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Hon. Chrystia Freeland
Minister of Finance

cc Tiff Macklem, Governor, Bank of Canada
Michael Sabia, Deputy Minister, Department of Finance

Subject: Canada Real Return Bond Program

The Canadian Institute of Actuaries (CIA) would like to offer the following comments on the recent decision to terminate the issuance of Government of Canada real return bonds (RRBs). The decision will have implications for the retirement security of Canadians.

Notably, RRBs are used to determine the amount of assets that should be held by defined benefit pension plans providing inflation-linked benefits as well as the commuted values to which their members are entitled. We estimate that about $1 trillion of registered defined benefit pension assets covering over three million Canadians are tied to inflation-linked benefits. Therefore, without the continued issuance of RRBs, the valuation of retirement savings for over three million Canadians will become much less clear.

RRBs are also used as a risk management tool to hedge inflation-linked promises. Examples include pension plans with inflation-linked benefits and insurance companies that issue inflation-linked products. Without the continued issuance of RRBs, it is possible that insurance companies may stop providing products that are linked to inflation or charge significantly more for these products.

Impact on pension plan risk management

RRBs are used by pension plans with inflation-linked benefits as a liability-matching asset to offset inflation risk. In a low interest rate environment like the one we have witnessed in recent years, some pension plans have invested in other types of assets with returns that are somewhat correlated with inflation and that offer a better yield, like infrastructure and real estate. The link between inflation and returns on these other assets is significantly more tenuous.

Therefore, RRBs remain by far the best asset available to directly hedge Canadian inflation risk. RRB indices are useful for investment planning purposes, and where RRBs have been used as a liability-matching asset, recent inflation experience has shown how RRBs can mitigate inflation experience in the obligations they back. Government-issued RRBs are also important because we expect that few private enterprises can economically issue them.

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Without RRBs, it will be more difficult for pension plans to properly hedge their inflation-linked liabilities. This could lead to an increase in pension plan financial volatility and a decrease in plan member benefit security.

Impact on life insurers

In the life insurance sector, companies sell products that are linked to inflation, such as annuities and disability policies. This would include annuity purchases performed by pension plans as part of a de-risking strategy, whereby the life expectancy, investment and inflation risks are transferred from the plan to an insurer. RRBs are used to hedge these products.

IFRS 17 (the new International Financial Reporting Standard that came into effect on January 1, 2023) requires separate assumptions for the discount rate and the inflation assumption, and these must be based on market observable rates. RRBs have been used for this purpose, so the existence of a robust market is necessary, even when the purchase of RRBs is not necessary.

Without RRBs, there is a possibility that insurers will either stop issuing inflation-linked products, or charge significantly more to absorb inflation risk. This would have negative implications for pension plans looking to more proactively manage their risk or to wind up. Reduced liquidity in this market could also trigger price increases to inflation-linked products such as disability insurance.

Decreased retirement security for three million Canadians

In a number of Canadian jurisdictions, the solvency funding requirements for pension plans with inflation-linked benefits rely on the existence of either inflation-linked annuities (for smaller plans) or the existence of RRBs (for larger plans). As mentioned above, insurance companies may stop selling inflation-linked annuities or charge significantly more for them. Without RRBs, the size of solvency liabilities for plans that provide inflation-linked benefits will increase or become unknown, which will erode security for plan members.

Plans in a wind-up situation without sufficient assets due to an increase in the cost of purchasing inflation-linked annuities may require a regulator to modify the pension promise, to allow them to substitute the inflation-linked increases with fixed increases. Note this is not allowed in all jurisdictions.

In addition, RRBs are used to calculate commuted values[1] for pension plans that provide inflation-linked benefits. Without RRBs, it will be more challenging to determine fair commuted values for plan members, which could result in members receiving inadequate retirement payments.

As mentioned, we estimate that about $1 trillion of registered defined benefit pension assets covering over three million Canadians are tied to inflation-linked benefits. Therefore, without

[1] A commuted value is the amount transferred by a defined benefit pension plan to the locked-in account of a former plan member who elects to receive their plan entitlement in the form of a lump sum. Since a commuted value represents a crystallization of a former member's entitlement, it is important that the assumptions and estimates used to calculate commuted values are reasonable and that, where feasible, economic assumptions are market based.

the continued issuance of RRBs, the valuation of retirement savings for over three million Canadians will become much less clear.

Impact of Bill C-228

It should be noted that Bill C-228, which places pension plans in a higher priority upon company insolvency and bankruptcy, if it receives royal assent, may compel more plans to offload obligations to insurance companies and/or protect against risks that could affect the sponsors' cost of borrowing, both of which become more difficult without RRBs.

Other implications

In the two decades preceding 2021, the inflation level was managed by the central bank and the volatility of inflation was low, making inflation easier to predict and, in retrospect, possibly leading to underestimation of inflation risk. Even though inflation protection was usually accompanied by lower returns, holders of RRBs continued to see value in the inflation protection provided.

With increased exposure to rising inflation, insurers and pension plans would be losing an important tool that can be used to hedge inflation, at a time when it is most critically needed. Although a secondary market for RRBs will continue to exist, there is not likely to be sufficient liquidity for inflation-linked insurance and pension products, due to the use of buy and hold investment strategies. The terms to maturity of RRBs already issued will become shorter and the RRBs that exist will not be adequate to manage the long-term inflation risk of a pension plan. It may be possible to construct an inflation hedge through foreign markets, such as US Treasury Inflation-Protected Securities and US inflation swaps. However, these introduce basis risk between the inflation rates experienced in Canada and elsewhere, as well as currency and curve risk, i.e., the risk that rates in Canada do not move in the same direction or at the same magnitude as foreign markets.

The cancellation of RRBs may also send an unfavourable signal to the market that the government is less willing to take on additional inflation risks when inflation is high. It is worth noting that Canada is now the only G7 country that does not issue RRBs.

Conclusion

The overall effect of the cessation of RRB issues will negatively impact the overall financial security of Canadians and the financial health of pension plans and other financial security arrangements.

We request not only that the decision to cease issuing RRBs be reconsidered but also that the annual issuance of RRBs be eventually increased, as the current level of approximately $1 billion is not sufficient. In the meantime, we would also request that the $3.8 billion of RRBs held by the Bank of Canada be sold into the market in an orderly fashion to promote liquidity.

The CIA appreciates your time and consideration of this matter, and we would welcome further discussion with you.

If you have any questions, please contact Chris Fievoli, FCIA, Actuary, Communications and Public Affairs, at 613-236-8196 ext. 119 or chris.fievoli@cia-ica.ca.

Sincerely,

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President, Canadian Institute of Actuaries

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