privately-held net marketable borrowing need, which takes into account estimates of the Federal Reserve's normalization of its System Open Market Account (SOMA) portfolio. Specifically, the estimates exclude SOMA rollovers (auction "add-ons") and include private financing required due to SOMA redemptions.

Treasury estimates privately-held net marketable borrowing needs of $329 billion for the July to September quarter, assuming an end-of-September cash balance of $350 billion, and $440 billion for the October to December quarter, assuming an end-of-December cash balance of $390 billion. The estimates for the July to September quarter imply an increase in bills outstanding of $69 billion, assuming no change in coupon auction sizes. Furthermore, these projections create a funding gap that Treasury will need to fill with increased issuance. Assuming a constant level of bills outstanding and coupon issuance at current auction sizes, Treasury is slightly underfunded for the remainder of FY 2018, with a wider gap anticipated for FY 2019. Pietrangeli noted that current estimates of the financing gap are sensitive to when the Federal Reserve will end the normalization of the SOMA portfolio.

Given recent issuance decisions, the weighted-average maturity of the portfolio continues to remain stable. Bills outstanding as a share of the total portfolio has increased to approximately 14 percent, remaining below the long-run historical average of around 23 percent. Portfolio roll-over, measured as the percentage of the portfolio maturing in less than one year or less than three years, remains stable and near historic lows. Bid-to-cover ratios remain steady, with a slight up-tick for longer-term nominal coupon securities. Finally, foreign awards at auction have remained stable.

Next, Deputy Assistant Secretary Lipscomb provided the Committee with a summary of quarterly refunding discussions with the primary dealers. Pursuant to the roll-out of the new benchmark 2-month bill, Treasury requested feedback regarding the appropriate size of initial auctions. Although respondents offered a range of opinions, Lipscomb emphasized the theme of auction sizes needing to be large enough to support market liquidity.

Treasury also received advice regarding how best to facilitate the initial reallocation of cash from Thursday maturities to a potential new settlement cycle. Primary dealers generally argued that temporarily issuing the 2-month for settlement on Thursday, but with a Tuesday maturity, would be beneficial for market participants, particularly those that could not invest in overnight Treasury repo. The Committee agreed that the new 2-month bill should be well received.

Lipscomb then provided perspectives on the broad range of factors considered when making financing decisions. Lipscomb noted appreciation for TBAC's advice on a heavier weighting to the belly of the curve, which included 2-, 3-, and 5-year maturities, based on long-run relationships between financing costs and relevant financial and economic variables. Lipscomb

then noted how the Treasury had decreased issuance in the 2- and 3-year maturities more than other maturities when funding needs had previously decreased. When considering market capacity in any tenor, she noted that market outreach, historical auction size maximums, and the results of dealer surveys are used to supplement quantitative modeling output. Taking these indications together, Treasury determined to move toward historical auction sizes in 2- and 3-year maturities as a first step in meeting longer-term financing needs. Lipscomb pointed out that, now that these sizes are nearer historical levels, including the 5-year in the heavier issuance weighting for coupon increases is more appropriate.

Director Pietrangeli then summarized primary dealer feedback on three hypothetical Treasury Inflation-Protected Securities (TIPS) issuance calendars that would incorporate a new 5-year CUSIP in the second half of the year. In general, primary dealers support increased TIPS issuance, particularly at the 5-year maturity, and support the potential for a new 5-year CUSIP in the second half of the calendar year. Dealer preferences were mixed, with most dealers preferring either Option 1 or Option 2. Option 1 was popular with those that preferred keeping one TIPS auction per month but opposed by those against removing a 30-year reopening. Dealers that preferred Option 2 believe that the market for 5-year and 30-year TIPS are sufficiently segmented to facilitate multiple auctions per month. Dealers who supported Option 3 viewed it as elegant and balanced, while those opposed viewed the change as too significant. The Committee then discussed the TIPS calendar options and broadly agreed that they would support either Option 1 or Option 2 and that further study and outreach by the Treasury is warranted.

Next, the Committee turned to a charge regarding commercial bank demand for high quality liquid assets (HQLA) and the role that Treasury securities are likely to play in bank HQLA portfolios in the context of Federal Reserve balance sheet normalization. The presenting member pointed out that the composition of the balance sheet of banks subject to Liquidity Coverage Ratio requirements would likely shift significantly. The presenting member projected a migration of HQLA portfolios in favor of Treasury securities, particularly Treasury bills. Committee members agreed with the thrust of the analysis and discussed a range of variables that could affect eventual outcomes.

The Committee then turned to a charge on the use and substitutability of Treasury securities versus housing finance related securities in investment portfolios. The presenting member discussed several characteristics that make agency mortgage backed securities (Agency MBS)

weakly substitutable for Treasury securities. As a result of the characteristics of these securities, Agency MBS behave differently than Treasury securities in response to changes in interest rates and perceived market risk.

The presenting member then described the shift in the composition of ownership of Agency MBS over the last decade and noted that now, with SOMA redemptions of Agency MBS projected to increase, investment managers are best positioned to absorb this additional supply available to the public.

Finally, the presenting member noted that Agency MBS that receive Level 1 HQLA treatment trade at a tighter spread to Treasury securities than conventional MBS and that this spread could tighten for conventional MBS if there were a change in their HQLA classification to Level 1. The presenting member cited the risks associated with Agency MBS as the binding constraint for banks' holdings of those securities for HQLA purposes, given that banks retain substantial capacity to add Agency MBS as Level 2 HQLA relative to regulatory maximums. The member highlighted expectations that the move to a single MBS security (UMBS) would provide a straightforward improvement for the liquidity of MBS securities.

Next, the Committee turned to a discussion around financing for the upcoming quarter. A member noted that market participants expect the same pattern of coupon issuance as the prior quarter. However, it was also noted that the sizes of the 2- and 3-year securities are now as close to their historical maximum sizes as the 5-year, making the consideration of including the 5-year in the $1 billion per month increase more timely.

The Committee adjourned at 12:30 p.m. for lunch.

The Committee reconvened at 1:35 p.m.

The Committee further discussed their financing recommendation for this quarter and recommended that Treasury increase issuance by $1 billion per month for 2-, 3- and 5-year notes and by $1 billion per quarter for 7- and 10-year notes, the 30-year bond, and the 2-year floating rate note. The Committee also recommended that new bill issuance be kept at a quarter to a third of new issuance over the intermediate term. The Committee further stated that Treasury should consider increasing TIPS issuance gradually over the intermediate term so that TIPS remain at a level of about 7 percent of outstanding debt on average over time.

The Committee thought that if a similar plan of increasing coupons was followed in November, the Treasury would be well positioned to meet the financing gap in FY 2019. Members did note that Treasury should remain flexible given the substantial uncertainties in the outlook for financing needs over the next few years.

The Committee then gave a brief update on the status of the TBAC debt issuance model. Of note, a paper describing the model was presented at the Brookings Institution earlier this year. The authors of the paper were in the process of incorporating feedback that they received during the presentation of the paper and hoped to have the paper published sometime this fall. In addition, work was underway to extend the model to include TIPS. The modelers were in the process of testing some of the preliminary results associated with the model extension and hoped to have the work done by September.

Finally, there was a brief discussion of the TMPG "*White Paper on Clearing and Settlement in the Secondary Market for U.S. Treasury*". The presenting members gave a brief overview of the findings in the paper, noting that it was out for comment until the end of September. Deputy Assistant Secretary Berry noted the paper identified important potential risks in the clearing and settlement process and that Treasury was supportive of the TMPG goal of making market participants aware of such risks.

The Committee adjourned at 2:40 p.m.

The Committee reconvened at the Department of the Treasury at 4:00 p.m. All Committee members were present. The Chair presented the Committee report to Secretary Mnuchin. A brief discussion followed the Chair's presentation, but did not raise significant questions regarding the report's content.

The Committee adjourned at 4:30 p.m.

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Laura Lipscomb
Deputy Assistant Secretary for Federal Finance
United States Department of the Treasury
July 31, 2018

Certified by:

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Beth Hammack, Chair
Treasury Borrowing Advisory Committee
Of The Securities Industry and Financial Markets Association
July 31, 2018

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Stuart Spodek, 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 – JULY 31, 2018

Fiscal Outlook

Taking into consideration Treasury's short, intermediate, and long-term financing requirements, as well as the variability in financing needs from-quarter to quarter, what changes to Treasury's coupon auctions do you recommend at this time, if any?

Commercial Bank Demand for HQLA

We would like the Committee to comment on commercial bank demand for HQLA and, more specifically, the role of Treasury holdings within banks' HQLA portfolios. Given projections for SOMA portfolio normalization over the coming years, please also comment on how bank demand for Treasury securities is likely to evolve over the medium-term (3-5 years).

Housing Finance Related Securities

Evaluate the use of Treasury securities versus the range of housing finance related securities (specifically debt and MBS issued by Ginnie Mae, Fannie Mae and Freddie Mac) in investment portfolios. Please discuss the extent to which different investor types view Agency debt and MBS as substitutes for Treasury securities. How do investors determine the premium required to invest in Agency debt and MBS compared to Treasuries? How have different policy changes or market conditions affected this premium over the years? What policy changes or market conditions could affect this premium?

Financing this Quarter

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

- The composition of Treasury notes and bonds to refund approximately $38.2 billion of privately-held notes maturing on August 15, 2018.
- The composition of Treasury marketable financing for the remainder of the July-September 2018 quarter, including cash management bills.
- The composition of Treasury marketable financing for the October-December 2018 quarter, including cash management bills.