Do Not Get Yield Burnt This Summer

Another Suspension of SLGS Has Occurred, Then Been Lifted

Not to be confused with slugs (which are "terrestrial gastropod mollusks with an elongated body and no external shell"), SLGS are securities offered by the U.S. Treasury to state and local governments as an investment alternative to assist these issuers of tax exempt securities in complying with yield restriction and arbitrage rebate provisions of the Internal Revenue Code.

The State and Local Government Series (SLGS) securities program was established in 1972 following federal legislation enacted in 1969 restricting state and local governments from earning arbitrage profits by investing tax-exempt bond proceeds in higher yielding investments. State and local governments may invest in time deposit or demand deposit types of SLGS. SLGS are typically used by governments when refinancing outstanding tax-exempt debt.

On May 14, 2002, the Treasury Department announced the suspension of sales of SLGS until further notice, effective May 15, 2002. The U.S. Treasury determined that the suspension was necessary because the statutory federal debt ceiling had not been raised. The suspension was expected to help the U.S. Treasury manage its debt, subject to the federal debt ceiling. The suspension was lifted July 9, 2002.

Governments Should Be Careful Not To Be Yield Burnt

As a result of the SLGS suspension, state and local governments were required to use open market U.S. Treasury securities for their escrows to refinance tax-exempt debt. When purchasing such open market securities, governments should be careful not to knowingly or unknowingly participate in yield burning.

Yield burning occurs when a government buys open market securities from an investment house/underwriter at prices that are prohibitively marked up. An investment house/underwriter that overcharges a government for open market securities purchased with the proceeds of tax-exempt bonds diverts money to itself at the expense of the U.S. Treasury and the state or local government. When money is diverted from the U.S. Treasury it's called "yield burning" because the overcharge illegally "burns" the yield down to a level that appears to comply with federal tax law, but does not.

The risks to the government are not only that it is being overcharged, but that its bonds will be declared taxable and as a result it will not be able to access the tax-exempt bond market in the future. These risks are real. According to the SEC, more than $171 million has been paid by 21 investment houses/underwriters to the U.S. Treasury to resolve charges of yield burning throughout the 1990's.

Although the current suspension has been lifted, future difficulties from reaching the federal debt ceiling are likely and continuing reviews of yield burning can be expected.