DEPARTMENT OF THE TREASURY
WASHINGTON

March 28, 1986

MEMORANDUM FOR: J. Roger Mentz
Assistant Secretary-Designate
Tax Policy

FROM: George D. Gould GDG
Under Secretary for Finance

SUBJECT: Senator Packwood's Proposed Modifications to the SLGS Program

Your office has requested our comments on Senator Packwood's proposed modifications to the Treasury's SLGS program, under which the Treasury issues securities (State and Local Government Series) to municipalities to permit them to comply with the anti-arbitrage provisions of the tax code. That is, the interest rates on the SLGS are set at rates equivalent to the rates on certain tax exempt securities (generally advance refundings) issued by municipalities in the market, thus avoiding arbitrage profits.

The current SLGS program was established by Treasury regulations in the 1970s and has not until now been the subject of legislative proposals. Under the current regulations, 20 days advance notice to Treasury is required prior to the purchase of SLGS. Also, SLGS must have a minimum maturity of 45 days.

While the language of the bill is apparently not yet available, we understand that the proposed Packwood modifications would eliminate our current requirements for both advance notice of purchases and a minimum maturity. The proposal would also direct Treasury to operate the program at no net cost to the Federal Government.

We do not understand why Packwood would have us convert the SLGS program into essentially a demand deposit facility. The current SLGS system is tailored to meet issuer needs and already provides a high degree of flexibility. We have received no comments from issuers that indicate that they find the current system places restrictions on them that prevent effective planning on their part. Of course, in extraordinary circumstances such as debt limit crises Treasury has no choice but to disrupt the SLGS program, but the proposed changes would not remedy that situation.

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We have the following problems with the Packwood proposal:

1. Cash and Debt Management Problems. Current investments in SLGS total approximately $86 billion, about twice the amount outstanding one year ago. In December 1985 (obviously not a typical month), net SLGS issues were $15.2 billion, compared to Treasury net borrowing in the market of $17.1 billion. Thus the proposed modifications could have a substantial impact on Treasury cash and debt management and thus on the market for Treasury securities.

Knowing when SLGS will be issued or redeemed permits Treasury to project its cash and market borrowing needs, provide advance information to the market, and thus minimize the market impact and costs of managing the public debt. Without this knowledge, Treasury could be required to make large and unexpected adjustments in the amounts it borrows in the government securities market. Market participants and current interest rates are very sensitive to changes on the order of $5 billion in Treasury's estimated quarterly borrowing needs. Sudden and unexpected inflows or outflows of SLGS funds of tens of billions of dollars could have serious adverse effects on the market.

Also, advance notice of purchases or redemptions of SLGS is especially important whenever Treasury's outstanding debt is close to the statutory limit on the public debt. Such information has been essential, e.g., in late 1985, to respond to urgent requests from the Senate leadership as to when the Treasury is likely to exceed the debt limit or run out of cash.

Large fluctuations in Treasury's cash balance have also raised monetary policy concerns, as consequent changes in Treasury balances at the Fed are offset by Fed open market operations and Fed watchers must distinguish between such offsetting actions and policy moves.

2. Cost Allocation Problems. Under the proposed modifications to the SLGS program, Treasury would be directed to operate the program at no net cost to the Federal Government. We would need to assess the costs directly related to the SLGS program and develop an appropriate fee structure that would spread costs equitably among SLGS investors. Fees are not now charged for SLG issues, but a complex fee structure might be necessary or all municipal issuers might be required to pay substantial fees to accommodate the demands of the more active accounts. In addition, the costs of the potential disruption of Treasury's orderly market financing pattern are immeasurable.

3. Pricing Problems. Treasury pricing of SLGS is based on the Treasury yield curve, which represents current yields on various maturities actively traded in the secondary market. Such market yield observations are generally accepted as a reliable basis for estimating current Treasury borrowing costs on new issues. However, market yields on securities with very short periods remaining to maturity are not a reasonable proxy for Treasury borrowing costs, because Treasury does not regularly issue securities with maturities less than 91 days and because as securities approach maturity their availability and trading diminish and thus their pricing is erratic. Consequently, to implement the proposal to offer SLGS with maturities less than 45 days, the Treasury would be required to devise a new market-based pricing system, which would require subjective and perhaps controversial judgments, to attempt to assure that the new system would involve no net cost to the Government.

4. Administrative Problems. The current automated system for handling SLGS, which was only recently implemented, was designed to handle SLGS as they are currently structured, and would not have the capability to handle them on the basis that is being proposed. The Bureau of the Public Debt estimates that it would take 18 to 24 months to build a new system, which would cost approximately $1 million. No funds have been budgeted or appropriated for such a system change in 1986 or 1987. Thus Treasury would not have the capability to handle SLGS on the proposed basis as of the date of enactment of the legislation.

5. Competition Problems. We are also concerned with growing dependence upon Treasury's financing facilities through the SLGS program. Treasury recognized the need in the 1970's for SLGS for what then appeared to be relatively modest potential amounts of advance refunding. The SLGS program has since become a major factor in municipal finance, with sophisticated investment programs designed to shift back and forth between SLGS and market instruments, and we understand that various current proposals would greatly expand the program and increase the demand for SLGS for other than advance refunding purposes. That is, municipal funds now on deposit with private financial institutions or invested in marketable securities are now proposed (apparently under various pending legislative or regulatory proposals) to be invested in an expanded SLGS facility. While we are not familiar with the details of these proposals, we are concerned that the Treasury SLGS program not be transformed into a substantial demand deposit facility which would displace private deposit and securities transaction functions. Our concerns in this regard go beyond our immediate cash and debt management interests to broader questions of the appropriate role of the Government in providing financial services. We recognize the need to reduce arbitrage profits, but we question the appropriateness of pursuing this objective in a way that creates perhaps needless demands for Government displacement of private financial services.

Conclusion

We would strongly oppose the proposed modifications to the SLGS program. Such modifications would clearly result in significant increases in the cost of the program. They could have significant adverse market impacts, and they could reduce investment yields to all State and local government investors in SLGS for the possible benefit of relatively few large issuers seeking to take maximum advantage of rapidly changing market rates of interest.

We would thus appreciate having your analysis of the potential demands for SLGS from the various proposals you are reviewing. Then we will be able to deal more effectively with the questions of how Treasury might meet those demands and the potential impacts on private financial institutions and on the market for our securities.

We understand that the Senate is likely to deal with the SLGS question shortly after it returns from the Easter recess. We would hope to have our above concerns resolved within Treasury in time to affect this process.

cc: Sherrie M. Cooksey