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What Interest Rate for Municipal Loans?

DISCUSSION *of Important Problems of Municipal Finance by Mr. Thomas Bradshaw, F.I.A., Toronto—Rate Should be in Harmony with Market Conditions—Responsibility Involved in the Administration of Sinking Funds.*

(Concluded.)

By **THOS. BRADSHAW, F.I.A.**

THE second matter to be discussed is the rate of interest which loans should carry. It is submitted that bonds issued from time to time should carry a rate of interest which is in harmony with market conditions. For some time past it has been the practice of some of our municipalities to make their issues at a set uniform rate of interest, as though it were a sacred matter to preserve such rate for all of its borrowings. As a rule, the rate so strenuously adhered to is materially less than the prevailing rate and not in keeping with that at which similar securities are bought to yield. The more correct view is, that bonds should be issued at such a rate that the municipality would be enabled to realize approximately par for its issues. The failure to recognize this principle has forced many of our municipalities to dispose of their bonds at heavy discounts.

One municipality, which has religiously issued its bonds for a considerable period at a 4½% interest rate, gets over the difficulty by increasing the amount to be borrowed over and above the actual cost of the works for which the loan is provided, to the extent of the expected discount that will have to be made when a sale is effected. An illustration of this is found by referring to a recent by-law of this municipality. The by-law stated that the actual cost of the works amounted to $1,460,000, while the debt incurred and the amount of bonds to be issued was set down at $1,586,612, or $126,612 more than the actual cost of the works. The reason given in the by-law for this large increase in debt over the actual cost of the work was, "To provide for the discount, if any, and the expense incidental to the negotiation and sale of the bonds." There is, of course, no expense incurred in connection with the sale of this municipality's bonds, inasmuch as they are sold by tender, and consequently the debt of the municipality was deliberately increased by $126,612 because it was known that at the rate of interest at which the loan was authorized the bonds could not be sold so as to realize par, or their face value.

The practice of selling bonds carrying a rate of interest materially less than the current rate for like securities has the effect of unduly swelling the municipality's debt. It is only necessary in this connection to consider the loan above referred to. If this loan had carried the normal rate of interest, a rate which would have enabled the municipality to dispose of its bonds at about par, the debt created would have been only $1,460,000, instead of $1,586,612. The increase in this particular debt amounted to not less than 8¼%.

At a time when the debts of many of our municipalities are assuming large amounts, it is important that they should not be improperly inflated, and the municipality's financial position thus adversely represented. Moreover, when debts of the different municipalities are being closely scrutinized and compared by financial houses and investors, it is important, for the sake of their credit, that nothing should be done that would place them in a worse condition than that which they are entitled to occupy. It is well known that the more favorable the financial affairs of a municipality are, the more highly will its bonds be regarded and the higher will be the price which they will command.

In the municipality to which reference has been made it may be interesting to state that in the year 1914 its debt was increased by $752,000, or almost 7%, through discount on bonds issued at a rate of interest inconsistent with market conditions. This amount the city had not received or expended, and to that extent its debt was unwarrantably swollen.

It might be thought that it would injuriously affect a municipality's credit in the investment market if its bonds were to be issued at a higher rate of interest than that which obtained in past times. There is absolutely no foundation for this view, as investors and financial houses recognize that governments and municipalities, like corporations and individuals, must be prepared to pay the current rate of interest for their loans. Justification for varying the interest rate is to be found in the practice of governments and important municipalities. They adopt the principle of putting out their loans at a low rate when money is cheap and a higher rate when money is dear. We have only to mention in this respect the action of such important borrowers as the British and Dominion Governments, the City of New York and the Province of Ontario. Great Britain and New York have increased their interest rate to 4½%, the Dominion of Canada to 5%, Ontario has effected loans within the past year at a 5% interest rate; moreover, is it not just as injurious to a municipality to have its bonds, on account of the low rate of interest which they carry, selling away below par, as it is to issue its securities carrying a higher rate of interest?

The third and last matter which I will refer to is, the administration of Sinking Funds. While I have advocated the desirability of doing away with the issuing of new loans according to the Sinking Fund Method, a number of Ontario municipalities, about 125, having Sinking Funds for the redemption of their existing long-term bonds. The aggregate of these funds now amounts to approximately $26,000,000. Their administration entails considerable responsibility. Some have been administered with much care and skill; others, regrettable to say, have been grossly