Presentation to the Treasury Borrowing Advisory Committee

May 2, 2006

Debt Portfolio Analysis

Broad Portfolio Considerations

- Minimize expected costs over time
- Minimize variability of interest costs over time
- Minimize operational risks
- Maximize primary and secondary market liquidity

Portfolio Analysis Project Outline

- Examine properties of steady state portfolios
  - Develop tools to evaluate alternatives
- Examine appropriate short-run responses of portfolio composition to temporary shocks
  - Issuance “smoothing”
- Integrate short- and long-run models
  - Optimal debt issuance policies
  - Scenario analyses: alternative budget, interest rate, inflation paths

“Steady State” Analysis

- What are the properties of debt portfolio when debt-GDP ratio and portfolio composition are at long-run levels?

- Key Inputs
  - Term premiums
  - Interest rate volatility
  - Market demands

- Key Outputs
  - Expected interest costs
  - Variance of interest costs
  - Debt turnover
  - Liquidity premium

- Loss Function
  - Weights attached to individual outputs

Cost Minimizing Portfolio

A cost minimizing portfolio that takes all the considerations noted above into account might be taken as one that minimizes the total loss function given by:

$$L = Excess\ Cost + Liquidity\ Cost + Rollover\ Cost + Variability\ Cost$$

subject to the constraint that the portfolio shares must sum to 1. This equation is easy to quantify and solve algebraically.

Practical Products

- Types of questions that can be addressed
  - Impact of shift in maturity composition of portfolio
  - Impact of changes in nominal versus inflation-indexed composition
  - Impact of changes in auction schedule
  - Evaluation of new securities
- Expect to have preliminary materials for review in August
- Develop standard materials for chart package

Securities Lending Facility

- A “Lender of Last Resort” provider of Treasury securities to address periods of severe financial market disruption.

- Pros:
  - Could be effective in addressing systemic fails episodes
  - Could be an effective crisis management tool

- Cons:
  - Could contribute to moral hazard by “bailing out” shorts
  - Could be “gamed” by market participants
  - Could undermine private sector efforts to improve market resilience

Basic Structure

- Term loans, forward delivery
- Lending rate set at 0 percent
- Eligible institutions—primary dealers
- Treasury securities pledged as collateral
- All CUSIPS available?
- Reporting requirements?
- Borrowing limits?

Next Steps

- Comment period on “strawman” proposal ends August 11
- Continue informal discussions
- Decision whether to develop a refined proposal late this year
- Publish revised proposal for comment
- Pursue legislative changes if necessary

Options on Bond Issuance

- Maintain current February/August issuance and maturity cycle.
- Maintain current issuance calendar, but rotate with May/November coupon cycle (i.e., issue in February 30 ¼ -year and in August 29 ¾ bonds).
- Move issuance calendar to match May/November coupon dates in alternate years.
- Maintain \$20-\$30 billion but move to quarterly issuance with first bond reopened second quarter, new bond at 30 ¼ years opened in third quarter, reopened in fourth quarter.