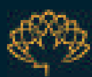

A Practical Perspective

CPP Investment Board

Canada Pension Plan Investment Board:

A Practical Perspective on Pension Fund Investment

Remarks by

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to the

Irish Association of Pension Funds Conference

on The Irish Stability Fund – The Investment Issues

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It is a great honor for me to be the keynote speaker before such an august gathering of the Irish Association of Pension Funds.

You have asked me to provide a practical perspective on the creation and management of the Canada Pension Plan Investment Board … paying particular attention to investment issues, stakeholder relations and political influences.

I am glad to oblige. I hope our experiences in Canada will prove useful as Ireland sets about addressing its pension agenda.

The solutions Canada developed in response to our state pension crisis began with a clear definition of responsibilities for the principal players involved – the sponsoring governments, the state pension plan itself, and the entity created to invest in capital markets.

Furthermore … and perhaps most important in the end … the Canadian solutions include open, compulsory and frequent accountability to the public by the three different principal parties.

In Canada we have a federal system of government. Both our national government, which we refer to as our federal government, and the provincial governments have a role and a responsibility for the national pension plan. The two levels of government are joint stewards of the Canada Pension Plan.

Together, they set contribution rates, benefit levels and the funding policy … although the federal government alone administers the plan.

The Canada Pension Plan itself is very much part of the distinctive fabric of Canadian society … and touches virtually all adult Canadians.

Today, more than 12.5 million Canadians contribute to the Plan through a specific payroll deduction matched by their employers. And close to 4 million people draw pension benefits annually.

For a large number of Canadians, the Canada pension is the cornerstone of their retirement income. They are directly affected by decisions regarding contribution rates, benefits, retirement age, survivor entitlements and disability provisions.

The third entity … the CPP Investment Board … is a new organization that is legally and functionally separate from the governments and the plan.

We have our own 12-member board of directors and our own management team that is responsible for investment and operating decisions.

Our primary job is to invest surplus Canada Pension Plan funds in capital markets. By building up the value of these funds over the long term … we will help the federal and provincial governments to keep their pension promise to Canadians in the 21st century.

So with that background on governments as the plan sponsors … the Plan itself as an integral part of the caring Canadian society … and the CPP investment Board as a

separate investment organization … let me now share what I believe is relevant history.

The Canada Pension Plan was created in 1966 as a pay-as-you-go plan. The idea was that each generation would pay the pensions of the previous generation. It was never intended to be a fully funded plan.

And that made sense 30 years ago. The number of Canadians over 70 … the retirement age in those days … was small relative to the working population.

Back in the 1960s we had a booming economy … plentiful jobs … and rising wages.

Canadians could afford to be generous to the generation that had endured the hardships of the Great Depression in the 1930s … and the sacrifices of the Second World War in the 1940s.

The Canada Pension Plan was designed to provide all working Canadians with retirement income … as well as financial help to their families in the event the breadwinner died or became disabled.

That made sense, too. In the 1960s many Canadians did not have a pension. Those who did sometimes lost it if their employer went bankrupt.

Few had pension portability among employers. Workers who hated their jobs had to grin and bear it … or lose their pension entitlements if they quit.

From the beginning … the idea was to replace a portion of the worker's pre-retirement earnings with a guaranteed pension. In other words, the Canada Pension Plan is not … nor was it conceived as … an income redistribution program.

By introducing pension portability and a guaranteed retirement income … the Canada Pension Plan accomplished important social change.

All in all, the plan was a great idea. It delivered full coverage, portable benefits, inflation protection and the major source of income for many seniors. And substantially more money came in to the plan each year than went out.

Let's fast forward 30 years to the mid-90s.

By 1996, more than 10 million Canadians were paying $11 billion in CPP contributions … while 3.5 million Canadians were beneficiaries drawing close to $17 billion in benefits … for a deficit of $6 billion in that year alone.

Clearly more money was going out than was coming in.

The plan was headed for serious trouble due to escalating costs from improved benefits … lower contributions than originally expected … and demographic change.

The baby boom generation will start to retire in large numbers around 2011. By 2030 … about 23 percent of Canadians will be 65 or over.

Today there are five Canadian contributors for every pensioner … the same ratio as in Ireland.

By 2030 … there will be only three workers to support every pensioner … a demographic shift similar to that forecast for Ireland.

Clearly we were both headed in the same financially disastrous direction.

As a result of these factors … the federal chief actuary in Canada estimated in 1995 that the plan reserve would be exhausted by 2015 … and future generations would have to pay 14.2 percent of their contributory earnings to keep up with the needs of retired Canadians.

I'm sure all this sounds grimly familiar. The financial burden on future generations would be intolerable.

This impending crisis sparked an extensive review of the Canada Pension Plan by federal and provincial governments … which led to fundamental change in 1997.

It was decided to put the Canada Pension Plan on a firmer financial footing by increasing contribution rates and improving plan administration.

As a result, the plan will move over the next 20 years from exclusively pay-as-you-go to fuller funding.

Let me explain how our federal and provincial finance ministers have agreed to do this.

According to the plan's most recent actuarial report, the present value of accrued pension benefits under the Canada Pension Plan totalled $465 billion on December 31, 1997. The plan had $36.5 billion in assets, mostly government bonds.

As a result, assets represented about 8 percent of liabilities.

According to the federal and provincial finance ministers, the CPP will be funded in future on a "steady state" basis. This concept means that contributions will level off after 2003 at 9.9 percent of pensionable earnings for employed Canadians.

The 9.9 percent rate is expected to remain steady indefinitely and be sufficient to sustain the pension promise.

Under the steady-state formula, the Canada Pension Plan will build a reserve equivalent to five years of benefits … instead of two years previously … or about 20 percent of liabilities.

The actuarial report assumes that this reserve not needed to pay current pensions will earn a 4 percent real rate of return … that is, above inflation … to keep the Canada Pension Plan in a steady-state funding status after 2003.

With inflation projected by the actuarial report to grow at 3 percent annually over the next few years, the nominal investment objective is therefore approximately 7 percent.

And that's where we at the CPP Investment Board come in.

The CPP Investment Board was created by an Act of Parliament to manage the Canada Pension Plan's reserve assets … and commenced operations in October, 1998.

As I noted, we are independent of the Canada Pension Plan.

We have one job -- to invest all funds received from the Plan. By increasing the long-term value of these assets … we will ultimately help the plan to meet its pension obligations.

In essence, we are an investment company building a diversified portfolio of assets.

I know you are particularly interested in investment issues … so let me spend a few minutes discussing our investment mandate, current investment activities, and future direction.

First, our investment mandate.

Our legislation sets two clear objectives: One is to manage the assets entrusted to us in the best interests of the Canada Pension Plan's contributors and beneficiaries. The second is to maximize investment returns without incurring undue risk.

The objective of maximizing returns without qualifying conditions … other than being prudent about risk … is common along North American pension funds.

As you know, the key decision affecting long-term investment returns is the allocation of funds between equities and fixed-income securities … that is, principally between stocks and bonds.

In developing our asset mix policy, we consider the existing assets in the Canada Pension Plan. These are fixed-income securities, mostly bonds, and are managed by the Department of Finance.

Historically, the Plan lent surplus funds at preferred rates to the provinces. The federal government also borrowed funds from time to time. The result today is a government bond portfolio owned by the Plan valued at more than $30 billion.

To offset the dominance of these fixed-income securities … and to diversify the asset base … we at the CPP Investment Board are investing 100 percent of the cash flow received from the Plan in equities.

How are we doing that?

In 1997, our federal and provincial finance ministers thought it would be prudent during our formative years for us to invest passively any funds we allocated to Canadian equities. That is, to put the money in stock index portfolios that replicated an established stock market index.

This made sense for several reasons. As a new organization, it would take time to recruit investment professionals. For example, I did not join the organization until almost one year after it become operational.

Another reason is that investing in stock index funds is cost efficient. It's an easy way to gain exposure to equity markets in a hurry.

A further reason is that the historical data shows passively managed index funds have an excellent performance record. If you look at North American pension funds … you will find they significantly invest passively rather than actively in equities.

So, while we were restricted to passive equity investing in Canada during our start-up period – I think we would have chosen that approach anyway.

As we did in making foreign equity investments … where we face no restrictions on passive versus active investing.

In Canada, we opted for the leading market index, the Toronto Stock Exchange 300 Composite Index.

Outside Canada, we selected two foreign index funds. One is the Standard & Poor's 500 index that contains large public companies in the United States … and the other is the EAFE Index of about 1,000 companies in Europe, Asia and Australasia managed by Morgan Stanley of New York.

How we allocate capital between Canadian and foreign opportunities is straightforward.

Unlike Irish pension funds, the foreign investments of Canadian funds are restricted.

The federal government recently increased the foreign content limit to 25 percent of assets at cost. This will rise to 30 percent next year.

But until last month … we were obliged to invest 80 percent in Canada … and only 20 percent externally.

Our timing in launching an equity program that was 80 percent Canadian could not have been better. In our first full-year of investing, to March 31 of this year, the Toronto stock index was one of the best performers in the world … returning approximately 45% compared to 16% for the MSCI world index minus Canada. That, I'm sure you agree, is a good start.

To-date we have about $3.5 billion Canadian invested in equities, or approximately $2 billion Irish punts. What this means in terms of asset mix is that about 90 percent of the combined assets of the Canada Pension Plan and the CPP Investment Board are fixed-income securities and 10 percent are equities.

That is an extremely low percentage of equity compared with the average Irish pension fund allocation of 70 to 75 percent.

Clearly we have a long way to go before we achieve a reasonable asset mix. But the funds available to us will grow extremely fast in the next few years.

According to a projection last December by the federal government, the CPP Investment Board will receive between $70 billion and $90 billion from the Canada Pension Plan by the end of 2007. We expect to have $100 billion invested within the decade.

This will position us as one of the largest institutional investors in Canada and an important investor on the global stage.

However, I should stress that we are still very much in our start-up mode.

I joined the CPP Investment Board last September … and soon after hired a vice-president of finance and operations. At this point, we are the only two members of the executive team.

But that is going to change over the next few months.

Our vision is to build a virtual corporation with a very small team of senior professionals. We will hire three experienced investment professionals; a Vice President – Research and Risk Management, a Vice-President – Public Market Investments, and a Vice President – Private Market Investments. This team will develop our longer-term investment strategies and retain outstanding external capabilities to implement those strategies through a series of partner-like relationships.

Of course, retaining external expertise may not always be the best course available to us. We will build staff resources where equal or better performance can be achieved at lower cost.

We don't need a big organization. A small one can be focused … have access to the best talents available at home and abroad … have the flexibility to respond to the rapidly changing global marketplace and economy … and, in all this, serve the public interest by being cost effective.

As I mentioned, we currently invest only in equity index funds.

Recently, the federal and provincial finance ministers relaxed the restriction that limited us to passive equity investing in Canada.

We can now actively invest up to 50 percent of the funds we allocate to Canadian equities … and expect this restriction to be removed entirely in the next year as we staff up and diversify our activities.

Once we have assembled our executive investment team, we will look at the benefits of passive and active investing in equity and debt, merchant banking, private equity, infrastructure projects, venture capital opportunities, real estate investments and derivative contracts.

In other words, we will consider the range of investments available to other investors.

One of the issues that I understand you are concerned about is protecting the integrity of the investment function against political influence.

This is a genuine concern – and one that has been raised by the news media in Canada that sometimes questions the ability of the CPP Investment Board to be truly independent.

I notice in Irish Pensions magazine that the Irish Association of Pension Funds expressed the view (and I quote):

“The commissioners should combine the expertise, experience and stature that will enable them to fulfill their role effectively, credibly and independently.”

Your editorial goes on to say: “While the primary legislation should remove the threat of political interference, in extreme circumstances the Commissioners may be called on to protect the integrity of the funds under the control.”

How have we handled similar concerns back in Canada?

First, as your editorial calls for, we have clearly defined the roles and responsibilities of the different players in the pension picture – the players I touched on at the start of my remarks.

The CPP Investment Board is accountable to both levels of government … as we should be in those areas where our legislation requires us to be.

After all, the Canada Pension Plan is an important expression of our nation’s capacity to care for one another. The CPP Investment Board has a role to play in securing the plan’s long-term financial future … and helping elderly Canadians to retire with a little more grace.

But what does this mean in practice?

The federal and provincial finance ministers are required to review the Canada Pension Plan every three years. That, by the way, is an improvement over every five years historically.

The review includes the role and responsibilities of the CPP Investment Board. It was at the last review in December 1999 that the minister amended the restriction on our ability to invest actively in Canadian equities.

Another practical example is that the federal finance minister … in consultation with the participating provinces … is required to initiate a special examination of our financial and management control, and information systems and management practices, at least once every six years.

Perhaps a more pertinent example and model worth considering is how our directors are appointed. It works like this.

The federal government and the nine participating provinces have one representative each on a nominating committee that consists of public officials and business leaders, with a private sector executive in the chair.

This nominating committee recommended candidates for appointment by the federal finance minister who then sought input from his provincial finance minister colleagues.

As you can see … there are already checks and balances early in the process … with an arm's length nominating committee and the need for agreement among different governments, usually with different political philosophies.

Our legislation states that it is desirable to have sufficient directors with proven financial ability or work experience relevant to the goal of maximizing investment returns.

As a result, the nominating committee recommended directors with expertise in investment, business, economics and financial management.

The initial board has staggered terms … with half the directors serving a two-year term that expires later this year … and the remainder serving a three-year term that expires late next year.

Each director can be appointed or re-appointed for a three-year term … and can serve a maximum of three terms, or nine years.

Still, is there a risk of political interference in our investment decisions?

We think not. Remember that the federal finance minister must consult with provincial counterparts before making board appointments. That alone is a powerful check on any temptation to make narrowly partisan or ideological appointments.

A second check against political intrusion is that any change in our legislated mandate requires the approval of the federal parliament and the agreement of two-thirds of the provinces with two-thirds of the population. In effect, this is a constitutional check, and a powerful one.

Furthermore – and this is the most important check of all -- our commitment to extensive public accountability ensures that Canadians will be kept current with what we are doing and any proposed changes.

All in all, we have a lot of checks and balances in our accountability … two levels of government, the CPP Investment Board with its own board of directors and management, and millions and millions of Canadians who contribute to and benefit from the Canada Pension Plan.

Let me close by commenting a little further on accountability to stakeholders.

In the normal political process, the federal and provincial governments are accountable to Canadians who contribute to and benefit from the Canada Pension Plan.

Second, the Plan itself is now required to be more accountable than it was in the past. For one thing, it is required to publish an annual report – annually. For another, it must send an annual pension statement to all contributors. In the past, it reported to contributors on an individual basis once every five years or more.

And third, the CPP Investment Board has very clear accountability, mostly spelled out in our legislation.

We must publish an annual report and make it available to all interested Canadians. Our second annual report, for the year ended last March, will be issued in June.

We must publish quarterly financial statements. That is unusual for a pension fund, recognizing that our investment horizon is three decades rather than three months.

And we must hold a public meeting at least once every two years in every province. We will hold 10 public meetings across Canada this fall … from St. John's in Newfoundland to Victoria in British Columbia … with eight stops in between.

On top of all that, we are communicating willingly with Canadians through the news media, our Web site, public speeches and participation in private meetings and conferences.

Canadians from coast to coast have a direct financial interest in how we manage the assets entrusted to us. They have a right to know what we are doing with their money. And they will.

I hope my remarks have helped you to better understand the role of the CPP Investment Board … its arm's length relationship with the Canada Pension Plan and both levels of government … and our independence in implementing our investment mandate.

I believe that we are embarked on a noble quest – to help deliver the pension promise and thereby make retirement more comfortable and secure for the millions of Canadians who are counting on us.

Thank you for the invitation to be with you today. I now look forward to your comments and questions.