Canada as an Investment Safe Haven: Implications for Municipal Credit

Kyle Hanniman

IMFG Post-Doctoral Fellow
Institute on Municipal Finance and Governance
Munk School of Global Affairs
University of Toronto

kyle.hanniman@utoronto.ca

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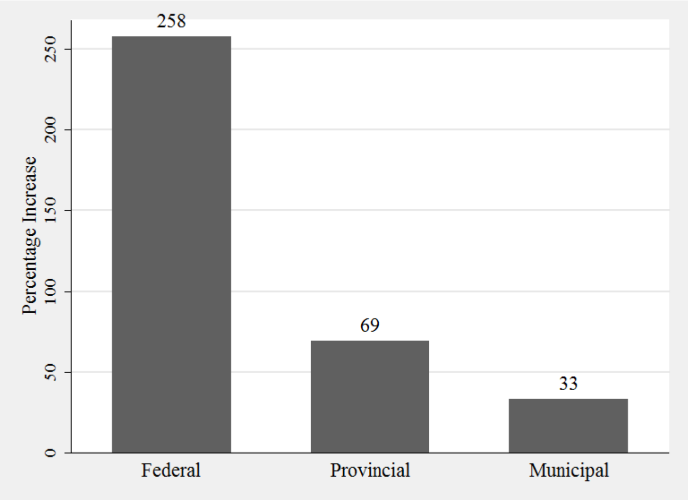
Percentage Increase (Book Value) in Non-Resident Holdings of Government Bonds

Jan.2008 to Dec.2012



Statistics Canada, Own Calculations

Why Worry about Safe-Haven Flows?

Because they implicate...

Market discipline of government finances

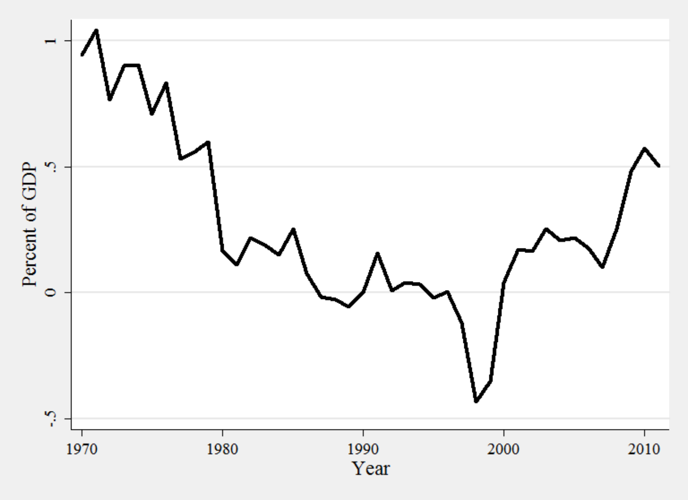
- More relevant at provincial than municipal level (municipal indiscipline constrained by provincial oversight)

Costs and stability of infrastructure finance

- Municipalities have massive infrastructure needs; borrowing is an important part of the solution
- Municipal infrastructure investment is up

Borrowing Like It's 1979: Infrastructure Financing Is Up

Net Municipal Borrowing as a Percentage of National GDP



Statistics Canada, OECD, Own Calculations

Key Questions

- What factors are driving foreign investment in Canada's government bond markets? What factors are driving investments in municipal and provincial bonds in particular?
- How are these developments affecting municipal borrowing costs and spreads?
- Are there long-term risks and opportunities associated with these developments? What are municipal governments doing to manage them?

Outline

- Drivers of international investment
- Implications for municipal borrowing costs and spreads
- Risks and opportunities; policy response

Why Foreign Investors Like Canada

Global hunt for safety and yield

- Driven by ultra-low interest rates and risk aversion

Government of Canada bonds attractive in this context

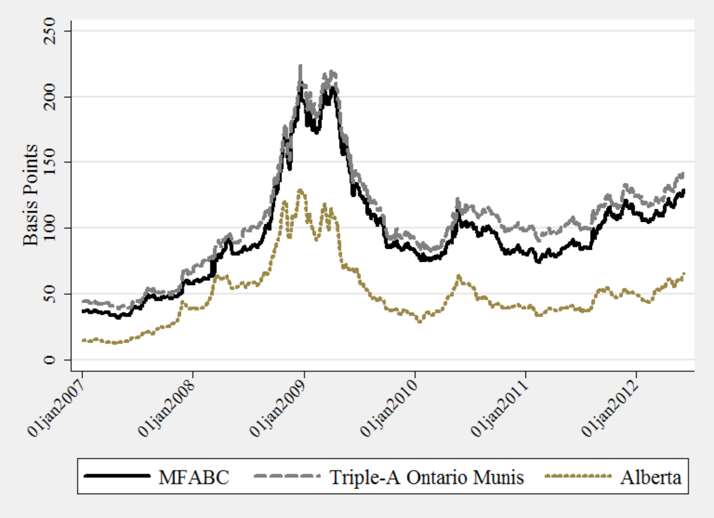
- Low credit risk
- Stable currency

Municipal and provincial bonds have several attractive features

- Safety
- Liquidity (sometimes)
  - Issuers of “relatively” liquid municipal debt include MFABC, Montreal, Toronto, York, Peel, Ottawa, Vancouver, TransLink, Winnipeg
- Interest rate spread over Canada bonds

Subnational Spreads over Canada

Selected AAA Borrowers



CIBC, BMO; 10-Year Constant Maturity Bonds

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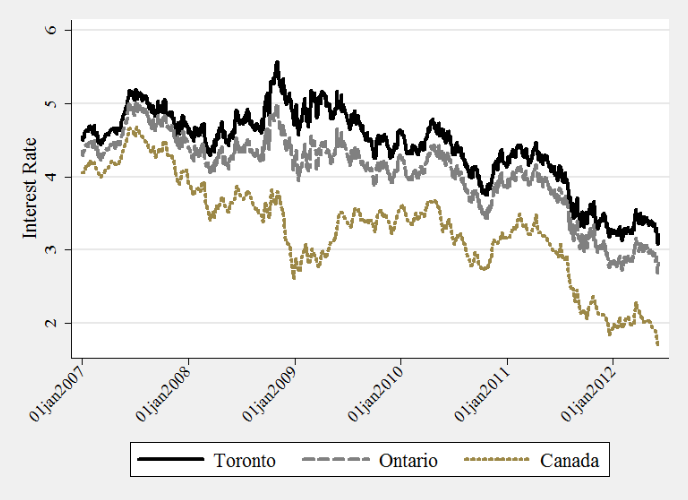
Borrowing Costs Have Plummeted

Canada Bond Yields Dominant Driver of Subnational Rates



CIBC, BMO, Bloomberg; 10-Year Constant Maturity Bonds

Drivers of Low Benchmark Rates

Yields have fallen in general; function of

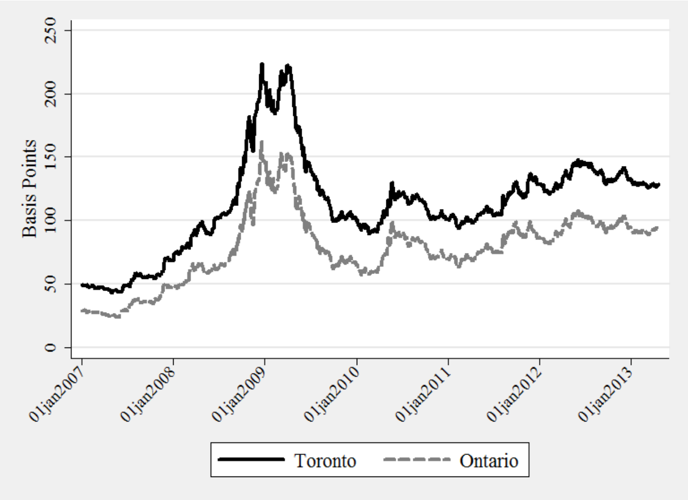
- Loose and unconventional monetary policies
- Weak global economy
- Global savings glut

Yields have fallen in safe-haven countries in particular; function of

- Flight to quality in global capital markets
    - Safe-haven flows reflect this trend

Intergovernmental Spreads Have Widened...

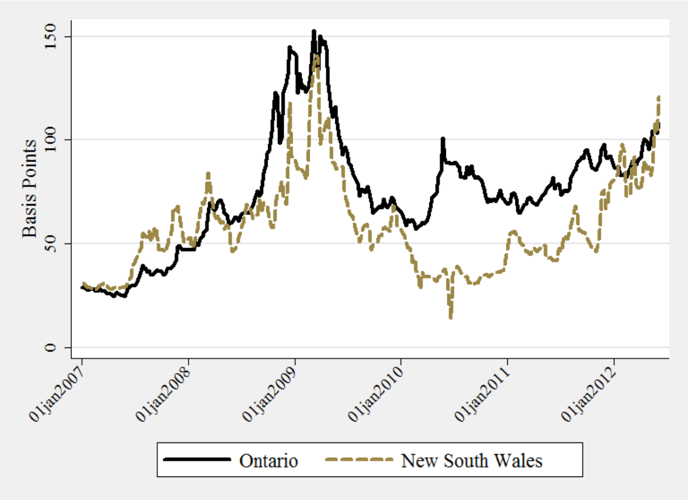
Spreads over Government of Canada Bonds



BMO; 10-Year Constant Maturity Bonds

...Similar Developments Evident in Other Countries

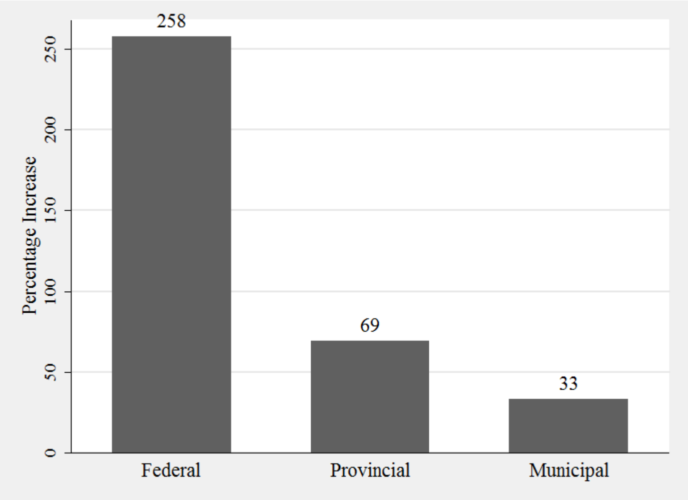
Ontario and New South Wales Spreads over Respective National Bonds



CIBC, Reserve Bank of Australia; 10-Year Constant Maturity Bonds

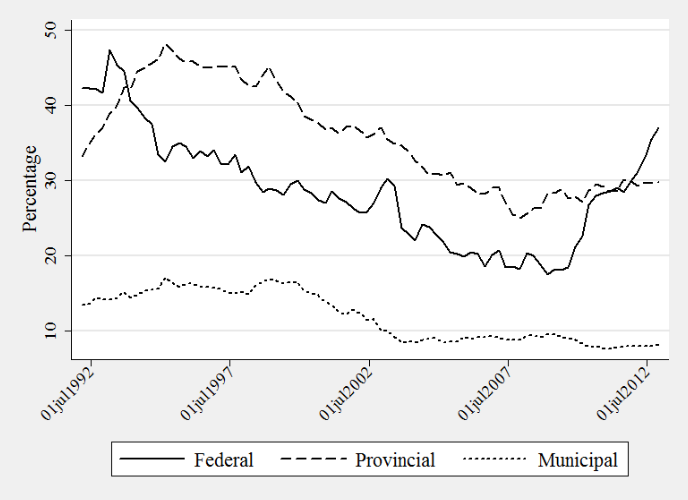
Are Safe-Haven Flows Driving Spread Widening?

Percentage Increase (Book Value) in Non-Resident Holdings of Government Bonds; Jan.2008 to Dec.2012



Statistics Canada, Own Calculations

Percentage of Non-Resident over Public Bond Holdings



Statistics Canada, Bank of Canada, Own Calculations; Calculations based on book values of bonds

Safe-Haven Flows and Spread Widening

Safe-haven flows disproportionately favour higher tiers of government

- Foreign purchases of federal paper outstripping net supply

These patterns aren't entirely surprising...

- Safe-haven flows naturally favour higher tiers of government (standard flight to liquidity / quality effects)

...but not entirely explained by conventional mechanisms

- Investment patterns also reflect informational frictions: investors under invest in sectors with which they are least familiar (insight from home-bias literature)
- Foreigners have superior information on higher tiers of government; Why?

Challenges of Subnational Credit Analysis

Why do international investors have inferior information on subnational borrowers?

- Lower profile in credit markets
- Lack of comparable cross-national economic and fiscal data
- Lack of information on political and fiscal ties to higher levels of government (principal determinant of subnational credit risk)

Possible questions for international investors

- Are subnational debts implicitly guaranteed?
- Are subnationals subject to credible fiscal and borrowing rules?

Costs of acquiring this information are high and demands for information are growing

Empirical Evidence: Informational Gaps Reflected in Investment Policies

Research consists of interviews with bond underwriters in Canada and Germany (2011-2013)

Interviews reveal that foreign investment patterns reflect costs of credit analysis. Foreigners invest in the following order:

- sovereign governments
- explicitly guaranteed entities (e.g. CMHC)
- first-tier implicitly guaranteed entities (e.g. provinces)
- second-tier implicitly guaranteed entities (e.g. municipalities)

Not all investors make it to municipalities (e.g. central banks and non-U.S. investors stop at provinces)

Interim Summary

- There's been a sharp increase in foreign investment in provincial and municipal bonds
- Investors are attracted to the safety, liquidity, and return on these securities
- Borrowing costs are declining, but subnational spreads are widening due to risk aversion and the informational challenges of analyzing subnational credit risk

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Risk and Opportunities

Opportunities

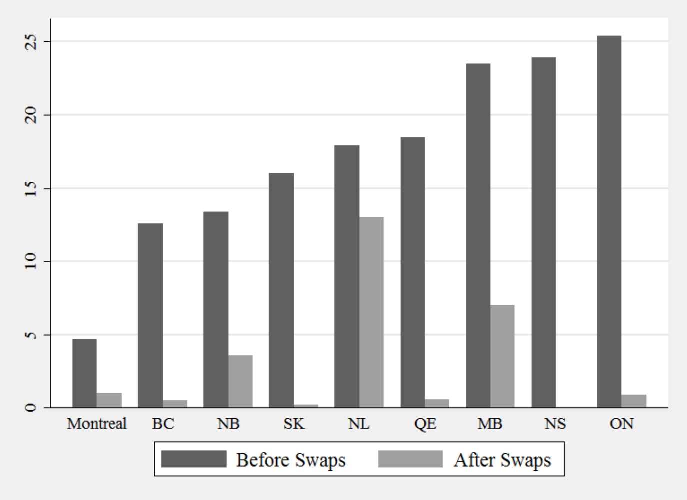
- Lower borrowing costs
- More diversified investor base

Potential risks

- Moral hazard (bigger risk for provinces than municipalities)
- Foreign currency mismatches (provincial and municipal FX exposures are limited)
- Foreign capital flight (partly offset by investor relations efforts)
- International reputations of benchmark borrowers - i.e. Canada and Ontario

Foreign Currency Risk Is Immaterial:

Percentage of FX Debt/Direct Debt (2011)



Zero exposure before swaps for Alberta, PEI, Durham, Halton, London, Muskoka, North Bay, Ottawa, Peel, Quebec City, Toronto, Vancouver, Waterloo, Winnipeg, York; Source: Moody's Investors Services

Managing Opportunities and Risks:

Investor Relations Efforts

Municipal and provincial governments actively cultivating international investors by providing more and better information

- Road shows and one-on-one meetings with investors
- Improved websites
- Advanced notice of bond issues

These efforts could narrow spreads and limit the risks of capital flight

But they have limits: Municipal and provincial reputations are only as strong as Canada's