Challenges and Opportunities of Utilizing State and Local Government Series (SLGS) Securities

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Overview of State and Local Government Series (SLGS) Securities

- The SLGS program was established in 1972 as a result of federal legislation that restricted state and local governments from earning arbitrage profits by investing bond proceeds in higher yielding investments.[1]
- Key features of SLGS include:
  - A form of U.S. Treasury security **backed by the federal government.**
  - Available for investment of proceeds of tax-exempt bond issues.
- Timing:
  - Subscriptions of **$10 million or less** must be submitted at least **five calendar days** before the issue date.
  - Subscriptions of **greater than $10 million** must be submitted at least **seven calendar days** before the issue date.
- Types of offerings:
  - **Time Deposit SLGS** – fixed rate of interest based on maturities ranging from 30 days to 40 years (0% SLGS permitted for 15 days or more).
  - **Demand Deposit SLGS** – tax-exempt, one-day certificates of indebtedness that pay interest based on a floating rate.

[1] *Source: Treasury Direct, About the State and Local Government Series Securities.*

Overview of Time Deposit SLGS

- Time Deposit SLGS pay a fixed rate of interest based on maturities ranging from 30 days to 40 years and **are taxable securities (subject to arbitrage and yield restriction rules).**
- Yields are set daily by 10:00 a.m. Eastern and are designed to be one basis point below Treasuries.
  - Can vary somewhat considerably based upon a variety of technical factors.
- Commonly used in escrows for refunding or defeasance transactions.
  - Easy to administer, lower transaction costs, and no concerns about fair market value.
- Maturity length:
  - Certificates of Indebtedness: 15 days to 1 year.
  - Notes: more than 1 year to 10 years.
  - Bonds: more than 10 years to 40 years.
- Time Deposit SLGS are relatively illiquid - may be redeemed at a market value upon 14 days (max of 60) of advance notice.
  - The proceeds of an early redemption may not be subsequently invested in marketable securities at a higher yield.

Overview of Demand Deposit SLGS

- Demand Deposit SLGS are one-day certificates of indebtedness that pay interest based on a floating rate and **are tax-exempt securities that are therefore <u>exempt</u> from arbitrage rebate and yield restriction.**
  - **This makes them an attractive investment option for issuers earning positive arbitrage that they otherwise cannot keep.**
- Yields are based on 13-week Treasury bill auctions and adjusted down to reflect tax-exempt status.
- **Arbitrage rebate and yield restriction are two different calculations.**
  - You could have negative arbitrage AND positive yield restriction liability.
    - Example: Temporary period of project fund expires in a rising interest rate environment.
- Demand Deposit SLGS are relatively liquid:
  - Redemptions of $10 million or less: **1 business day** of notice.
  - Redemptions between $10 million and $500 million: **3 business days** of notice.
  - Redemptions greater than $500 million: **5 business days** of notice.

Poll Question #1

- Arbitrage rebate and yield restriction are the same thing.

  A. True

  B. False

Why Demand Deposit SLGS?

- Demand Deposit SLGS may offer a unique investment opportunity due to the current high interest yield environment.
  - The yield of Demand Deposit SLGS was over 4% this past summer – well above historical averages.
    - The yield has begun to drop and is now at 3.55% as a result of Fed interest rate cuts.[1]
  - The yield is higher than many tax-exempt bond arbitrage yields related to issuances from the past several years.
  - As a result, an opportunity may exist for issuers to earn and retain positive arbitrage by utilizing these securities.
- **Immediate attention is warranted**; the Federal Reserve has started cutting rates and may continue to do so.
- Always consult with your advisors and bond/tax counsel.

[1] *As of October 29, 2024*

Where are the Potential Opportunities for Demand Deposit SLGS?

Account	Fund Maturity	Typical Duration	Arbitrage Condition
Bona Fide Debt Service Fund	0 to 40 Years	0 to 1 Year	No Rebate Restrictions
Current Refunding Escrow	90 Days or less	Less than .25	No Rebate Restrictions
Construction / Project Fund	1 to 3 Years	1 to 3 Years	Potentially No Rebate Restrictions
Debt Service Reserve Fund	0 to 40 Years	1 to 2 Years	Subject to Arbitrage Rebate
Cash Defeasance Escrow	0 to 10 Years	0 to 10 Years	Subject to Arbitrage Rebate & Yield Restriction
Long-Term Sinking Fund	0 to 40 Years	0 to 40 Years	Subject to Arbitrage Rebate & Yield Restriction

Opportunities for Demand Deposit SLGS investment strategy may exist.

Liquidity and Other Considerations For SLGS

- Redemption notice required to liquidate SLGS.
  - **Time Deposit** – early redemption at market value requires at least 14 days notice (no more than 60 days).
  - **Demand Deposit** – redemptions can be made at any time after settlement and require anywhere from 1 to 5 business days notice based on size.
- Best to evaluate other alternatives such as open-market Treasuries.
  - Better liquidity.
  - May be higher yielding.
  - No restrictions on restructuring the portfolio if liquidity needs change.

Cash Defeasance Escrows

- Many issuers who are doing cash defeasances are investing in Time Deposit SLGS that are actively yield restricted.
- **Opportunities:**
  - **Blending of Yield Restriction Liability**
    - Leveraging existing negative yield restriction liability may allow the issuer to invest in time deposit SLGS at a yield in excess of the arbitrage yield.
  - **Demand Deposit SLGS**
    - Investing in this type of tax-exempt security allows the issuer to retain all earnings including those above the arbitrage yield of the bonds being defeased.
      - Most appropriate for short-duration defeasances.
      - Could underperform if interest rates drop quickly.
      - Must be gross funded.

Project Funds Not Meeting a Spending Exception[1]

- A project fund is exempt from rebate if it meets a spending exception.
  - Consider Demand Deposit SLGS if a spending exception is not met and they offer a yield in excess of the arbitrage yield.
- **Other Considerations:** Small Issuer Exception
  - $5 million of tax-exempt bonds in a calendar year (increased to $15 million if at least $10 million is used to finance public schools).
    - Exempt from rebate and therefore should not consider Demand Deposit SLGS.
    - *Small Issuer Exception does not apply to private activity bonds.*

Spending Exception	Expenditure of Proceeds Timeframe
Six-Month Spending Exception ***(All Gross Proceeds)***	6 months – 100%
Eighteen-Month Spending Exception ***(All New Money)***	6 months – at least 15% 12 months – at least 60% 18 months – 100%
Two-Year Spending Exception ***(Construction Issues)***	6 months – at least 10% 12 months – at least 45% 18 months – at least 75% 24 months – 100%

[1] Source: *Treasury Regulations Section 1.148-7*.

Project Funds – Temporary Period Expiring

- The temporary period is a timeframe during which available construction proceeds can be invested without being subject to yield restriction.
  - Applies only if the issuer “reasonably expects” to satisfy the expenditure test, time test, and due diligence test at the time of issuance.
    - Reminder, the time test says an issuer must “reasonably expect” to expend at least 5% of the net sale proceeds on capital projects within 6 months after issuance.
  - Typically 3 years.
    - Other temporary periods can apply depending on nature of proceeds.
    - 5 years possible with certification from an engineer or architect.
- **Potential Opportunity:**
  - Invest in Demand Deposit SLGS as soon as the temporary period has expired as long as Demand Deposit SLGS have a yield higher than the arbitrage yield.
    - Make sure temporary period was not waived in tax certificate.
- **Consideration:**
  - Best opportunity for bonds issued to fund large and complex projects in 2020 and 2021.

Debt Service Reserve Funds

- Debt Service Reserve Funds can be invested without yield restriction if the fund is “reasonably required”, however they are still subject to rebate.
  - The small-issuer exception (less than $5 million) applies for reserve and replacements funds.
- “Reasonably required” means the fund cannot exceed:
  1. 10% of the principal amount of the issue.
  2. Maximum annual debt service on the issue.
  3. 125% of the average annual debt service on the issue.
- **Opportunity:** If the corresponding bond issue has a positive overall arbitrage position, consider moving to Demand Deposit SLGS if the yield is higher than the arbitrage yield.

Poll Question #2

- Which of the following is not true about Time Deposit and Demand Deposit SLGS?
  A. Time Deposit SLGS are fixed rate and Demand Deposit SLGS are variable rate.
  B. Subscriptions of $10 million or less must be submitted with 5 days notice whereas subscriptions of greater than $10 million must be submitted with 7 days notice.
  C. They are available for investment of tax-exempt bond issues.
  D. They are not a U.S. Treasury security backed by the federal government.

Evolving SLGS Regulations

New Final Rule

- The Treasury Department's Bureau of the Fiscal Service ("Treasury") recently released a final rule that amended the regulations governing SLGS securities.[1]
  - Rule went into effect **August 26, 2024.**
  - New rule further prevents prohibited uses of the SLGS program, which generally relate to investing in SLGS to create impermissible cost-free options.
- "No Maturity Longer than Necessary"
  - As a result of the misuse of the SLGS program, the Treasury is requiring that the term of any SLGS security be no longer than reasonably necessary for the issuer's governmental purpose.
    - Defined as "the issuer's expected use of invested funds".
- Maturity date restrictions:

New Rule	Old Rule
Early redemption requests cannot be entered until 14 days after the issue date	Early redemption requests could be made the day after issuance

New Rule	Old Rule
Issuers must provide maturity dates when the subscription is submitted	Issuers must provide maturity dates prior to settlement

[1] *Source: Final Rule. Effective August 26, 2024 by the Department of the Treasury Bureau of Fiscal Service.*

Effect of the Public Debt Limit on SLGS

- The Federal debt limit is set to be reinstated on **January 2, 2025** [1], potentially triggering the suspension of the SLGS program.
- Outstanding SLGS count against the federal government's debt limit.
- Thus, when the government approaches the debt limit, the Treasury can enact extraordinary measures.
  - One of these measures is suspending the SLGS program.
- **Since 1995, the SLGS window has been closed sixteen times**, for periods ranging from 24 hours to 235 days.[2]
  - Most recent suspension was from May 2, 2023 – June 5, 2023.
- Possibility for another suspension in early 2025 if an agreement to raise the debt ceiling cannot be met.
  - SLGS subscriptions placed prior to window closure will be honored.
  - Without access to SLGS, issuers are forced to structure escrows for refundings and defeasances with open market securities or cash (very high opportunity cost in this interest rate environment).

[1] *Source: CRS Report. (October 4, 2024). A Binding Debt Limit: Background and Possible Consequences.*
[2] *Source: Treasury Direct. FAQs for SLGS.*

Poll Question #3

- Which of the following is **false** regarding the public debt limit and SLGS?
  A. Outstanding SLGS count against the federal government's debt limit.
  B. SLGS subscriptions placed prior to a window closure will be honored.
  C. The SLGS window has never been closed before.
  D. If the SLGS window closes, issues must use cash or open market securities to fund their escrows.

Questions/Discussion

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