CPP INVESTMENT BOARD

The Third Option: A new funding model for a national pension plan

Notes for remarks by

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to

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Good morning… and thank you John for that kind introduction.

It is a pleasure for me to be here this morning, as I have a great deal of admiration for AARP… for the dedication it brings to research and public policy development; and for the passion it brings to advocacy on behalf of its members. This briefing series on Global Aging is another example of your international public policy leadership.

I am also pleased to be here on Capitol Hill to speak about pension reform and specifically the Canadian experience. I look forward to answering your questions a little later.

It was 10 years ago that Canadian policy-makers took action to reform our system, full in the knowledge that they were a mere 20 years away from a serious pension crisis. In doing so, they created a new model for the funding of public pension plans.

The Canada Pension Plan Investment Board – the organization I represent – is the operational foundation for this new approach. Its establishment can be viewed as the development of a *third option* for pension sustainability -- a *hybrid* that marries the best of traditional government-funded pensions and the pure privately funded alternative.

First, let me set out the fundamentals of the Canadian regime.

Our retirement security system stands on three pillars. Since 1927, there has been a national old age security program in Canada. The modern program provides a very modest benefit to seniors. A Guaranteed Income Supplement, similar to your Supplemental Security Income plan, was added for Canada's lowest income seniors in 1967. That's the first pillar.

The second pillar is tax-deferred private savings. Many Canadians have private pension plans through their employment. And like their U.S. neighbours, they can contribute individually to tax-deferred retirement savings plans similar to your IRA programs. Through the provision of tax relief, governments have encouraged individual retirement savings programs, and a significant industry has grown up around this pillar.

The third pillar is the Canada Pension Plan, which was created in 1966 and is administered by the federal government and nine of our 10 provinces. It was designed as a 'pay-as-you-go' *defined benefit* pension plan for working Canadians. It is a mandatory plan, to which all employers and their employees – including the self-employed – must contribute. Excess contributions are channelled to a single reserve fund.

It is important to note that the Canada Pension Plan is *not* a state-*sponsored* plan. It's a state-*administered* plan. The federal and provincial governments have no liability for the plan. And most important, the assets in the CPP fund are *not* government assets.

It's also important to be clear that the CPP was never intended to be enough *on its own* to sustain an individual or family through retirement. It was designed to replace up to 25 per cent of the average industrial wage. It is one important component in retirement security. Together with the Old Age Security program, and private pensions and tax-deferred savings, the CPP helps provide retirement security for working Canadians.

By the mid 1990s, it was becoming apparent that the demographic and economic phenomenon known as the Baby Boom was going to have a significant impact on the sustainability of the CPP. In 1996, contributions to the plan amounted to $11 billion, while the plan paid out $17 billion in benefits.

More troubling, actuarial projections showed that even with scheduled contribution rate increases, the Plan would be unable to fully pay benefits by 2015. It was a rude awakening, but it also caused something remarkable to happen – it led politicians representing both federal and provincial governments to work in common cause.

Together, the two levels of government charted a new course. They… consulted with Canadians… collaborated with each other… formulated a plan and then, together, they created a new mechanism for funding the CPP.

That mechanism had a number of key components, but the overall funding model was based on the creation of a private sector investment engine that would power a critically important social program. Most important, it would balance arm's length independence with accountability.

First, the Federal and Provincial Finance Ministers worked with Canadians to reach agreement on a series of modest future reductions to CPP benefits to lower costs – a remarkable outcome for any government-administered pension plan.

Next, the Ministers took the politically brave step of accelerating the scheduled increase in contributions that employers and employees pay into the fund from 5.6 to 9.9 per cent – an increase of almost 80 per cent in less than half the original timetable.

Canadians also said they had serious reservations about governments controlling these pension assets. Policy-makers heard those concerns, so the third step was to effectively segregate the CPP funds from the public treasury, putting the funds – and future investment decisions – out of the reach of the political decision-making process.

To do that, the Canada Pension Plan *Investment Board* was created as an independent entity, arm's length from government. This independence is firmly entrenched in legislation that I will outline in a moment.

Each of those steps, of course, represents a myriad of details and complex formulas. But I'd like to concentrate on just a few specifics.

Let's start with the last, first – how did the policy-makers ensure that the funds were beyond political interference?

As a start, the money in the reserve fund is *not* part of general government revenues. The funds aren't owned by government; they're invested on behalf of contributors. By law, these funds cannot be used for any purpose other than to pay benefits, invest in future growth and to administer the fund.

Several months ago, I spoke with former President Clinton about our experience. He told me that the concept of diverting a portion of the federal surplus into an investment vehicle similar to the CPP Investment Board was floated here in Washington. He said the concept got stiff opposition here from no less than Alan Greenspan. Among his concerns, Mr. Greenspan felt that politicians could not resist the temptation to interfere with the investment plans of such a fund.

The Canadian designers of this program anticipated that problem, so first they sealed the cookie jar… and then they moved it out of reach.

They did that by giving the CPP Investment Board a simple but powerful investment mandate: Maximize investment returns without undue risk of loss. In short, the fund has very few investment constraints, but it has to *perform*. We are not a captive source of credit for governments… We do not have to buy government debt unless we choose, and only then if it meets our stringent return guidelines… And, we are not required to make loans to state-owned firms.

Then the plan's designers enshrined that mandate, and its governance model, in legislation. That legislation can only be amended by the federal government *and* two-thirds of the provinces representing two-thirds of the population. Interestingly, it's the same formula by which our constitution may be amended.

The policy-makers took additional measures to ensure the new CPP Investment Board was further protected. Our Code of Conduct says that our directors and employees will not allow any of our business activities to be subject to political interference. It asks them to report immediately any attempt to influence our investment, hiring or procurement decisions to the CEO, or in the case of directors, to the Chairperson.

In keeping with our arms-length status and investment mandate, we report to an independent board of highly qualified directors. Board members are appointed through a nominating process that balances governments' legitimate role in selecting directors with private sector input, expertise and independence.

As a result, the board consists of professionals with investment, business and governance credentials who are encouraged to have long-term investment horizons. The directors review and approve investment policies, management recommendations for external investment managers, and set compensation for internal management, linked to performance. Results are verified by independent auditors. The fact that we report to the board of directors, *not* to government, is a very critical detail.

It is, in short, a familiar private sector model. And yet there is still oversight by our 10 government stewards, who have obligations *and* opportunities such as independent audits, and periodic reviews of legislation and regulation. A thorough public disclosure regime ensures transparency.

It is a fine balance of arm's length independence with rigorous accountability. On the one hand, we can compete with the world's top institutional investors and private equity groups for global investment transactions… and on the other we have public meetings where Canadians can examine our activities and ask us tough questions about our results.

So… 10 years after it was envisioned, how has this *third option* worked?

If we go by the numbers, I'd say it has worked pretty well. To date, we have assets of more than 110 billion Canadian dollars – a significant increase from the $44 billion legacy government bond portfolio we began with. In just under six years, our investment program has produced investment income of more than $41 billion for the CPP fund. And our annualized real rate of return, over the past four years, is 11.52 per cent.

To put that in perspective, Canada's Chief Actuary says our plan needs a real rate of return – that's return after inflation – of 4.2 per cent, over a very long-term investment horizon, to sustain the plan at the current contribution rate.

We are comfortably meeting that obligation. As such, I can report that our governance model has worked, and our investment model has worked.

In the past six years, we have also created a broadly diversified investment portfolio. That portfolio is in keeping with our investment mandate – maximum return without undue risk – and with our long-term investment horizons. Public equity, private equity, government bonds, venture capital, real estate and investments in infrastructure have built a diversified foundation under the CPP. And because contributions exceed benefits for the next 15 years, the first dollar of investment income generated by the CPP fund will not be needed to help pay benefits until 2022.

To understand the importance of that, remember that a decade ago the actuaries projected that the CPP would be unable to pay benefits by 2015.

According to Canada's Chief Actuary, by 2016 we will have about $250 billion in assets under our administration. Even with the coming surge in retirements expected in the next decade, we will administer one of the fastest growing *and* one of the largest single-purpose pools of investment capital in the world. By nearly any measure, that makes the CPP one of the most actuarially sound plans of its kind in the world. The Office of the Chief Actuary of Canada tells us it is among the top plans in the OECD countries, in the company of Norway, Sweden, the Netherlands and Australia, and probably the top among G7 nations.

Our strong investment orientation gives us clear direction, but it also offers us leadership opportunities. And we have recently pursued one such leadership opportunity that is firmly rooted in our investment mandate. In October of 2005, our board of directors adopted our own Policy on Responsible Investing, or PRI.

At its core, the policy reflects our belief that responsible corporate behaviour with respect to environmental, social and governance factors – commonly referred to as ESG factors – can generally have a positive influence on long-term financial performance.

In April of 2006, we were the only Canadian institutional investor asked to help develop the Principles for Responsible Investment, a world-wide initiative under the aegis of the United Nations.

We also participate in a number of global coalitions and initiatives among institutional investors, promoting better disclosure… initiatives like the Enhanced Analytics Initiative, the Carbon Disclosure Project, and the Extractive Industries Transparency Initiative.

(pause)

There are many challenges still in front of us at the CPP Investment Board, of course. Challenges such as dealing with a global investment mandate… the search for top investment professionals… a changing asset mix… new risk management strategies… and new investment partners.

So… how do the lessons of the Canada Pension Plan Investment Board apply here? Do we recommend our model for you?

We wouldn't be so bold as to do that. It's not for us to say. After all, good neighbours know when to mind their own business.

Still, we have seen the value of establishing a national pension plan with a pool of funds that government can't touch… of building sturdy checks and balances into the governance model… of creating a private sector engine to drive a vital social program… and of creating a balance between arm's length independence and accountability. We have found a *third option*, a choice that is neither a purely government plan nor a purely private solution.

We've also watched as nations like Ireland and New Zealand successfully established funds based on the Canadian blueprint. Our governance model has been recognized by the World Bank as best practice for national pension funds. And we have a steady stream of visitors from national pension funds from around the world come to see our model and learn how we operate.

We're aware that your governments, your legislators, your industries, your institutions and your leaders have recognized the challenges facing your retirement security programs. From our experience, that's an important first step. We also know that you are blessed with tremendous resolve as a nation – that when you make up your minds that change is what's needed, change is what happens.

We wouldn’t presume to tell you how to do that, of course, but we’d be happy to share with you what we have learned.

That is, after all, what good neighbours do.

Thank you, and I’d be happy to entertain any questions you may have.

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