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Are SLGS Needed Now That Tax-Exempt Advance Refunding Bonds are Banned?

WASHINGTON – Municipal market demand for state and local government series securities is certain to plummet in the wake of tax law changes that halted tax-exempt advance refundings after Dec. 31.

The vast majority of SLGS were purchased for advanced refunding escrows, municipal bond market experts say. Unlike open-market Treasuries, the maturities of SLGS can be especially tailored to match the maturities of bonds in advance refundings so yield restrictions are not violated.

The exact percentage is unknown because Treasury officials don't keep track of what SLGS are to be used for at the time of purchase.

"There is a self-certification that the funds being used for the purchase fall within the definition of 'eligible source of funds,'" Brad Benson, spokesman for Treasury's Bureau of Fiscal Services, said in an email.

Overall SLGS usage is tracked by Treasury. As of Dec. 29, there were 21,015 outstanding SLGS (bonds and notes) valued at $94.4 billion.

Dave Erdman, director of the Wisconsin State Capital Finance Office, estimates that 90% to 95% of the SLGS his state has purchased have been used in connection with advanced refundings.

One might question whether the SLGS program is still needed.

Treasury won't comment, but its plans may become clearer when the time comes to reopen the window on SLGS purchases.

That should happen soon. Congress faces a Feb. 28 deadline to raise or suspend the debt ceiling before Treasury exhausts its extraordinary measures, which include haling SLGS sales.

Treasury closed the SLGS window on Dec. 8 when the department began taking extraordinary measures to avoid breeching the nation's debt ceiling.

"Based upon available information, Treasury expects to be able to fund the government through the end of February," Treasury Assistant Secretary for Capital Markets Clay Berry said in a statement Wednesday. "Treasury urges Congress to act promptly on this important matter."

Normally Treasury reopens the window on purchasing SLGS immediately after Congress raises or suspends the debt limit.

Erdman, who is a member of the Government Finance Officers Association debt committee, said there are good reasons for keeping the SLGS program.

"I have other transactions that I do that I need to use SLGS that are not related to an advanced

refunding," he said.

Rich Moore, treasurer of the National Association of Bond Lawyers, echoed that sentiment.

"Anytime there are yield restrictions, SLGS are the correct bond issue," Moore said, citing acquisition financing and equity defeasance of tax-exempt bonds as two examples.

"I hope they don't discontinue it," said Moore, a partner in the San Francisco office of Orrick, Herrington & Sutcliffe.

Erdman said the current low investment yields may make it look like lower yielding SLGS aren't needed. "But I've been doing this long enough that when the investment rate increases pretty soon you are at or exceeding bond yield restrictions that you need to comply with," he said. "While the current market may not point to it, historically we had had, and we will have, markets where instruments like SLGS are necessary."

"Even if I was going to use cash to defease some bonds, I have to be cognizant of the yield restrictions and in order to meet those yield restrictions, I often use SLGS," Erdman said. "There are other needs out there for SLGS over and beyond escrows that are funded with tax exempt refunding transactions."

GFOA considers its discussions with Congress on reinstating advance refundings "to be very much alive," said Emily Brock, director of GFOA's federal liaison center.

The outline of the Trump administration's infrastructure plan recently leaked to the media would allow advanced refundings of tax-exempt private activity bonds used for infrastructure.

"I think that signaled that the White House and the administration understand that advance refundings are a policy tool that can be used to free up capital for more infrastructure spending Brock said.

Sam Gruer, managing director of the New Jersey office of Minneapolis-based Blue Rose Capital Advisors, said Treasury may weigh the cost of keeping a reduced SLGS program with the benefit of providing a public service that helps state and local governments comply with tax laws on arbitrage.

"I don't believe any municipality will be catastrophically harmed if the SLGS program is discontinued," Gruer said. 'It will be more expensive for the smaller issuers. For the larger issuers, often they don't use the SLGS program any way."

By Brian Tumulty

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