



**The Case for Clarity:
Sovereign Wealth Funds and the Canada Pension Plan Investment
Board Governance Model**

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Good afternoon. I am very pleased to have been invited to participate in this important and highly topical discussion on Sovereign and Public Pension Reserve Funds. I commend this OECD committee for its efforts to encourage best practices in pension fund governance through working sessions such as these. One of the ideas I want to share with you today is that a national pension reform model created in Canada 10 years ago may provide some relevant concepts and potential solutions to some of the public policy challenges presented by Sovereign Wealth Funds today.

Sovereign Wealth Funds, as you well know, are not new – they have been around for decades. What *is* new is that these funds have emerged in recent years as active direct investors – acquiring sizable international assets in sensitive industries, such as transportation infrastructure, telecommunications and energy. Also, they are growing at an astounding pace. Deutsche Bank has estimated that Sovereign Wealth Funds today hold \$3 trillion in assets – double the size of the global hedge fund industry – and could grow to \$10 trillion in 10 years.

Consequently, and not surprisingly, the role of Sovereign Wealth Funds in global capital markets has escalated into an international public policy issue with extensive political and economic implications, and with concerns being expressed by governments, regulators and other opinion leaders.

We have heard plenty through the media about those concerns: that Sovereign Wealth Funds are controlled by governments, are opaque and that they may use their financial clout in the pursuit of non-commercial national security, political or economic objectives.

In response, we are already seeing calls for new protectionist legislation, which could have negative consequences for the free flow of capital and access to global investment opportunities. This would penalize not just Sovereign Wealth Funds but return-driven national pension funds operating with much higher transparency.

The threat to these return-driven investors is clear. They may be mislabeled as Sovereign Wealth Funds simply because they are national funds. We believe that policymakers and opinion leaders can facilitate clarity by looking beyond the labels of Sovereign Fund, Sovereign Pension Fund and so on, to examine the underlying characteristics of these large pools of capital. They can then be better positioned to consider public policy based on facts, not labels.

As the Chair of the Canada Pension Plan Investment Board I know that we have, on occasion, been incorrectly categorized as a Sovereign Wealth Fund. While we do have the word “Canada” in our name, the CPP Fund, managed by the Canada Pension Plan Investment Board, is neither a sovereign entity nor a sovereign fund. And we are not a sovereign fund for a number of reasons:

- Our assets are not government assets. Rather they are contributed directly by employees and employers.

- We do not receive any tax revenues or fiscal top-ups.
- Assets are strictly segregated from government assets.
- And by law, we operate at arm's length from government, with very high transparency and abide by a clear and singular mandate to “maximize investment returns without undue risk of loss.”

Based on those characteristics, some observers would not even classify us as a public pension reserve fund.

But Canada's model for national pension reform can offer some lessons about managing a large and growing pool of capital – lessons that may be applicable to Sovereign Wealth Funds. These lessons centre on the twin concepts of clarity of purpose and transparency. Based on the Canadian experience, we believe that if observers had the answers to five key questions about the objectives of Sovereign Wealth Funds, the public policy debate would be better informed and would result in a more judicious response to the issue.

Those questions would be:

- Number 1: For what purpose was the Sovereign Wealth Fund or Sovereign Fund created?
- Number 2: How will the funds be used?
- Number 3: What is the governance and oversight structure?
- Number 4: How is the investment policy created?
- Number 5: Is there sufficient disclosure on all of the above?

At the CPP Investment Board, we were fortunate to have all of these questions answered for us – albeit for an entirely different reason – when we were created as part of the Canada national pension reform model in 1997 – 10 years before the current concern about Sovereign Wealth Funds.

Why Was the Fund Created?

In answer to Question 1, Why was our fund created?, Canadian policymakers answered – to help sustain the Canada Pension Plan. In 1996 the Canada Pension Plan, like many public pension plans, was facing a pension funding crisis. That year, it received C\$11 billion in contributions and paid out C\$17 billion in benefits, with an asset base of more than C\$35 billion. Unless something was done, the plan’s collapse would be only a matter of time. Today the CPP Fund has more than C\$120 billion in assets (roughly €82 billion), earned a 13.6 per cent annualized investment rate of return over the past four fiscal years and has grown by about C\$80 billion since inception – two-thirds of which derived from investment income. Canada’s Chief Actuary has estimated in his latest report that the fund will grow to more than C\$310 billion by 2019 and has projected that the CPP will be sustainable throughout the 75-year period of the report.

The model Canada created to solve its national pension crisis set the CPP on a solid financial footing. At the same time, it has been cited as a best-practice model for pension fund governance around the world because of its mutually reinforcing set of governance characteristics that include clarity of purpose and transparency.

We recognize that Canada's model was created in response to a unique set of facts and circumstances. But based on the steady stream of visitors from other national pension funds who come to study our model, we believe that some elements of Canada's blueprint for national pension reform could help address not only the governance issues of other pension plans, but also some of the problems of Sovereign Wealth Funds today.

From our advance materials you will have noted that the Canada Pension Plan is a national defined benefit pension plan operated for the benefit of 17 million Canadians. And we, as the CPP Investment Board, were created as a purely return-driven professional investment management organization to operate in the private sector and to make investment decisions at arm's length from governments.

So why did Canada devise such a different national pension plan model – a model that we at the Canada Pension Plan Investment Board did not create. The design was the fruit of an extraordinary policy reform process involving Canada's federal government and nine Canadian provinces working together in the mid-1990s to rescue the Canada Pension Plan. From the outset, their top priority was to create a governance structure that would protect the organization – including its board, its management, its assets and its investment decisions – from political interference. The fact that these politicians identified political interference as our greatest threat is remarkable in itself. The solution they devised to achieve their goal was original, bold and visionary. And it has worked.

Let me bring it alive for you with three examples of day-to-day operational life at our organization.

- First: We do not submit our investment strategy or business plans for government approval.
- Second: We do not have government officials sitting on our board.
- Third: We do not submit our compensation policies and pay levels for government approval.

How will the funds be used?

The policymakers also saw the importance of clearly answering Question 2: How will the funds be used? Their answer: to help pay pensions and nothing else.

Powerful Investment Mandate

To reinforce absolute clarity about the CPP Investment Board's objective, the reforms called for a simple, but powerful investment-only mandate. To quote from our legislation, we are mandated to achieve, "**a maximum rate of return without undue risk of loss**".

The legislation goes further. It stipulates that we must not pursue other objectives that are inconsistent with that investment mandate.

So, for example, there is no pressure or obligation for the CPP Investment Board to invest in Canada, buy government debt, make loans to state-owned firms, provide credit to governments, invest in politicians' favourite projects or invest with a view to any

particular social policy agenda other than the goal of helping to secure Canada's national pension plan.

Segregating the Assets

Segregating the pension assets from government revenues was another vital part of the framework they built to ensure that the funds would be used as intended. After all, these assets are contributed directly by working Canadians – employees and employers – as part of a defined benefit pension plan and the money belongs to the millions of Canadians who are contributors to or beneficiaries of the plan. They are not government assets funneled to the plan through the tax revenue system. Indeed the Canadian government is neither a sponsor nor a guarantor of the plan.

And what is the governance and oversight structure?

With the investment mandate articulated and the funds segregated, the policymakers also recognized the importance of answering Question 3: What is the governance and oversight structure?

Governance Structure Based on an Arm's-length Relationship with Governments

The answer was clear: a governance structure based on an arm's-length relationship with governments. Although many organizations say that they are arm's length from governments, the CPP Investment Board's legislated structure and subsequent measures adopted by the board make this claim a reality. The reforms called for management to report not to governments, but to an independent and qualified board of directors. Board

members possess strong credentials in business, finance, actuarial science, portfolio management and other relevant disciplines. Moreover, directors are appointed through a nominating process that balances governments' legitimate role in selecting directors with private sector input to identify directors with the requisite expertise and independence. To be clear, these are not political appointments or representatives of a given constituency, but rather a group of qualified professionals with a common duty to serve the best interests of the Plan's contributors and beneficiaries.

An example of the board's commitment to the arm's-length principle is embedded in its Code of Conduct. In accordance with the Code, directors, officers and employees have a positive duty to report immediately any attempted political influence if they have been subjected to pressure with respect to investment, procurement or hiring decisions. In our nine years of operation, there has never been any attempted influence. So ours is a pure investment-only mandate that meets the standard of "commercial-only".

How is the Investment Policy Created?

Which brings us to Question 4 – How is the Investment Policy Created? The board of directors, not governments, approves investment policies, determines with management the organization's strategic direction and makes critical operational decisions such as hiring the Chief Executive Officer and determining executive compensation. The CEO, in turn, hires and leads the management team, including the investment professionals who make portfolio decisions within investment policies agreed to by the board of directors.

This organizational structure ensures that investment professionals make investment decisions at arm's length from governments.

Is there Sufficient Disclosure?

And finally Question 5: Is there sufficient disclosure?

Transparency and Accountability

Policymakers ensured that our legislation required a high level of transparency and our board and management have voluntarily raised transparency to an even higher level.

Early in the life of the CPP Investment Board, the board of directors adopted a disclosure policy that states:

“Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf, and how the investments are performing.”

The power and effectiveness of this disclosure policy has served us well.

We report our results on the same basis as most Canadian public companies, including the presentation of independently audited financial statements, as well as the inclusion of a Management's Discussion and Analysis and a Compensation Discussion and Analysis, in our annual report.

In addition, we post our investment policy and objectives on our website as well as a full list of our public equity holdings. The website also identifies our private investment fund partners and real estate fund partners, how much we have committed to their funds, and how much has been drawn down. We believe that it is possible to provide a very high degree of transparency without compromising our proprietary investment insights.

In addition to these voluntary measures we have adopted, our legislation imposes a duty on us to hold public meetings every two years in all nine participating provinces, to participate in a federal/provincial triennial review of the Canada Pension Plan, and to open our books for a routine special examination every six years.

Changes to the Model

The Act

There is one powerful element of our governance model that I have left until the end because it is a product of our federal/provincial system. Any changes to our Act, which enshrines our governance model, would require agreement between the federal government and two-thirds of the provinces representing two-thirds of the population in order to amend the legislation. This is the same formula required for amending Canada's constitution – a high standard indeed in Canada. It prevents unilateral and potentially ill-considered or hasty changes. Changes are possible, but only after full consideration of the potential implications. The federal and provincial governments' commitment in enacting these reforms was truly extraordinary.

All told, it amounts to a far-sighted formula that was designed with intense collaboration in response to a funding crisis.

Finally let me reflect on two things. First, our model is uniquely well-suited for our purposes and each piece of the formula is vitally important in preserving the maximum-strength quality of our governance model. We believe that if one element of the model were removed it would significantly weaken our protections. Secondly, for other pools of capital around the world that are addressing problems unique to them, it may be appropriate to adopt elements of the Canadian blueprint to help solve those problems.

For those pools of capital, it will be increasingly important to articulate the specific measures that clarify and codify their investment objectives. Transparency, while not easy, is rewarding. It imposes extraordinary accountability, to be sure, but pays for itself with the trust and confidence it enables an organization to build with others.

So to conclude, I leave you with three messages.

The CPP Investment Board is not a Sovereign Wealth Fund and should not be caught up in the fear surrounding these entities. I have detailed the power of our governance model in support of this fact.

Some Sovereign Wealth Funds might be able to respond to fears about their motives by clarifying their objectives and generally increasing their transparency.

Increased transparency by these funds would contribute to a more informed debate and would allow international policymakers to move beyond labels and offer more judicious responses to this challenge.

Thank you.