Demand Deposit SLGS and Bond Proceeds: It's Not What You Earn, But What You Can Keep

The current yield curve environment has created an opportunity for issuers of tax-exempt bonds to invest at a lower yield than prevailing market yields to potentially increase retainable earnings. Demand Deposit State and Local Government Series Treasury Securities (Demand Deposit SLGS), which are a series of direct-issue obligations from the U.S. Treasury offered exclusively for compliance with the arbitrage rebate and yield restriction requirements,* may be valuable to issuers in certain circumstances as they seek to maximize the amount of earnings they retain when investing tax-exempt bond proceeds.

However, future changes in interest rates could reduce or eliminate this opportunity. This may particularly be the case should the Federal Reserve (Fed) continue to implement its rate-cutting cycle. Any Demand Deposit SLGS strategy should be carefully considered on an issue-by-issue basis and managed in response to future interest rate changes.

What are Demand Deposit SLGS?

- Demand Deposit SLGS are certificates with no fixed maturity date. The obligations roll over daily and remain outstanding until redeemed, in whole or in part.
- The yield on Demand Deposit SLGS is variable, generally resets weekly and is based on the average yield of the most recently auctioned 13-week Treasury Bills. The yield on the 13-week T-Bills is adjusted lower to create a tax-exempt equivalent yield.
- Demand Deposit SLGS are not subject to the arbitrage rebate and yield restriction rules.

Elevated Short-Term Yields Create Opportunity

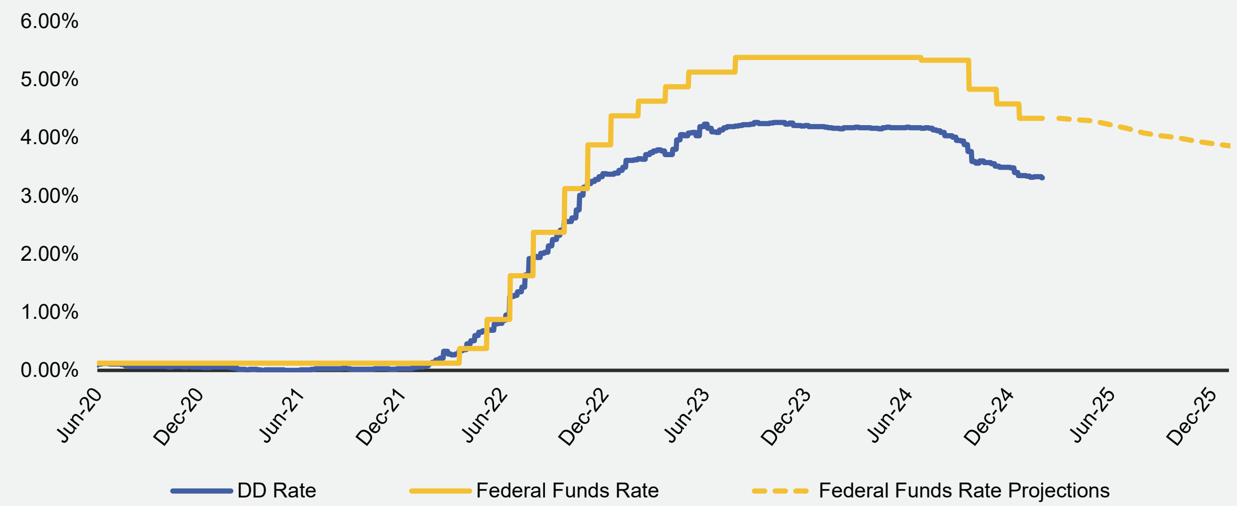
The Fed's aggressive interest rate hiking campaign of 2022 – 2023 has significantly increased short-term yields relative to the ultra-low post-pandemic interest rate environment. Rates on Demand Deposit SLGS, which are impacted by yields on the short end of the Treasury curve, have likewise moved higher.

***Not Familiar with Arbitrage Rebate Rules?**

For more detailed information about the arbitrage rebate basics that every investor should know, please refer to another published piece of ours - [Arbitrage Rebate 101](#).

The following table shows how Demand Deposit SLGS rates have significantly risen beginning in the summer of 2022, and have begun to steadily decline starting in September of 2024 in response to the Fed loosening monetary policy. As evidenced by the Federal Funds Rate Projections shown below, the Fed is expected to cut short-term rates further over the coming year. The rate on Demand Deposit SLGS are likely to fall accordingly, but may remain at levels that continue to offer value for bond issues with very low arbitrage yields.

Sharp Rise of Demand Deposit SLGS Rates



Source: Bloomberg and SLGSafe. Federal Funds Rate Projections as of January 30, 2025.

How Can Investing in Lower Yields Increase the Earnings I Keep?

Given the significant increase in taxable yields over the last few years, many bond proceeds accounts that are subject to arbitrage rebate or yield restriction must rebate earnings above the arbitrage yield from taxable investments. However, because Demand Deposit SLGS are a tax-exempt investment, all earnings can be retained even if invested above an issue's arbitrage yield. A hypothetical example of the potential benefit from investing in Demand Deposit SLGS relative to taxable alternatives follows:

Taxable Investment	
Investment Balance:	$50,000,000
Term:	50% Spent in 18 Months
Arbitrage Yield of Bonds:	2.50%
Taxable Earnings Rate:	4.25%
Taxable Earnings:	$2,522,044
Earnings to Rebate:	$1,068,835
Retainable Earnings:	**$1,453,209**

Demand Deposit SLGS Investment	
Investment Balance:	$50,000,000
Term:	50% Spent in 18 Months
Arbitrage Yield of Bonds:	2.50%
DD SLGS Earnings Rate:	3.30%
DD SLGS Earnings:	$1,943,538
Earnings to Rebate:	N/A
Retainable Earnings:	**$1,943,538**

Benefit from Demand Deposit SLGS vs. Taxable Investment: **$490,329**

The Mechanics of Investing in Demand Deposit SLGS

Purchases and redemptions can be executed directly with the U.S. Treasury via SLGSafe, the Treasury's online portal. The size of the request determines the timing of transactions. The U.S. Treasury requires advance notice of issues and redemptions to better forecast needs. Investors should plan carefully around draw schedules and other liquidity needs to ensure cash is available when needed.

Purchases

- Subscriptions greater than $10 million must be submitted seven calendar days before issuance.
- Subscriptions of $10 million or less must be submitted five calendar days before issuance.

Redemptions

- Redemptions greater than $10 million must be submitted at least three business days before settlement.
- Redemptions of $10 million or less must be submitted at least one business day before settlement.

In the event that the Treasury suspends SLGS sales, Demand Deposit SLGS are converted to 90-day certificates that continue to bear interest. Investors may still redeem Demand Deposit SLGS during a suspension by following the normal procedures.

What Can PFM Asset Management Do to Help?

PFMAM's arbitrage rebate and investment specialists can perform a customized review of the relevant bond issue to determine if Demand Deposit SLGS are an appropriate investment. Demand Deposit SLGS have a lower yield than comparable taxable investments, which requires an issuer to forgo interest income. As such, they should only be utilized if an account is generating or expected to generate positive arbitrage. Note that Demand Deposit SLGS may not be an optimal investment approach for issues that can meet an exception to the arbitrage rules or have preexisting negative arbitrage.

If Demand Deposit SLGS are deemed suitable, PFMAM can offer the following range of services shown in the table below.

Coordinate & File SLGS Subscription	Rate & Arbitrage Monitoring	Value-Add Reporting
► Coordinate with various parties to obtain the requisite information to subscribe for SLGS ► File a subscription via the SLGSafe application ► Serve as a resource to custodians that are unfamiliar with the mechanics of Demand Deposit SLGS	► Monitor the rate of Demand Deposit SLGS relative to the arbitrage position of the relevant bond issue and advise if/when a change in strategy is appropriate	► Provide periodic reporting that summarizes the benefit of additional retainable earnings from investing in Demand Deposit SLGS relative to taxable alternatives

To learn more or discuss in greater detail, please reach out to SPG@pfmam.com and ArbitrageRebate@pfmam.com.