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

February 21, 2023

Hon. Chrystia Freeland
Deputy Prime Minister and Minister of Finance
House of Commons
Ottawa, ON
K1A 0A6
Sent via email

Deputy Prime Minister Freeland:

RE: Finance Canada's Decision to Cease the Issuance of Real Return Bonds (RRBs) – Impact on Pension Benefit Security

ACPM is the leading advocacy organization for a balanced, effective, and sustainable retirement income system in Canada. Our private and public sector retirement plan sponsors and administrators manage retirement plans for millions of plan members, including both active plan members and retirees.

Our membership is comprised of plan sponsors, administrators and service providers who work in the retirement income industry on a daily basis. Collectively, their priority is to ensure the best possible outcome that will provide their plan members with the pension and retirement security that they expect. Based on this expertise, we provide further details below on the impact of RRBs on retirement benefit security, risk management, benchmarking, and pension plan funding.

Robust risk management practices are an integral part of pension plan security and sustainability. Ceasing the issuance of real return bonds (RRBs) in Canada reduces retirement benefit security by reducing the ability of both pension plan sponsors and individual Canadians to manage risk.

The Canadian Institute of Actuaries estimates that about $1 trillion of defined benefit registered pension assets covering over 3 million Canadians are tied to inflation-linked benefits. Without access to RRBs, the retirement savings of those 3 million Canadians could be adversely impacted.

Retirement Benefit Security and Risk Management

Inflation is a key risk for all pensioners, including those who are part of a registered pension plan and those who are not. In indexed defined benefit pension plans, some or all of this risk is transferred to the plan through automatic indexation, but pension plan sponsors rely on the available of appropriate tools, such as RRBs, to manage this risk.

Registered pension plan sponsors must manage inflation risk to support pension plan sustainability – this is especially important for pension plans that provide cost-of-living adjustments tied to the rate of inflation.

RRBs are an important tool in building a balanced portfolio that manages inflation risk. Without RRBs, it will be more difficult for pension plan sponsors to manage inflation risk, especially in liability-driven and liability-matching investment strategies. Removing an investment class opportunity also reduces fund diversification.

Pension plans and insurers offering annuities linked to the Consumer Price Index (CPI) will be less equipped to hedge their liabilities against inflation risk as a result of this decision. This will cause inflation to potentially have a negative impact on plan member benefit security.

Although alternatives to Canadian RRBs for managing inflation risk may be available, they are less direct at hedging Canadian inflation risk and are not always appropriate or available in all situations. Real assets such as real estate and infrastructure have some inflation-protection properties over the long term, but still provide only partial protection and are difficult for plan sponsors with smaller pension funds to invest in. In addition, these types of funds have some limitations on liquidity and may not be appropriate depending on the cashflow requirements of the pension plan. Plan sponsors may have to look to RRBs issued by other countries (e.g., U.S. Treasury Inflation Protected Securities), but this approach introduces currency risk, potentially requiring a currency hedging program which not all pension plans will be able to manage. In addition, foreign inflation is not perfectly correlated with Canadian inflation.

Further, the trading of RRBs provides data to determine pension plan funding requirements. Without that data, there will be increased volatility in pension plan liabilities and funding requirements.

Many Canadian workers and pensioners who are not part of indexed registered pension plans also need to manage inflation risk, especially after retirement. Ceasing the issuance of RRBs reduces the pension security of individuals by reducing their ability to manage inflation risk through investment products that rely on RRBs to hedge inflation.

Without the protections provided by RRBs, inflation hedging will be more expensive and Canadians who own (either through individual investments or participation in a pension plan), or start investing in inflation-linked products, will experience greater costs.

Benchmarking and Pension Plan Funding

The yield on Canadian RRBs is used as a benchmark to determine various defined benefit pension plan liabilities, including liabilities that are used as a basis for funding requirements.

When reporting on the financial position of the pension plan, either on a plan funding or accounting basis, plan sponsors make an assumption regarding long-term inflation. The implied market inflation determined by comparing yields on long-term nominal bonds and RRBs is typically used as one part of the analysis in determining this assumption.

In some cases, especially when determining liabilities for financial statements, implied market inflation is used directly as the assumed long-term rate of inflation. Without RRBs, plan sponsors will lose a key market-related signal of long-term inflation, which could negatively impact plan member retirement security and the accuracy of financial statements.

The Office of the Superintendent of Financial Institutions (OSFI) allows for large Federally regulated pension plans to use a replicating portfolio approach as an alternative settlement method for solvency valuation purposes. A replicating portfolio approach relates to the establishment of a theoretical portfolio of assets that produces cash flows that match the expected benefit payments to plan members, which may include RRBs for pension plans indexed to inflation. However, this methodology is only permissible by OSFI if the theoretical portfolio is deemed investable. Without RRBs, this methodology may not be available for pension plan sponsors and will lead to more uncertainty around pension plan funding.

When members of a pension plan terminate from the plan, they have the option to take the lump sum value, also known as the commuted value, of their pension entitlement. The Canadian Institute of Actuaries' *Standards of Practice* provides guidance on the assumptions used to calculate the commuted value. The yield on Canadian RRBs is used to determine the implied rates of increase in CPI, which is used for pension plans that include pension indexation linked to inflation. Without RRBs, plan sponsors will face increased difficulty in determining how much money they are legislatively required to pay to Canadians who are owed commuted values.

Consultation

The decision to cease issuance of RRBs has had an adverse effect on the RRB market and will have a growing adverse impact on key stakeholders. Many of these stakeholders, including ACPM members, were surprised by the announcement to cease issuance of RRBs as they were not aware of the consultation process. We recommend expanding the number of market participants included in debt management strategy consultations to include representatives from large pension plans with indexation provisions and insurance companies that provide annuities to pensioners.

Low liquidity in the RRB market is not necessarily a signal that there is low demand. First, pension plans often use RRBs as part of a buy and hold strategy in order to reduce inflation risk. Second, managing inflation risk through RRBs is a dynamic process that depends on inflation expectations, current bond yields, and expected future bond yields. Historically low RRB yields may have reduced the desirability of real return bonds for a limited time, but that does not imply that the demand will always be suppressed.

Recommendation

ACPM recommends that Finance Canada support the long-term sustainability of Canadian pension plans and a well-functioning pension system by restarting the issuance of real return bonds at the earliest opportunity. The decision on future RRB issuance, even if the timing is not determined, should be publicly stated as soon as possible to support stability within the RRB market.

Thank you for the consideration of our comments and we can be available if we can be of further assistance.

Sincerely,

Ric Marrero
Chief Executive Officer
ACPM

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