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The Association of Canadian Pension Management
L'Association canadienne des administrateurs de régimes de retraite

April 11, 2018

The Honourable Bill Morneau
Minister of Finance
Department of Finance Canada
140 O'Connor Street
Ottawa, Ontario K1A 0G5
Via email: bill.morneau@canada.ca

Re: Issuance of Long-Term and Real Return Bonds

Dear Minister Morneau,

ACPM is the leading advocate for pension plan sponsors and administrators in the pursuit of a balanced, effective and sustainable retirement income system in Canada. We represent pension plan sponsors, administrators, trustees and service providers and our membership represents over 400 companies and retirement income plans that cover more than 3 million plan members.

Since the 2008 global financial crisis, Canadian pension plans have been under extreme pressure due to the historically low interest rate environment. This has directly affected pension plans' ability to provide secure retirement for their members. In response to the financial crisis and the subsequent low-return world, many Canadian pension plans lowered their asset-liability mismatch risk through an increased allocation to long-term bonds. Long term nominal and real return bonds are the perfect instrument for lowering a pension plan's most significant risk: its interest rate (and inflation risk if the plan provides pension indexing before and/or after retirement).

Many Canadian pension plans would like to de-risk to a greater degree, but they struggle to implement these lower risk strategies due to competition for a limited supply of long-term government nominal and real return bonds. This competition with other domestic and foreign investors for a very limited supply of long-term bonds results in extremely low rates and limited attractiveness in buying these bonds, especially real return bonds. With the current historically low interest rates and flat yield curve, we feel that there is a unique opportunity for the federal government to help remedy this issue, while also supporting the government's debt management objective to "raise stable and low-cost funding… and to maintain a well functioning Government of Canada securities market" [Government of Canada – Debt Management Strategy for 2017-18].

A strategy of issuing more federal long-term bonds would help remedy the supply of both government long bonds, but also would support the Canadian capital markets liquidity and pricing of provincial and corporate long-term bonds which rely on benchmark Canada bonds of the same maturity for the effective functioning of the market. An improved market for long-term provincial and corporate bonds could generate greater supply for these securities as well.

In the past few years approximately 85% of the Federal Government's bond issuance has been in instruments with a maturity of less than 5 years. This was done with the primary objective of minimizing the government's borrowing costs. In the declining interest rate environment that we have been in for the past three and a half decades, combined with an upward sloping / normal yield curve, this was a highly successful strategy. By borrowing on the short end of the yield curve and refinancing frequently, the federal government was able to minimize its borrowing costs. As Canada also had a low debt-to-GDP ratio, the liquidity risks of this strategy, or the risk that the government would not be able to roll its debt, were very low. This was a highly successful strategy that saved Canadian taxpayers a significant amount of money.

While no one is able to predict future interest rates, we feel that the era of a zero "real" interest rate (i.e. nominal interest rates being close to or even less than inflation) brought on by the 2008 financial crisis is unsustainable over the medium term and may already be close to ending. When we return to a regime where investors again earn a significant "real" yield on federal government bonds, then the debt management strategies that worked in the past may no longer work as well. In fact, in an environment of slowly rising rates and an extremely flat yield curve, the government's overall cost of borrowing by issuing short-term bonds may well be higher when compared to issuing longer term bonds. Moving to a higher proportion of longer term bond issuance could also lower the government's refinancing risk and liquidity risk.

The primary purpose of defined benefit pension plans is to ensure that every dollar of pension benefit owed to their members is paid to them. Benefit security is critical for pensioners as they frequently do not have other significant sources of income and have limited ability to return to the workforce. As such they are a vulnerable group. Pension plans, and regulators, measure a plan's level of benefit security through its funded status, or the ratio of their assets to pension obligations. A positive funded status is an indication of a strong ability to meet the pension promise in the future. It allows both retired and active pension plan members to rest assured that their pension is secure and that they can be more confident they will receive their pension benefit. Due to the fact that women have a longer life expectancy than men, pension benefit security is even more critical for women than it is for men.

The current low-return / low-interest rate environment risk results in a double hit to pension plans and their ability to provide a secure retirement income for their members. It both lowered expected future returns, which increased plans' ongoing normal costs, as well as pushed pension plans to reduce their investment risk in the hope of avoiding a situation where the sponsor might be forced to make additional special contributions.

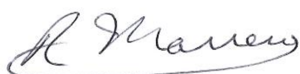
This created significant demand for long-term bonds, as in addition to being significantly less volatile than equities, long-term bonds (nominal and real return) are the perfect instrument to hedge a pension plan's interest rate and inflation risks. Interest rate risk is typically the greatest risk to a pension plan's primary objective of ensuring that all benefit promises are kept.

Unfortunately, the current limited supply of long-term government bonds has resulted in lack of availability and extremely high pricing, which has restricted the push by many pension plans to de-risk their investment strategy. While corporations have issued some long-term bonds, the supply is limited, at least partially attributable to the low liquidity in this market from lack of benchmark Government of Canada bonds, and significant additional issuance of federal bonds is required and would be welcomed by market participants. This supply shortage is most acute for real return and ultra-long bonds. This has a direct effect on benefit security for pension plan members. The federal government's recent issues of ultra-long bonds are a great step forward in providing pension plans with an enhanced tool to hedge their asset-liability risk, but much more is required.

There currently exists an opportunity for the federal government to help correct this situation while taking advantage of the extremely flat yield curve and the expected upward movement of interest rates over the medium term. We feel that this would be a win-win situation for the federal government as it would contribute to enhanced benefit security for pension plan members, while lowering the federal government's cost of borrowing over the medium term and contribute to a better-functioning Canadian capital market.

We would welcome the opportunity to further discuss these concepts with you or with your departmental officials. We also look forward to contributing to the process announced in the federal government's 2018 Budget on the issue of balancing corporate sustainability and retirement benefit security.

Sincerely,



Ric Marrero
Interim CEO
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cc: Lynn Hemmings, Senior Chief, Financial Sector Division
Ian Foucher, Deputy Director – Financial Sector Policy