Canadian Municipal Bonds

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Interest in Canadian municipal bonds from the viewpoint of bank examiners stems from the fact that from time to time these securities are encountered in bank portfolios. Naturally, they are encountered with greater frequency in the portfolios of institutions contiguous to Canada than elsewhere in the United States, but a surprising number of issues are held by small banks remotely situated. In recent years, certainly, there is no evidence that the holdings have given rise to any serious banking problems. Canadians, in this respect, scarcely differ from other municipal securities. There is a feeling though, that Canadian municipals as a group could be troublesome given the proper combination of events. It is for this reason that time devoted to a thoughtful consideration of the special problems inherent in Canadian municipal securities would seem to be well spent.

Size of Problem. Banking statistics are not particularly helpful in an endeavor to ascertain the volume of Canadian municipal securities held by insured banks. The amount of these issues has never been reported separately. However, a review of the available data suggests that holdings of Canadian municipal issues in bank portfolios were less than $75 million in the mid-thirties and that the amount probably never exceeded $100 million. At the present time, the figure is no doubt somewhat smaller than the maximum reached during the period since 1934.

Compared with the volume of Canadian debt outstanding, it is clear that holdings by insured commercial banks are relatively small. The Dominion debt is estimated at about $13 billion. The debts of the Provinces probably amount to $1,800,000,000, and the minor subdivisions of government account for almost $1 billion of bonds. In addition, there is about a half billion of Canadian securities bearing governmental guarantees of one sort or another. A more or less casual review of bank examination reports indicates that obligations issued by the Dominion Government, the Provinces and the larger cities are the ones most frequently held by American banks. However, insured banks apparently have not, at least in recent years, been an important factor in the absorption of Canadian securities.

Even if precise over-all statistics on insured commercial bank holdings of Canadian issues were available, they would only add some refinement of detail to the picture. Difficulties caused by any category of bank assets are not measured by any system-wide aggregates but by the number of individual banks holding unmanageable quantities. So, if we desire to appraise the magnitude of the problem, it will be necessary to study individual bank holdings. Unfortunately, a so-called frequency distribution of Canadian bond holdings is not presently available in our statistics. At best, one has to rely upon impressions derived from the reading of examination reports. However, there is not much reason to believe that the problem is particularly acute or widespread, although from time to time certain banks do appear to hold rather substantial quantities of these securities.

Probably more to the point is the fact that small blocks of Canadian issues are noted in the most unexpected places. For example, these bonds appear in portfolios of small banks operating in the Deep South and the Southeast as well as in a number of institutions whose specialty is cattle loans in the Plains States. These holdings, let us hope, are not large enough to cause any real trouble to the banking system or even to individual banks. Nevertheless, it is undesirable to have even five or 10 of the poorer quality of Canadian bonds in the portfolio of a bank whose investment record has been mediocre or worse.

Within the past few years, distributors of Canadian municipals at times apparently have concentrated sales effort on the smalltown and less well-informed bankers. This is an unwholesome situation. One cannot object if informed bankers buy Canadian securities, but it certainly is unfortunate when bankers who are obviously out of touch with the situation buy an investment which they are not particularly competent to judge.

Standards for Canadian Municipal Holdings. The standards applicable to Canadian issues should not be dissimilar from those established for any American municipal security held by a bank. Certainly, no one has made a case for the relaxation of any basic credit requirements. The fact that Canadians are completely outside of our legal system is in itself sufficient to justify relatively high standards of investment quality. Admittedly, securities are not likely to be well selected if paramount consideration is given to legal rights. Yet it is well to remember that the holder of a Canadian bond acquires remedies enforceable only in a foreign jurisdiction.

American municipal securities are outstanding in sufficient volume to provide our banks with a thoroughly adequate area of investment. Right now it is reasonable to suppose that the net amount outstanding is somewhat in the order of $14 billion and the volume is growing almost daily. For reasons of taxation and otherwise, the insured banks have increased their holdings more or less steadily over a period of years. The recent figures show that almost $4½ billion of municipal bonds are held by insured commercial banks. Accordingly, the statistics do not suggest that the American banks are suffering from a shortage of appropriate municipal investments. In these circumstances, it would be advisable to maintain investment standards to the fullest extent.

Why Banks Buy Canadian Municipals. The reasons motivating the purchase of Canadian municipals for bank investment are various, but unquestionably yield rather than considerations of quality or balance in the securities portfolio predominates. Owing to the many uncertainties, some of which are rather material, the yields on Canadian issues tend to be relatively high. The lure of yield is not easily withstood by investors, and the managers of bank portfolios are no exception. Strangely enough, the promise of a fractionally greater interest income often is sufficient to sway the judgment of a securities buyer. Many times, the yield differential does identify a "bargain"; not infrequently however it earmarks a potential loss of principal. The yield, of course, is not augmented by any special tax advantages such as accrue to holders of our State and municipal issues.

Other considerations no doubt are important in accounting for the purchase of Canadian municipals by banks. The historical fact that banks have always bought them is no doubt a powerful factor. Investments tend to be made on a customary basis to a very large extent. Finally, in some of the States bordering on Canada the bank managers are as well informed about Canadian as their own credits.

Special Problems in the Analysis of Canadian Investments. Canadian municipal bonds are foreign securities and, as such, payment always involves a foreign exchange problem. This is true despite the fact that the debt may be stated in dollars and payable at an American fiscal agency. Such a contractual provision places the hazards of exchange upon the obligor but it does not obviate the problem. So long as Canada does not have too burdensome an exchange problem, and provided the dollar amount at stake is small, bondholders will probably fare well enough. Nevertheless, it is well to remember that the American portfolio of Canadian securities is one of the minor complications of the problem with respect to Canada's trade balances.

This is not the time nor place to undertake a detailed analysis of Canadian international balances of payments. However, one need not be a student of foreign exchange in order to come to the conclusion today that the currencies of the world are suffering definitely from maladjustment. This single fact would be sufficient to argue that commitments impinging even remotely on foreign exchange should be avoided whenever possible.

Admittedly, the Canadian economy is rather closely tied up with our own fortunes. To the American holder of Canadian bonds this is a favorable element. On the other hand, Canada cannot hope to escape the consequences of her political, social and financial ties with England, and it is anybody's guess what they may cost over either the near or the long term.

Except for a few of the large metropolitan banks, it is doubtful that many American institutions are in a position to judge foreign exchange aspects of a Canadian munisipal credit very precisely. Bankers who own these securities, however, should not be permitted to forget that the foreign exchange problem is implicit in their investment. The uncertainties of this character emphasize the importance of requiring bank investments to be concentrated in issues of the highest credit quality.

The difficulty of assembling information with respect to Canadian municipal issues greatly complicates the problem of credit analysis. Data regarding the Dominion Government in the customary sources of investment information are quite complete, the Provinces are covered reasonably well but the reports on the minor subdivisions of government are exceedingly sketchy. In the course of our studies of Canadian issues, we made an effort to obtain financial reports directly from the issuers of securities. This involved a very substantial amount of correspondence, and the reports when finally obtained were far from up-to-date.

The legal relations between the Dominion and the subdivisions of government in Canada add a further complication in the analysis of obligations. Sometimes these relationships may add strength to situations which appear on the surface to be unsatisfactory. At other times, one is left with the feeling that weakness is present, but it eludes the analyst.

In recent years, the Canadians have discussed at great length the fields of taxation which would be appropriate for the Central Government and the Provinces respectively. Certain so-called Dominion-Provincial tax agreements have been negotiated recently. For example, pursuant to these agreements, some of the Provinces have relinquished the authority to make levies on incomes and inheritances. It appears that whenever the Provinces vacate a field of taxation to the Dominion Government they receive a subsidy in return. This subsidy, of course, becomes part of their general revenues. It cannot be thought of as available solely for debt service.

A more or less superficial study of the relationships between the various units of government leaves one with the general feeling that whenever a subdivision of government gets into trouble there is a possibility that at the next higher level some governmental unit may come to the assistance of the unfortunate. However, history demonstrates more often than not that aid is not forthcoming. As a consequence, one would want to know a great deal more about the relationship between governmental units before he concluded that credits were bolstered by factors as intangible as these.

The study of even very recent debt history in Canada reveals a surprising number of default records. Largely, no doubt, because investors have to be inveterate optimists--and bank investors are no exception--these records do not seem to throw the pall over securities which one would expect. However, defaults have occurred, and so far as anyone can foresee they will reoccur when the evil days come. This is still another reason why high standards of investment quality should be required.

The debt burden of Canadian municipals measured, for example, by the relationship between outstanding securities and assessed value tends in most instances to be definitely on the high side. In part, this results from the fact that the standards for public services are quite advanced; but the economy is relatively immature. To some extent, it may be a reflection of a public revenue system which places only moderate reliance on the general property tax. Broadly speaking, however, a high debt ratio is a high debt ratio and not a good sign whenever it is found. Unless bank management can furnish some cogent reasons, it seems that an examiner would be well advised to complain if the debt ratio on a block of municipal securities is high. With only a little trouble, investors can find Canadian issues which very definitely measure up to standards we consider appropriate for American issues.

A surprising volume of debt created by the Canadian municipalities is in term rather than serial form. This is unsatisfactory from the viewpoint of the obligor because at least American experience has demonstrated that unless a municipal debt is serialized adequate provision for its retirement is not likely to be forthcoming. From the viewpoint of the portfolio manager, serial maturities afford a simple method for arranging a schedule which will insure a liquidation of the investment without reliance upon the market.

A study of financial reports for a considerable number of Canadian municipalities reveals, as one would expect from the volume of term securities, an extensive use of sinking funds to provide for the retirement of debt. Moreover, the quality of these sinking funds ranges from extremely good to mediocre or worse. Sometimes it is obvious that the fund, at least up to the time of the report, has been used in a manner which will accomplish its purpose. However, it is evident that some of the funds are not properly managed. When, for example, one finds transfers between the financial accounts of a municipality considered as a sinking fund asset, there is nothing to do but despair.

American experience in the field of municipal credit usually gives at least lip service and sometimes a more substantial adherence to a philosophy of debt retirement. On the other hand, in Canada it appears that sentiment favorable to debt retirement is not nearly as firmly established. For example, in the course of the war period American municipalities reduced outstanding net debt by about 15% whereas the reduction in the outstanding Canadian obligations was relatively much smaller. In short, one could argue from the evidence that Canadian municipal debt is a much more "permanent" phenomena than the debt of American communities. The absence of a satisfactory debt retirement program is viewed with askance by careful investors. Broadly speaking, a pay-out plan which contemplates the liquidation of an existing debt in twenty years is good evidence that it is manageable.

Need for Simplified Analysis. A review of a great many investment portfolios leaves one with the feeling that simplicity in the analysis of securities is a major requirement for bank investment. Percentagewise, and even on the very largest portfolio, dollarwise the earnings from investments are not very great. Certainly the small difference in returns obtained from issues of the highest quality and those of inferior grades is too small either to justify the risk of loss or the expense of finding the so-called "sleepers" from issues that otherwise appear to be bad.

It is perfectly obvious to me that only a very few banks can afford the facilities for analysis required to buy a large assortment of Canadian issues. In the first place, only a few institutions would have available the necessary information. In this connection, it would be well to point out that Moody's Bond Handbook or the Manual on Governments furnishes the starting point and not all of the data required by any means. Previous comments with respect to foreign exchange are indicative of the scope of the problem.

Not only is it difficult for the bank investor in Canadian issues to assemble the necessary information, but in addition to that, and more important, the institution must have a personnel qualified to analyze and interpret the data. This is obviously costly. Unless the portfolio is exceedingly large, it would be hard to believe that one man could devote all his time to these activities. Unfortunately, a study of Canadian securities is very definitely not a part-time occupation. One is driven to the conclusion that in the absence of an elaborate arrangement for analyzing these credits the only alternative is to confine purchases to a few of the very highest quality issues and then only if the institution has some familiarity with the Canadian situation. In the absence of that familiarity, the best alternative is to avoid investments in this area.

Summary and Conclusions. To sum up then, Canadian municipal securities have always been, and probably always will be held by American banks. The aggregate investment is likely to be small, but for certain institutions the holdings will amount to a fair portion of the total investment portfolio.

Canadian issues held by insured banks should measure up to the standards of acceptable bank investments. Furthermore, banks holding Canadian municipals should be able to demonstrate that they are able to cope with the peculiar difficulties in selecting and managing these issues. Not only does this involve appropriate sources of information, but it calls for personnel qualified to analyze and interpret the pertinent data.

Needless to say, any readjustment found to be necessary with respect to a bank's holdings of Canadian issues should be effected gradually and in an orderly manner. It is never wise to attempt hasty liquidation of securities and these issues are no exception to the rule.