Canadian Bond Investors' Association
Association canadienne des investisseurs obligataires

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CBIA CALLS FOR REVIEW OF THE DEPARTMENT OF FINANCE DECISION TO ABRUPTLY CEASE THE ISSUANCE OF REAL RETURN BONDS (RRBS)

November 14, 2022

The Canadian Bond Investors' Association (CBIA) represents over 50 of the largest fixed income institutional investor organizations in Canada, with over $1.2 trillion in fixed income assets under management. Our member organizations include sophisticated institutional investors such as insurance companies, bank-owned investment managers, pension funds and investment advisers. Our mandate includes acting on behalf of institutional fixed income investors in addressing key issues with legislators, regulators, bond issuers, investment dealers and other industry participants. We are the voice of Canadian bond investors and speak not only for those investors but also for the pensioners, policy holders and retail investors who depend on our members for the sound management of their investments.

The CBIA would like to share with the Department of Finance its surprise and specific concerns following the decision to abruptly cease issuance of Real Return Bonds announced in the release of its 2022-2023 Debt Management Strategy Update (Strategy Update) on November 3, 2022. The Department of Finance has implemented this important decision without holding a thorough, focused consultation with market participants, which negatively impacted the functioning of capital markets and will have many negative implications for various types of market participants and their clients.

Wrong signal, bad timing

Many of our members are concerned that the decision to eliminate inflation-linked securities as a funding source comes at the worst possible time for investors as our economy faces a period of high inflation. Now more than ever investors have greater interest in inflation-protection products as they reassess their inflation risk exposures. More particularly for pension plans, aging demographics should only amplify this demand in the future. Eliminating RRBs not only reduces the diversity of funding by excluding certain market participants but also alters the perception of all market participants that the Government of Canada is not confident that it can deal with the inflation problem, with possible serious ramifications for the Canadian Dollar, Canadian interest rates and international demand for Canadian bonds. Despite being a thought leader and one of the early adopters of inflation-linked funding, Canada will now be the only G7 country that would not be issuing inflation-linked bonds.

An incomplete process

The Strategy Update cites the results of the September and October 2022 consultations led by the Department of Finance and the Bank of Canada. Unfortunately, the consultation lacked robustness and failed to properly identify the fundamental sources of demand from Canadian bond investors, particularly sophisticated institutional investors such as pension funds, insurance companies, mutual funds and ETFs. RRBs in Canada have typically exhibited a lower liquidity profile than nominal bonds. Given the appetite of institutional investors for RRBs, they are often part of buy-and-maintain strategies, held for the purpose of delivering the proper cash flows against future benefit payments. The liquidity profile of these bonds, from a trading perspective, is therefore greatly influenced by the demand from those long-term buy-and-hold investors. This mischaracterization of the demand side of the equation has led to the wrong conclusion that the limited liquidity was a reflection of the general lack of demand.

We strongly encourage the Department of Finance to explore the fundamental demand for RRBs from the point of view of institutional investors. Without an understanding of a complex set of elements underpinning this demand, ignoring them could lead to unintended consequences.

The importance of maintaining RRB issuance

A basic source of demand is the reinvestment of semi-annual coupons by current RRB bond holders desiring to maintain their inflation protection levels. By itself, over the past couple of years, this simple ongoing operation was large enough to absorb the entire annual issuance.

Long actuarial liabilities make natural buyers

Insurance companies and pension plans are natural investors of RRBs due to the nature of their liabilities. Historically, contractual promises have frequently been tied to the Consumer Price Index (CPI) through direct annual indexation of benefits. Benefits, such as pensions, health care

or other claims, are also, to a certain extent, indirectly linked to realized inflation through salary increases or service and material costs to provide coverage.

We believe, in the current inflationary environment, there is strong, and possibly growing demand, for RRBs that are held by buy-and-hold type investors who are reluctant to sell their positions in a product line where supply is limited. Asset managers of all stripes are increasingly being asked to create portfolios that can achieve a certain level of inflation protection. In the case of RRBs, inflation protection comes in two forms. First, hedging the present value of liabilities with financial instruments whose values move in tandem and second, covering the realized inflation risk embedded in future benefit payments, holding assets generating coupon payments adjusting with inflation.

In the recent period of very low interest rates, a very common practice for some pension plan sponsors was to grant periodic cost-of-living increases to retirees for plans that did not provide automatic indexing. If we continue to experience a period of sustained high inflation, we can expect pressure from retirees to revive this practice. At a minimum, we could expect increased demands from unions for adjusting pension benefits to the cost of living for collectively bargained pension plans.

Deep access to alternatives… not for everyone

Although larger pension plans are better equipped to manage inflation risk, relying on other instruments such as real estate and infrastructure projects, smaller pension plans without the necessary expertise have to rely on unsuitable publicly available securities or employ riskier strategies to hedge inflation that involve derivatives. Pension plans closed to new members, often from corporate sponsors, are also in need of more reliable and accurate inflation protection that only RRBs can offer.

Without the proper instruments to hedge inflation risk, insurance companies are also unable to offer products such as indexed annuities, creating a void for sponsors wanting to fully de-risk a plan. Retaining the risk on the plan balance sheet without the ability to purchase RRBs would introduce more volatility and risk for participating members.

Consequences for solvency funding?

From a regulatory point of view, governing bodies and the Canadian Institute of Actuaries are relying on the RRBs market to value pension plan liabilities. Without a functioning RRBs market, without available long-dated inflation-linked bonds corresponding to the liabilities, those valuation methodologies would be put into question. The pension solvency valuation basis for indexed plans relies on a discounting methodology of future projected real cash flows based on a real yield driven by the RRBs market and a survey of insurance company pricing. At the Federal level, the Office of the Superintendent of Financial Institutions (OSFI) allows large plans which are too large to purchase annuities from insurers to adopt a liability-replicating portfolio approach to discount their future liabilities. Under this methodology, for indexed plans in

particular, a combination of nominal federal and credit bonds with a synthetic inflation swap overlay can be used to derive a theoretical discount rate which includes both the inflation protection of the RRBs and the credit spread of provincial and corporate bonds. It is worth noting that this methodology is permissible by OSFI if the theoretical portfolio is deemed investable.

Supply side: moving towards a better market structure?

On the supply side, the government's role in providing benchmarks across both nominal and real bond markets is crucial in helping support a vibrant and transparent domestic market. Although recent issuance was not significant relative to the RRBs outstanding amounts, the primary market was a source of liquidity and supported the overall liquidity profile. This unexpected announcement caused a material liquidity event to occur for both broker-dealers with an obligation to make markets in these securities and for investment managers investing on behalf of their clients. The RRBs secondary market is now distorted, and these distortions will continue to increase over time leading to even more unreliable market information. Broker-dealers already cannot provide two-way markets in these instruments since previously announced auctions have been cancelled, market data for calculating risk limits is now unreliable and owners of existing RRBs hesitate to sell for fear of not being able to replenish at a later time. The bid-ask spreads are substantially wider, and some maturities have become untradable. As time progresses, market for RRBs is expected to deteriorate further and they will only trade by appointment. The secondary market for RRBs provides important information to all participants about future inflation expectations. The new and existing retail and institutional investors in RRBs and the investment managers operating on their behalf will now have a dilemma with respect to the maintenance of existing portfolios and the implementation of new ones.

The CBIA calls on the Department of Finance to reconsider this hasty decision and take time to evaluate this complex situation. Consideration should not only be given to the reinstatement of the original program but also to taking steps to improve the market structure such as issuance across the curve and broader index inclusion. The Bank of Canada, as an agent of the Government of Canada, is well-positioned to facilitate this type of process. Our Association and its members can provide valuable service to the Government of Canada in this matter, please do not hesitate to engage us.

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