Pension Investment Association of Canada
Association canadienne des gestionnaires de caisses de retraite

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Grahame Johnson
Assistant Deputy Minister
Financial Sector Policy Branch, Finance Canada
90 Elgin Street
Ottawa, Ontario K1A 0G5
Via Grahame.Johnson@fin.gc.ca

Re: Pension Investment Association of Canada (PIAC) calls on Finance Canada to open a consultation regarding the abrupt decision to cease the issuance of Real Return Bonds.

Dear Assistant Deputy Minister Johnson,

The Pension Investment Association of Canada (PIAC) has been the voice for Canadian pension funds since 1977 in matters related to pension investment and governance. PIAC's members manage over $2.8 trillion of assets on behalf of millions of Canadians. Our mission is to promote sound investment practices and good governance for the benefit of plan sponsors and beneficiaries.

The purpose of this letter is to address the comments made by Assistant Deputy Minister Johnson in the Standing Senate Committee on National Finance on October 3, 2023 regarding a consultation process on real return bonds (RRB). PIAC strongly urges Finance Canada to open a longer and more in-depth consultation with financial market participants on the topic.

As stated in PIAC's letter to Finance Canada in January 2023 on this matter, PIAC recommends reconsideration of the recent decision to immediately cease the issuance of RRBs. This decision was made without a fulsome consultation or warning and impacts our members' ability to responsibly invest and manage the pension entitlements of hard-working Canadians. Moreover, Canada is now an outlier in the developed world by abandoning its RRB program, as highlighted by Senator Gignac to ADM Johnson.

Unrealistic Assumptions Informed by Narrow Consultations:

PIAC calls on Finance Canada to open a more comprehensive consultation process regarding this decision to ensure all stakeholder perspectives are considered. The decision to cease the issuance of RRBs was made based on narrow consultations that led the Department of Finance to conclude that the demand for RRBs was low. Unfortunately, this decision was made without robust consultations with some of the primary purchasers of RRBs, including certain pension plans, insurance companies, and other sophisticated investors.

While RRBs have typically exhibited a lower level of liquidity than nominal bonds, it does not mean that there is low demand for the product. Institutional investors for RRBs typically use RRBs as part of a buy and hold strategy, for the purpose of matching cash flows against future benefit payments indexed to inflation. It would be a mischaracterization to state that limited liquidity equals a general lack of demand.

Another stated reason for the abrupt cessation was due to the size of the RRB market relative to the total Canadian sovereign debt. As per data from BIS, although RRBs only account for 2% of total sovereign debt, the share of ILBs relative to total debt was consistent to other developed countries that have issued ILBs. For example, ILBs represent 3% of total government issuance in Germany and Australia and 4% in Spain.

The Importance of Real Return Bonds:

As long-term investors responsible for managing long-term liabilities, pension plans are natural buyers of RRBs. Many of our pension plans pay a pension benefit that is indexed to inflation so that pensions maintain their purchasing power. Thus, for those plans choosing to buy and hold RRBs, they can serve as a valuable investment tool to keep up with the need to pay out indexed pensions.

In the current inflationary environment, RRBs have a heightened significance as a tool for pension plans to meet their obligations to their members. Asset managers are increasingly being asked to create portfolios that can achieve a certain level of inflation protection. RRBs provide the most direct and cost-effective inflation hedge for pension liabilities linked to Canadian inflation.

With such pressure to maintain inflation sensitive portfolios, the abrupt end to RRB issuance forces pension plans to look to alternative markets outside of Canada, and to more complex, administratively expensive and less liquid real assets, to manage inflation risk. Inflation-linked bonds issued by other sovereigns, or other inflation sensitive assets such as real estate, infrastructure and commodities are not only more expensive, complex and less liquid; they do not have the same direct linkage to Canadian inflation. Furthermore, smaller pension plans, and plans with a mature demographic may not have the scale, skilled management or timeframes to seek out and manage alternative investments. Thus, with this sudden decision, the government has removed a valuable investment tool for pension funds in Canada.

Harming the Secondary Market*:*

The abrupt end of RRB issuance worsens the relative illiquidity of RRBs leading to even more unreliable market information. Effectively, the decision has created a "dead asset", handcuffing pension plans that are looking to build liquidity through inflation sensitive assets. The deteriorating liquidity has made rebalancing needs transactionally expensive and at times impossible. More importantly, as stated by the Canadian Bond Investors' Association, bid-ask spreads are substantially wider, and some maturities have become untradeable making market data for calculating risk limits unreliable. Finally, the worsening market data may affect the ability of pension funds to use RRBs as collateral in secured funding transactions or margining.

Impacting All Canadians:

The global shifts of de-globalization and more active fiscal policy may lead to a longer elevated inflationary environment. Consequently, Canadian workers will face a higher cost of living during their retirement years and will be more dependent on their pensions to help them meet their financial needs. The RRB issuance cessation reduces the diversity of assets available to pension plans and will push plans to seek less correlated alternative investments in potentially riskier markets. Without a product linked to Canadian inflation, the extra cost from managing alternative investments will ultimately be passed down to Canadian workers. In addition, Canada's aging demographics and the potentially shrinking workforce will amplify the need for investment returns required by Canadian retirees to meet the increasing cost of living without additional social assistance.

PIAC is calling on Finance Canada to open a consultation process regarding its decision to stop the issuance of RRBs. A thorough consultation will allow you to hear the many impacts the decision has had on pension funds of different sizes and within different sectors. The valuable feedback from the CMB consultation period is an example of the importance of collecting insights from all market players. We would be happy to meet with you or your staff to discuss the contents of this letter or answer any questions.

Yours truly,

Don Andrews
Deputy Executive Director

Cc:
Hon. Chrystia Freeland – Minister of Finance,
Via email: chrystia.freeland@fin.gc.ca

Mr. Andrew Bevan – Chief of Staff to the Minister of Finance
Via email: andrew.bevan@fin.gc.ca

Mr. Chris Forbes – Deputy Minister, Department of Finance Canada
Via email: chris.forbes@fin.gc.ca