State and Local Government Series (SLGS) Treasury Debt: A Description

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Introduction

The U.S. Treasury projects the federal debt will reach its statutory limit before May 16, 2011. On May 2, 2011, in anticipation of reaching the statutory debt limit, U.S. Treasury Secretary Timothy Geithner sent a letter to Congress indicating that he would declare a debt issuance suspension period on May 16 to extend Treasury's borrowing capacity until early August 2011.

In the same letter, Secretary Geithner also indicated that Treasury would use its existing authorities to extend borrowing capacity. One example of this is that on May 6, 2011, the Treasury Department will "suspend until further notice the issuance of State and Local Government Series (SLGS) Treasury securities."[1]

As of April 30, 2011, SLGS represented 1.27% ($180.8 billion) of total debt outstanding (approximately 0.5% of outstanding debt is not subject to the debt limit). Suspending SLGSs will not change the debt limit, rather just delay the date when it is reached. Some have expressed concern that this suspension will have a negative impact on state and local government finances. This report explains SLGS, a nonmarketable custom tailored security, and how suspension may impact state and local government issuers.

SLGS Purpose

SLGSs are an administrative tool state and local governments use to comply with Internal Revenue Service rules on how the proceeds of tax-exempt bonds can be invested. Generally, state and local government issuers cannot invest tax-exempt bond proceeds "to acquire higher yielding instruments."[2] SLGSs are nonmarketable securities offered by the U.S. Treasury to state and local government bond issuers that, by design, comply with IRS rules.

SLGSs are helpful for state and local government debt management. State and local governments issue debt to finance an array of large capital projects. The timing of spending on these projects and required coordination with state and local budget appropriation cycles typically results in a mismatch between when bonds are issued and when spending needs arise. SLGSs provide a "safe harbor" investment option for state and local governments to "park" the proceeds until needed.

Often, issuers will sell a second tranche of tax-exempt bonds to replace outstanding bonds to take advantage of falling interest rates or to establish a reserve fund (or escrow account) to help repay or service the "old" bonds.[3] Typically, if the old bonds are redeemed within six months, the proceeds from the new bonds are in compliance with IRS regulations. This is considered a "current refunding."

[1] U.S. Treasury, Letter to The Honorable John A. Boehner, released May 2, 2011, available at http://www.treasury.gov/connect/blog/Documents/FINAL%20Debt%20Limit%20Letter%2005-02-2011%20Boehner.pdf. This was the third letter sent. See CRS Report RL31967, *The Debt Limit: History and Recent Increases,* by D. Andrew Austin and Mindy R. Levit.

[2] Generally, when proceeds of tax-exempt bonds are invested in higher-yielding instruments, they are considered "arbitrage bonds." These arbitrage bonds are not permitted under IRS rules and are taxable, see 26 U.S.C. 148(a)(1).

[3] Generally, the size of the reserve fund cannot exceed 10% of the original bond issuance.

In contrast, if the proceeds of the new issue are outstanding for more than six months, the new bonds would likely violate IRS rules and lose their tax-exempt status. This is considered "advanced refunding" and the proceeds from the bonds are most often used to purchase SLGSs.

Advance refunding is necessary as many outstanding bonds cannot be bought from the holder or "called" back before a given number of years, typically 10 years. Thus, the SLGS maturity must roughly match the term of the old bond to be refunded. For example, if a refunding bond (new) were issued today for a bond (old) that can be called one year from today, an SLGS with a term of one year would be purchased. Today, the interest rate paid by the U.S. Treasury on the security would be 0.18%.[4]

SLGS Volume

SLGS volume has declined as state and local governments have been not been refunding existing debt and the need for SLGSs has waned. As noted above, as of April 30, 2011, $180.8 billion of SLGSs are outstanding—down from $291.3 billion four years earlier. **Table 1** reports SLGSs outstanding in April for the last five fiscal years. The slow decline will likely continue as market participants seem to have not changed their appetite for the SLGS instruments.[5] The declining volume likely reflects strained state and local budgets generally and the relatively low interest rate paid by the U.S. Treasury. The lower rate reduces the opportunity cost of unspent bond proceeds. Through April of FY2011, SLGS redemptions ($64.7 billion) have exceeded SLGS issues ($52.4 billion) by $12.3 billion.

Table 1. Total SLGS Outstanding and Percentage of Total Debt Outstanding

On April 30 of Year Listed

Year	April SLGS Outstanding (in millions)	Change from Previous April	Percent of Total U.S. Treasury Debt Outstanding[a]
2007	$291,250		3.3%
2008	$286,818	-1.5%	3.1%
2009	$238,195	-17.0%	2.1%
2010	$209,445	-12.1%	1.6%
2011	$180,849	-13.7%	1.3%

Source: U.S. Treasury, Debt Position and Activity Report, various fiscal years, available at http://www.treasurydirect.gov/govt/reports/pd/pd_debtposactrpt.htm.

a. Roughly 0.5% of total debt outstanding is not subject to the debt limit.

[4] U.S. Treasury, "SLGS Daily Rate Table," available at https://www.treasurydirect.gov/GA-SL/SLGS/selectSLGSDate.htm, visited May 5, 2011.

[5] Temple-West, Patrick, "Treasury Schedules SLGS Closure for Friday," *The Bond Buyer*, May 2, 2011.

SLGS Suspension

The suspension of the SLGS program will likely create some disruptions for tax-exempt bond issuers that had anticipated using SLGSs for debt management. As noted in the U.S. Treasury letter, the suspension will "impose some added cost and inconvenience on state and local governments."[6] Without SLGSs, issuers will find other assets to invest and will be required to monitor the investments to insure they do not violate IRS rules. The IRS rules apply to the yield on the asset investment, not necessarily the type of asset. A likely alternative would be other U.S. Treasury securities purchased on the secondary market. As noted above, the impact of the suspension is mitigated by the apparent decline in demand for the instruments. An extended suspension, however, may generate significantly more disruptions as compliance costs would increase for potentially more issuers.

According to the U.S. Treasury, the SLGS program has been suspended six times in the previous 20 years. The periods of suspension lasted an average of 63 days, and are detailed in **Table 2**. The most recent suspension was for one day. In past suspensions, little market response was noted though some used the opportunity to suggest changes to the SLGS program to improve its operation.[7]

Table 2. Suspension of the SLGS Program Over Last 20 Years

Begin	End	Days
October 18, 1995	March 29, 1996	163
May 15, 2002	July 7, 2002	53
February 19, 2003	May 26, 2003	96
October 14, 2004	November 21, 2004	38
February 16, 2006	March 16, 2006	28
September 27, 2007	September 28, 2007	1
	Average	63

Source: U.S. Treasury, "State and Local Government Series: Frequently Asked Questions," released May 2, 2011, available at http://www.treasury.gov/connect/blog/Pages/secretary-geithner-sends-debt-limit-letter-to-congress.aspx.

Notes: CRS Calculations based on U.S. Treasury data.

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[6] U.S. Treasury, "State and Local Government Series: Frequently Asked Questions," released May 2, 2011, available at http://www.treasury.gov/connect/blog/Pages/secretary-geithner-sends-debt-limit-letter-to-congress.aspx.

[7] *The Bond Buyer*, "Market Participants Ask Treasury to Make Changes in Slugs," January 19, 1996.