The Canadian Model:
A Framework for Independence and Accountability

Notes for remarks by

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Thank you Jamie for that introduction – and I am pleased to appear before you today to share the CPP Investment Board’s perspective on some matters that are hopefully relevant to your discussions within this working group.

Specifically, we have a perspective on the issues of governance, transparency and accountability that are central to the CPP Investment Board and how we operate.

One of the concerns that is sometimes raised about funds that are perceived to have some government influence in their operations is that those funds may be used for public policy goals rather than economic or return goals.

This was certainly a concern voiced by Canadians at the time of the creation of the CPP Investment Board and our governance model is instructive in this regard because it was designed specifically to protect against political interference, while maintaining a high degree of accountability.

In the time allotted I’d like to briefly review the origins of the CPP Investment Board and then discuss the key elements of our governance structure, our approach to accountability through transparency, and our investment and risk management framework.
Origins of the CPP Investment Board

The Canada Pension Plan was established in 1966 as a ‘pay-as-you-go’ plan funded by compulsory contributions made jointly by employees and employers.

By the mid-1990s, the sustainability of the Fund was in crisis. In 1996, the CPP paid out $17 billion in benefits but took in only $11 billion in contributions – and the trend was worsening. An actuarial report projected the plan’s contingency reserve would be exhausted by 2015.

Facing this stark reality, in February, 1997, the provinces and the Federal government reached agreement on major reforms to the CPP. The reforms included the following key steps:

- A modest reduction in future benefits;

- A change from the original ‘pay-as-you-go’ model to partial pre-funding with an accelerated increase in the contribution rate from 5.6 to 9.9 per cent in order to create a sizeable reserve fund;
• The segregation of the CPP assets from government assets and revenues; and

• The creation of the Canada Pension Plan Investment Board to manage this fund for the benefit of over 17 million Canadian contributors and beneficiaries.

These reforms were the result of an intensive public consultation process undertaken by the Federal and Provincial governments.

Through this process, Canadians made it clear that while they were willing to accept a higher contribution rate, they were distrustful of leaving their pension funds under political control. Plan participants felt that government influence on investment decision-making could lead to poor investment performance, and that they would suffer the consequences through higher contribution rates and/or lower benefits.

Since they were bearing the ultimate risk of higher contributions or lower benefits, Canadians set out the terms of the fundamental risk-sharing arrangement. They would consent to the benefit reductions and the contribution increases, provided that government would consent to a governance model that provided for a professional investment organization operating at arm’s length, according to a purely fiduciary-driven commercial mandate.
This was the defining moment in the reforms of the CPP and the creation of the governance model for the CPP Investment Board.

Ensuring that the investment process remained at arm’s length and independent from governments became an essential and closely scrutinized feature of the CPPIB governance structure.

This independence was then balanced against the need for sufficient accountability to governments – which are the effective agents of the CPP participants - to allow people to determine if CPP assets are being profitably and prudently managed for the exclusive benefit of plan participants.

To this end, the reformers created a “maximum-strength” governance model designed to strike a balance between independence and accountability, and they gave the CPPIB a clear and singular mandate to achieve a “maximize rate of return without undue risk of loss.”

The CPPIB’s governance model is set out in *The Canada Pension Plan Investment Board Act*, which is the legislation governing the CPPIB.
As an indication of the lengths pursued by the reformers to protect the CPPIB from political interference, this law includes an extraordinary provision. It can only be amended by a consensus of the Federal government and at least two-thirds of the participating provinces representing two-thirds of the population.

To put this in perspective, this is an even higher level of agreement than the threshold required to amend Canada’s Constitution.

**Independence from Government**

I’ve given you the conceptual framework of our governance model. Let me now describe it in more practical terms:

- Management of the CPPIB reports not to government but to an independent board of highly qualified directors.

- While Directors of the CPPIB are appointed by the Federal government in consultation with participating Provincial governments, these appointments are made from a list of qualified candidates provided by a joint Federal-Provincial nominating committee with private-sector involvement.
• Directors are chosen based on their qualifications and are not affiliated with nor do they represent any particular constituency.

• As required by the CPPIB Act, the nominating process is designed to ensure that the board has directors with proven financial ability or relevant work experience so that the CPPIB will be able to effectively achieve its investment mission including overseeing a growing and complex organization with approximately $120 billion in assets under management.

• The board of directors, not government, 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.

• A stringent code of conduct stipulates that any attempts by government to influence our investment decisions, hiring practices or procurement must be appropriately escalated within the organization in order to determine what appropriate action should be taken.
To be clear, the CPPIB:

- Is bound by law to a clear and singular investment-only mandate:
  
  - Does not submit its investment strategy or business plans for government approval;
  
  - Does not have government officials sitting on its board; and

  - Does not submit human resources or other policies for government approval.

**Public Accountability through Transparency**

The CPPIB’s governing legislation requires a high level of transparency to help ensure public accountability. The legislation mandates quarterly detailed public reporting and the production of our annual report which is tabled in the Federal Parliament. This legislation also imposes a duty on the CPPIB to hold public meetings every two years in all nine participating provinces, and to open its books for a special examination every six years.

The CPPIB’s board and management have voluntarily raised transparency to an even higher level by adopting a disclosure policy which 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.”

In keeping with this policy, the CPPIB reports its results on the same basis as most Canadian public companies, including the presentation of independently audited financial statements, as well as the inclusion of Management’s Discussion and Analysis and Compensation Discussion and Analysis sections in the annual report.

In addition, the CPPIB posts its investment policy and objectives, as well as a full list of its public equity holdings, on its website. The website also identifies the CPPIB’s investment partners, how much it has committed to each of their funds, and how much has been drawn down.

Many funds have expressed the concern that this level of transparency will compromise their investment goals. Our experience has been to the contrary; we have been able to provide a very high degree of transparency without compromising our proprietary investment insights nor those of our investment partners. Moreover, our transparency has enabled us to build a degree of public trust and confidence that we do not believe would have been achievable otherwise.
Investment Strategy & Accountability Framework

Let me now turn to our investment strategy and accountability framework. The CPPIB operates according to a clear, singular and legislated mandate that directs it to achieve “a maximum rate of return without undue risk of loss, having regard to the factors that may affect the funding of the CPP and the ability to meet its financial obligations on any business day.”

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, or invest in accordance with any particular social policy agenda. In fact, we are explicitly prohibited from pursuing objectives that are inconsistent with our mandate.

The CPPIB has interpreted this to mean that its sole mission is to generate the returns required to help keep the CPP sustainable over the long term.

In defining sustainability, the Federal and Provincial finance ministers who serve as the CPP stewards expressed a desire that the CPP be able to pay benefits at current levels, adjusted for inflation, with an employer-employee contribution rate of no more than 9.9 per cent.
A 9.9 per cent contribution rate requires an annualized real return of at least 4.2 per cent over the 75-year projection period used in the Chief Actuary of Canada’s *21st Actuarial Report on the Canada Pension Plan*. 

Within those broad parameters of sustainability, the mission of the CPP Investment Board is to earn value-added returns over the long term to help secure the future CPP benefits of generations of Canadians.

To measure investment management performance in relation to the long-term 4.2 per cent annual real return assumption, the CPPIB developed a low-cost, low-complexity model that serves as our investment benchmark - composed of a prudent mix of Canadian and international equities and Canadian nominal debt and real return bonds. It is the yardstick by which we evaluate strategic decisions and measure our own performance. It also enables the Board to tie compensation directly to value-added performance and add a further layer of accountability.

This benchmark is the cornerstone of the Risk-Return Accountability Framework -- both in terms of our investment performance and by which others can judge our actions against our publicly-stated investment goals and objectives.
While this benchmark could meet the long-term funding needs of the CPP based on the reasonable capital market returns assumed in its design, the CPPIB has made a strategic choice to strive to generate additional returns above those inherent in the benchmark. Our investment strategy, therefore, is to add value above and beyond this strategic benchmark. Enhanced long-term returns improve the financial performance of the overall plan and thus contribute to the long-term sustainability of the CPP.

The range of investment strategies used in managing the CPP Fund has evolved over time. When the CPPIB began its investment program in 1999, cash flows were initially invested passively in public equities. In recent years, management has elected to pursue value-added returns by diversifying into new geographies and expanding the range of investment programs to include private equity, private debt, real estate and infrastructure, along with a broad array of other active investment programs in the public markets.

It is still early days, but so far the results of this strategy have been both positive and significant. In fiscal 2007, the last year for which results have been disclosed, we delivered $13.1 billion in investment income of which $2.4 billion was our value-added returns over and above our relevant market based benchmark.
The Fund’s total annualized rate of return for the past four fiscal years is 13.6% or 11.7% after inflation. Canada’s Chief Actuary has forecast the Fund’s assets will grow beyond $320 billion by 2020, and he has concluded that the Plan is sustainable for the 75-year period covered by his report.

In closing, I would say that transparency has proven an advantage, rather than a hindrance, in the pursuit of our corporate and investment objectives, and since our inception neither our governance model nor our independence from government has been challenged or threatened.

Thank you for the opportunity to participate in this forum. I hope this information will prove useful to the working group, and I will be pleased to answer questions during the discussion period.