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Withdrawal of real return bonds could financially impact DB pension plans: CIA

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The Canadian Institute of Actuaries is urging the federal government to reconsider its cessation of real return bond issuances, citing the potential financial impacts to defined benefit pension plans.

“We request not only that the decision to cease issuing real return bonds be reconsidered, but also that the annual issuance of real return bonds be eventually increased, as the current level of approximately $1 billion is not sufficient,” wrote CIA president Hélène Pouliot in a letter to Finance Minister Chrystia Freeland. “In the meantime,

we would also request that the $3.8 billion of real return bonds held by the Bank of Canada be sold into the market in an orderly fashion to promote liquidity."
The CIA estimates that roughly $1 trillion in registered DB plan assets, which cover more than three million plan members, are tied to inflation-linked benefits, wrote Pouliot. Pension plans with inflation-linked benefits use real return bonds as liability-matching assets to hedge against inflation risks. They also use these bonds to determine commuted values to which members are entitled.

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"Real return bonds provide an ideal inflation-linked hedge and also provide a benchmark for the break-even inflation rate implicit in yields from government bonds," says Dean Newell, vice-president at Actuarial Solutions Inc. "This break-even rate tells us what the market thinks about long-term inflation, which is used as a building block in the discount rate assumption we use to value liabilities and also to determine lump-sum payments for indexed-plan members who opt not to defer their pensions."

In the previous low interest rate environment, some pension plan sponsors invested in other assets — such as infrastructure and real estate — that are also correlated with inflation but yield better returns, wrote Pouliot. "The link between inflation and returns on these other assets is significantly more tenuous. Therefore, real return bonds remain by far the best asset available to directly hedge Canadian inflation risk."

A withdrawal of real return bonds from the market could lead to an increase in financial volatility and a decrease in plan member benefit security, she added, noting insurers also use real return bonds to hedge annuities. "Without real return bonds, there is a possibility that insurers will either stop issuing inflation-linked products or charge significantly more to absorb inflation risks."

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Arguably, there should be little immediate impact for DB pension plans relying on real return bonds because they tend to be long term, meaning the existing stock will be outstanding for decades.

"But if the only meaningful pricing data comes from auctions of new issues and the portfolio rebalancing that occurs in the days before and after the auctions, then the quality of the pricing data available to pension actuaries will deteriorate fairly quickly," says Douglas Chandler, an independent research actuary, an associate fellow of the National Institute of Ageing and a fellow of the CIA and the Society of Actuaries.

The impact on DB pensions won't be significant if the cessation of real return bonds is short term and reinstatement comes quickly, says Gavin Benjamin, a partner in the retirement and benefits solutions practice at LifeWorks Inc., who was involved in the formulation of the CIA's position.

However, if pension plan sponsors are considering increasing their holdings in real return bonds or annuitizing some of their retiree obligations, they should act promptly, he adds. "There is merit in doing so sooner rather than later because real return bonds will likely become more scarce."

Benjamin says pension plan sponsors could also look at purchasing real return bonds in markets outside of Canada. "The risk in that strategy, however, is in the difference in the rate of inflation between Canada and the country issuing the bonds."

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