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PSA

October 27, 1987

By Hand

The Honorable James A. Baker, III
Secretary of the Treasury
Department of the Treasury
15th & Pennsylvania Avenue, NW
Room 3330
Washington, DC 20220

Dear Mr. Secretary:

At 5:10 p.m. on October 22, 1987, the Treasury Department issued an announcement imposing new conditions on the purchase of SLGS (State and Local Government Series treasury obligations) by municipal bond issuers, retroactive to October 19. On October 23, Treasury modified its announcement to remove its retroactive effect and thus avoid potentially severe disruption in the U.S. Government securities market, for which we are most appreciative. Nevertheless, the new conditions imposed by Treasury preclude issuers in the future from restructuring refunding bond escrow portfolios by purchasing SLGS to replace Treasury securities purchased in the open market at the time the escrows were created.

Under applicable Treasury regulations, the yield issuers can obtain on refunding bond escrow investments (the "permitted yield") may not materially exceed the yield on an issuer's refunding bonds. The SLGS program was initially designed to provide a source of Treasury obligations which would permit issuers to comply with those yield restrictions. In many instances, however, the yield on SLGS (based on interest rates established weekly by Treasury) has been significantly lower than the permitted yield. In order to minimize their investment losses from negative arbitrage, issuers have been required to purchase Treasury securities in the open market in an attempt to match investment yields with borrowing costs as closely as possible under prevailing market conditions.

Until Thursday's announcement, issuers have been permitted subsequently to sell their open-market Treasury securities and purchase SLGS when such sale and purchase would permit issuers to more closely achieve the permitted yield on invested funds. The effect of such escrow restructuring has been to permit issuers to reduce their losses by eliminating some or all of the negative arbitrage resulting from the discrepancy between the permitted bonds' yield and the investment yield on the escrow securities.

The conditions imposed by the Treasury announcement preclude any SLGS puchase if the composite yield of the SLGS to be purchased will exceed the composite yield of the Treasury securities being sold based upon the sale price. The Treasury action thus prevents issuers from improving their investment portfolios to more closely match investment yield with permitted yield, and essentially locks state and local governments into a loss position, which results from the discrepancy between the SLGS yield and the permitted yield existing at the time the escrow was created.

This effective suspension of an important aspect of the SLGS program is inconsistent with the purpose of the SLGS program and with the legislative history and congressional intent underlying the statutory provisions imposing arbitrage yield restrictions, as most recently expressed at Section 1301(d) of the Tax Reform Act of 1986, and discussed in both the conference report on the Act, and the General Explanation of the Tax Reform Act of 1986 (the "Blue Book"):

> Congress intended that the Treasury Department will apply its regulations under the revised program (both as to demand <u>and time deposits</u>) <u>in the most flexible manner possible</u>. . . .
>
> (JCS-10-87, General Explanation of The Tax Reform Act of 1986, p. 1213, emphasis added).

Moreover, Treasury's action appears to be another federal affront to state and local governments that precludes them from saving their taxpayers' money. As a result of this unwarranted damage to state and local finance, PSA strongly urges the Treasury Department to rescind the conditions on the purchase of SLGS set forth in Treasury's October 22, 1987 announcement, as amended, and to restore the full SLGS program as soon as possible.

Very truly yours,

Clayton F. Brown, Chairman
Public Securities Association

cc: The Honorable Lloyd Bentsen
The Honorable Alfonse M. D’Amato
The Honorable Daniel P. Moynihan
The Honorable Dan Rostenkowski
Under Secretary George D. Gould
Assistant Secretary Charles O. Sethness
Assistant Secretary O. Donaldson Chapoton
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