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Communiqué

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C.D. Howe Institute study gives thumbs-up to CPP reforms

Changes to the Canada Pension Plan (CPP) — reflected in a federal-provincial agreement of February 1997 and in legislation recently tabled in the House of Commons — will lower the plan's long-term costs, reports a *C.D. Howe Institute Commentary* released today. The changes include small reductions in benefits, significant increases in contributions in the near term, and a new investment policy that would convert the plan from an essentially pay-as-you-go program with an investment fund of about $41 billion at the end of fiscal year 1993/94 to a partially but substantially funded program with an investment fund as large as $145 billion by the end of fiscal year 2004/05.

The study, entitled *Prudence and Performance: Managing the Proposed CPP Investment Board,* was written by David W. Slater, a former chair of the Economic Council of Canada who has considerable experience in the pensions field.

Slater notes that, although all cohorts of future contributors would have to put something toward building up the investment fund, the target of five times annual expenditures would probably not be met until the end of the first decade of the twenty-first century.

The CPP fund, Slater says, would be managed by a board, at arm's length from government, mandated to seek higher rates of earnings than the previous fund achieved by investing in a mixed market portfolio of fixed-income securities, equities, and property, Canadian and foreign.

The fund would operate as a fiduciary trust, Slater says, and should serve the interests of CPP contributors and beneficiaries — and no other interests, however meritorious. Its directors would have a duty to act with the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. Directors with special knowledge or experience would have an additional measure of fiduciary responsibility.

If managed like other major Canadian public and private pension investment funds, the CPP fund should be able to attain its target of a 3.8 percent real rate of return on investment, Slater argues. He also presents calculations to show that domestic and foreign financial markets will have no difficulty in accommodating the new, larger fund.

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Prudence and Performance: Managing the Proposed CPP Investment Board, C.D. Howe Institute Commentary 98, by David W. Slater (C.D. Howe Institute, Toronto, October 1997). 32 pp.; $6.00 (prepaid, plus postage & handling and GST — please contact the Institute for details). ISBN 0-88806-418-7.

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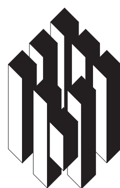

C.D. Howe Institute
Institut C.D. Howe

Communiqué

Embargo : à diffuser le *jeudi* 30 octobre 1997

Une étude de l'Institut C.D. Howe approuve les réformes du RPC

Les modifications apportées au Régime de pensions du Canada (RPC) — telles qu'elles figurent dans une entente fédérale-provinciale datant de février 1997 et dans un projet de loi récemment présenté à la Chambre des communes — mèneront à long terme à une diminution des coûts du régime, indique un *Commentaire de l'Institut C.D. Howe* publié aujourd'hui. Les modifications portent entre autres sur de légères réductions des prestations, une hausse importante des cotisations à brève échéance et une nouvelle politique d'investissement qui transformera le régime, d'un programme qui est essentiellement par répartition doté d'un fonds d'investissement d'environ 41 milliards de dollars à la fin de l'exercice 1993-1994, en un programme financé — bien qu'en partie mais dans une large mesure tout de même — par un fonds d'investissement qui pourrait atteindre 145 milliards de dollars d'ici la fin de l'exercice 2004-2005.

L'étude, intitulée *Prudence and Performance: Managing the Proposed CPP Investment Board (Prudence et performance : la gestion du Conseil proposé d'investissement du RPC),* est rédigée par David W. Slater, un ancien président du Conseil économique du Canada qui possède une vaste expérience en matière de régimes de pensions.

Comme l'indique l'auteur, malgré toutes les cohortes de cotisants futurs qui devront contribuer à l'édification du fonds d'investissement, ce ne sera pas avant la fin de la première décennie du XXIe siècle que l'on sera en mesure d'atteindre l'objectif fixé, celui d'équivaloir à cinq fois le montant des dépenses.

La gestion du RPC reviendrait à un conseil, affirme M. Slater, sans lien de dépendance avec le gouvernement, qui sera chargé d'obtenir un rendement plus élevé que le fonds précédent, grâce à des investissements dans un portefeuille mixte comportant des valeurs à revenu fixe, des actions et des propriétés, au Canada et à l'étranger.

Le fonds fonctionnerait à la manière d'une fiducie, indique l'auteur, et il devra tenir compte des intérêts des cotisants et des prestataires du RPC — et de ceux de personne d'autre, quel que soit leur mérite. Ses administrateurs auront le devoir d'agir avec prudence, diligence et avec les compétences que l'on attend d'une personne raisonnablement prudente dans des circonstances semblables. Tout administrateur possédant des connaissances ou une expérience spéciales aurait une responsabilité fiduciaire accrue.

S'il était géré comme tout autre organisme canadien important de placement de fonds de retraite public ou privé, le fonds du RPC devrait être en mesure d'atteindre son objectif de taux de rendement réel de 3,8 %, remarque M. Slater. Ce dernier avance également des calculs

indiquant que les marchés financiers nationaux et internationaux n'éprouveront aucune difficulté à répondre aux besoins du nouveau fonds élargi.

* * * * *

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Prudence and Performance:
Managing the Proposed CPP Investment Board

by

David W. Slater

As reflected in a federal-provincial agreement of February 1997 and in legislation recently tabled in the House of Commons, the Canada Pension Plan (CPP) is to be transformed. Proposed changes include small reductions in benefits, significant increases in contributions, and a new investment policy that would convert the plan from an essentially pay-as-you-go program with an investment fund of about $41 billion at the end of fiscal year 1993/94 to a partially but substantially funded program with an investment fund as large as $145 billion by the end of 2004/05. Although all cohorts of future contributors would have to put something toward building up the investment fund, the target of five times annual expenditures would probably not be met until the end of the first decade of the twenty-first century.

The CPP fund would be managed by a board, at arm's length from government, mandated to seek higher rates of earnings than the previous fund achieved. The implication is a mixed market portfolio of fixed-income securities, equities, and property, Canadian and foreign, with a moderate risk-reward profile. The fund should serve the interests of CPP contributors and beneficiaries — and no other interests, however meritorious.

The fund would operate as a fiduciary trust, and its directors would have a duty to act with the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. Directors with special knowledge or experience would have an additional measure of fiduciary responsibility.

If managed like other major Canadian public and private pension investment funds, the CPP fund should be able to attain its target of a 3.8 percent real rate of return on investment. And markets, domestic and foreign, should have no difficulty in absorbing the increased investment.

Main Findings of the Commentary

- As reflected in a federal-provincial agreement of February 1997 and in proposed legislation of July 1997, the Canada Pension Plan (CPP) is to be transformed. Small reductions in benefits, significant increases in contributions, and a new investment policy would convert it from an essentially pay-as-you-go program with a small investment fund to a partially but substantially funded program with a much larger investment fund.
- The CPP fund stood at about $41 billion at the end of fiscal year 1993/94. Under the new approach, it could be $145 billion at the end of 2004/05.
- Although all cohorts of future contributors are to put something toward building up the investment fund, the target of five times annual expenditures would probably not be met until the end of the first decade of the twenty-first century.
- The CPP fund would be managed by a board, at arm's length from government, mandated to seek higher rates of earnings than the previous fund achieved. The implication is a mixed market portfolio of fixed-income securities, equities, and property, Canadian and foreign, with a moderate risk-reward profile.
- The fund should serve the interests of CPP contributors and beneficiaries — and no other interests, however meritorious.
- The federal and provincial governments plan to impose some restrictions on the board's policy, such as a 20 percent foreign property limit and transitional requirements on provincial bond holdings. The proposed legislation permits other regulations; Canadians should have some clarification of their content before the proposed legislation becomes law.
- The fund would operate as a fiduciary trust. All directors would thus have a duty to act with the care, diligence, and skill that a reasonably prudent person would exercise in comparable circumstances. Those with special knowledge or experience would have an additional measure of fiduciary responsibility.
- If managed like other major Canadian public and private pension investment funds, the CPP fund should be able to attain its target of a 3.8 percent real rate of return on investment. And markets, domestic and foreign, should have no difficulty in absorbing the increased investment.
- The legislation proposes strengthened and more open reporting and evaluation for the investment board and for the entire CPP.
- The CPP proposals should lead to some increase in public sector saving in Canada. However, together with other recent changes — the new seniors benefit and tightened limits on tax-sheltered pension contributions — they would likely decrease private saving rates. The net increase or decrease in national saving remains to be determined by experience.
- People who have clearly paid for more of their pension benefits are likely to have a greater sense of responsibility for sustainability of the system.

During the past several years, a cluster of concerns has swirled around the Canada Pension Plan (CPP). Existing contributions are too small to fund even current benefits. What will happen when the large cohorts of baby boomers reach retirement age in the next decade or so? Will not a system that is essentially a pay-as-you-go scheme require a sizable — some say huge — increase in contributions? The present investment fund, which is limited to nonnegotiable government securities (mostly from the provinces), will soon be exhausted. Could the CPP not be made much more sustainable by increasing the investment fund and altering its holdings to a broader mix that would bring much higher rates of return?

In February 1997, the federal government and the provinces sought to answer those questions and others by issuing a statement of agreement to a sketch of changes to the CPP. Now, these changes have been incorporated into a bill that was introduced into the House of Commons on September 25.[1]

The changes, which envision small reductions of benefits and large increases in contributions, include the transformation of the CPP from a (mostly) pay-as-you-go program with a small, restricted investment fund to a partially funded program with assets equivalent to as much as 25 percent of its liabilities. The investment fund, which would increase over time, would be allowed to invest in a mixture of assets: treasury bills, government and corporate bonds, equities, other financial assets, and property, to be acquired and disposed of mainly in market transactions under the supervision of an arm's-length investment board to be established under powers contained in the proposed Canada Pension Plan Investment Board Act.

The broader portfolio opportunities are intended to yield rates of investment earnings higher than those of the present CPP portfolio. The combination of a larger investment fund for the CPP and higher rates of investment earnings is intended to make it possible to sustain the CPP benefit program with contributions lower than would be required under the existing pay-as-you-go program.

The objectives of this Commentary are to set out what powers the proposed board would and would not have; to examine issues of governance and process, information, and accountability bearing on the board; to examine means by which the future contribution, benefit, and investment objectives are to be achieved, adjusted, and maintained; to explore whether the investment expectations can be met; and to consider the board in the overall setting of the Canadian saving, investment, and financial system.

In other words, my focus is on investment board issues. Other features of the agreement (the proposed changes in benefit provisions and the contribution base and rates; the timetable for increases in contributions; and the target size of the fund) are noted as background but not analyzed here. For example, I accept the stated fund target of five years' worth of benefits; it might have been six or more years, but the precise ratio is immaterial to most of the issues examined here. The important point is that the target fund be sizable and capable of being achieved fairly quickly, before the cohorts of baby boomers reach age 65, exploding the ranks of CPP pensioners.

Accordingly, I proceed in the following way. The first section explains the key provisions of the new investment policy, as set out in the federal-provincial agreement. Accompanying the discussion is my own estimate of how the numbers might work out. Next comes a description of the new board, as proposed in the legislation.

Then I turn to some key issues: the meaning of the board's fiduciary responsibility, and the superiority of the independent governance model being proposed.

Next come sections on the board's probable investment policies, some of which are still unclear (because they would depend on yet-unknown regulations); whether the fund's stated goals are achievable; the legislation's stiffening of reporting requirements; and ways

Box 1: *A New Investment Policy (federal-provincial agreement, February 1997)*

Principle: CPP funds must be invested in the best interests of plan members and maintain a proper balance between return and investment risk. Governance structures must be created to ensure sound fund management....

Fuller funding of the CPP means the fund will grow substantially from about two years of benefits [the current level] to about five years of benefits over the next two decades. Achieving a higher investment return on the fund would contribute in an important way to keeping contribution rates down in future. Fuller funding of the CPP therefore requires a new investment policy in order to secure the best possible returns for contributors.

It is proposed that CPP funds be prudently invested in a diversified portfolio of securities in the best interest of contributors and beneficiaries. This new policy is consistent with the investment policies of most other pension plans in Canada and the QPP. Prudent assumptions indicate investing the fund in the market could generate an average real return of 3.8 per cent per year — i.e., a return of 3.8 per cent above the rate of inflation.

The fund will be managed professionally at arm's length from governments by an investment board. The CPP Investment Board will be governed by a qualified board of directors of up to 12 members. The Board will be accountable to the public as well as governments and will report its investment results regularly to Canadians.

The Board will be subject to broadly the same investment rules as other pension funds in Canada. The foreign property limit for pension funds will strictly apply. To ensure the fund's entry into the market proceeds smoothly, all of the Board's domestic equity investments will be selected passively, mirroring broad market indexes. This approach will be re-evaluated at the next CPP review.

When provinces borrow from the CPP, they will pay the same rate of interest as they do on their market borrowings. As a transitional measure reflecting historical arrangements, provinces will have the option of rolling over existing CPP borrowings at maturity for another 20-year term. For the first three years, provinces will also have access to 50 per cent of new CPP funds that the Board chooses to invest in bonds. After this three-year period, to ensure the fund's investment in provincial securities is consistent with market practice, new CPP funds invested in provincial securities will be limited to the proportion of provincial bonds held by pension funds in general.

Source: Canada, *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP* (Ottawa: Department of Human Resources Development and Department of Finance, February 1997), p. 13.

in which the legislation would (or might not) protect pensioners' interests.

After consideration of the combined effects of the proposals and other pension changes on Canada's national saving and other macroeconomic factors, I end with a brief conclusion.

A New Investment Policy

The most useful starting point for this study is the CPP's new investment policy (see Box 1) as set out in ordinary language in a federal government booklet, Securing the Canada Pension Plan,[2] which describes the federal-provincial agreement.

Perhaps the most fundamental point about this policy statement is what it does not (and could not) say. The overall responsibility for the CPP and most of its major features are not being delegated. They are the joint responsibility of the federal government and the participating provinces. The establishment of the CPP pension investment board and its main policies would be conditional delegations of pension fund management to a fiduciary trust. Although the performance of the CPP would depend partly on the performance of the board, the overall responsibility of safeguarding the CPP would remain with the federal government and the participating provinces.

Under the new investment policy, the CPP, like many other public and private sector pension funds, would become a trust, with a board at arm's length from governments. But the board would be accountable to governments, the CPP participants, and the public for good performance of the investment programs (indeed, as discussed later, the legislation's re-

porting and evaluation requirements are exceptionally strong).

The directors (trustees) are given scope to determine and execute the investment of the funds. By setting a target of 3.8 percent average real rate of return, the governments have signaled that the fund is intended to have an average rate of investment earnings larger than that earned on a portfolio of government bonds. The board is intended to invest in a wide variety of assets with a moderate risk-reward profile. Such an investment policy would lead to variations in investment returns over time, some years good and other years not so good; such variations go with the territory, even for well-managed investment funds. Given the discretionary trust of the investment board, the watchwords must be *prudence* and *performance.*

If the investment board is given power and discretion to manage the investment funds, how are the governments to exercise their overall responsibility for all aspects of the CPP program? All the main features of the CPP reform package involve forecasts of behavior — the future contribution base and amounts of contributions; the expenditures for retirement pensions, for survivor's benefits, for disability pensions, and so on; the growth of the investment fund; and the rates of investment earnings. Moreover, many of these forecasts are interdependent — for example, the growth of the investment fund would depend on the experience of contributions and expenditures as well as the rate of investment earnings. Thus, even if the investment board's performance was good, the CPP program as a whole could fall short of or exceed its targets and require adjustment of benefits and contributions.

It is not possible in this Commentary to provide best estimates for the reformed CPP financial prospects or the sensitivities of those prospects to variations in forecasting assumptions. These will be forthcoming from the federal Chief Actuary. At this stage, the best working assumption is that the estimates provided in the agreement have been made prudently and in recognition of the interdependencies involved. To have done otherwise would have been irresponsible and liable to undermine the credibility of the whole CPP reform program.

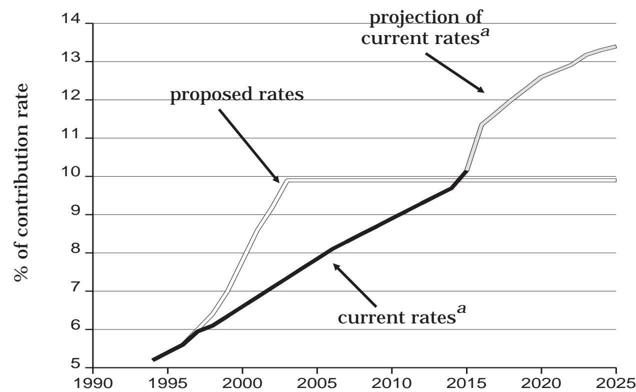
The Essential Features of the Changes

According to the agreement and the proposed act, the most fundamental features of the CPP are to be continued. Benefit programs, contribution bases and rates, and the establishment, objectives, and powers of the investment board would be determined by federal-provincial agreement. (Under the 1965 Canada Pension Plan Act, the provinces that did not opt out of the CPP — that is, all provinces except Quebec — are participants in the plan.[3] All the principal decisions under it require agreement between the federal government and two-thirds of the participating provinces with two-thirds of the population of all participating provinces.)

With few exceptions, all persons working in Canada, except those covered by the Quebec Pension Plan (QPP), must participate in the CPP, making contributions and being entitled to retirement and supplementary benefits under it. The proposals include modest reductions in various benefits from the existing CPP program, but broadly speaking, CPP benefits would play the same role in the overall Canadian retirement-income system as they do now. Maximum retirement benefits would still be intended to replace up to about 25 percent of the average industrial wage. Various supplementary benefits would be continued, though some will be reduced or frozen. The February 1997 announcement of the federal-provincial agreement includes these reassurances:

- All retired CPP pensioners or anyone over 65 as of December 31, 1997, are not affected by the proposed changes. Anyone currently receiving CPP disability benefits, survivor benefits or combined benefits, is also not affected.
- All benefits under the CPP will remain fully indexed to inflation.
- The ages of retirement — early, normal, or late — remain unchanged.[4]

Figure 1: *CPP Contribution Rates, Current and Proposed*



[a] Rates from the 25-year schedule established in 1990.

Source: Canada, *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP* (Ottawa: Department of Human Resources Development and Department of Finance, February 1997), p. 11.

Since benefits are to be reduced minimally, the burden of sustainability of the CPP rests mainly on increased contributions and improved investment earnings.

Contributions

The base for determining contributions is to be enlarged, and the contribution rate applied to it would increase over the next few years to a steady-state rate, forecast (using projected demographic and employment trends, inflation, productivity growth, real interest rates, and wage trends) as 9.9 percent of the contribution base. Figure 1 contrasts the contribution rates that would hold under the previously agreed 25-year schedule and the rates under the new federal-provincial agreement. The proposed new rates would increase gradually until 2003 and then continue on a plateau of 9.9 percent of the contribution base. The new rates would exceed the older agreed schedule until 2016 and thereafter be less than those implied by the 1995 actuarial report.[5] Particularly during the next decade, the proposed CPP contributions are intended to exceed the expenditures of the program, with the excess being transferred to the investment fund. Those excess contributions plus the plowback of investment income are intended to achieve and maintain a fund of about five times the average annual expenditures.[6]

In other words, the contributions are intended to meet two objectives: (1) taking into account the expected investment earnings of the CPP fund, to pay for benefits that will arise from future participation in the CPP, and (2) to build up an investment fund that will achieve a substantially funded status for the CPP program.

The Investment Fund

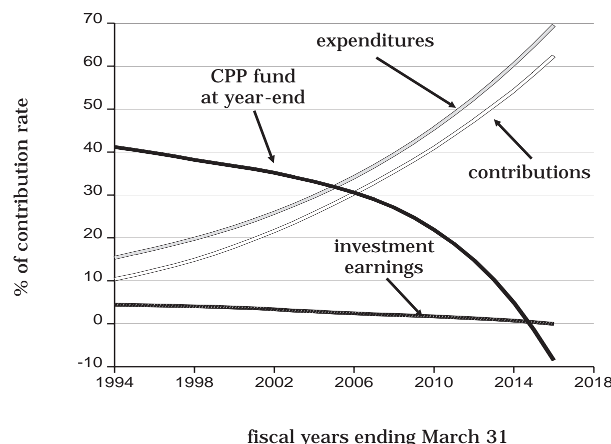
The forecast size and rate of earnings on the proposed investment fund are an important element in the new CPP approach. The plan's fiscal year 1995/96 annual report[7] had sounded an unmistakable alarm about the existing investment fund, showing it would be exhausted by 2014/15 (see Figure 2).

The proposed new fund and other changes are an attempt to reverse the situation. My own rough projection incorporates some of the proposed changes in the reform package — including reduced expenditures (as set out in the new package), increased contributions (due to both the expanded base and the increased contribution rate), and rates of investment earnings reduced to reflect lower inflation on the one hand but increased real rates of investment earnings on the other (see Figure 3).[8]

My rough projection indicates that the investment fund could meet its target of five times annual expenditure ("five years of benefits") as early as fiscal year 2009/10 through achieving some sufficient combination of reduction in expenditures, increases in contributions, and investment returns. (The Chief Actuary's report, released when the legislation was tabled, shows the fund-payout ratio peaking at 4.9 around 2020.)

Consider, for example, the following contrast between changes in the fund in fiscal year

Figure 2: ***The CPP Fund, Projection without Reforms***



fiscal years ending March 31

Source: Canada, Department of Human Resources Development, *Annual Report of the Canada Pension Plan, 1995/96* (Ottawa, 1995), p. 36.

1995/96[9] and those in 2009/10 under the assumptions of Figure 3:

		($ billions)
Fund at beginning of 1995/96		$40.5
Income		
Contributions	$12.5	
Investment earnings	4.3	
Total income	6.8	
Expenditures	– 17.5	
Difference	– 0.7	– 0.7
Fund at year-end, 1995/96		$39.8
Fund at beginning of 2009/10		$175.6
Income		
Contributions	$45.5	
Investment earnings	13.0	
Total income	58.5	
Expenditures	38.1	
Difference	20.4	20.4
Fund at year-end, 2009/10		$196.0

Another way of looking at the proposed changes is to compare the proposed contribution rates and the full cost of financing the future benefits. Preliminary reports indicate that future contribution rates of 7.0 to 7.5 percent (give or take a little) of the contribution base would be required to meet the full costs of the revised retirement and supplementary benefits of the CPP arising from future participation.[10] When the proposed steady-state contribution rate (9.9 percent of the contribution base) is achieved, 2.9 to 2.4 percent of the contribution base would remain to put to the CPP investment fund, which is intended to achieve and maintain a funded status for the CPP equal to five years of average benefit outlays. Thus, I estimate the fund's assets could amount to 25 percent of the CPP's liabilities, rather than the less than 10 percent it represents now.

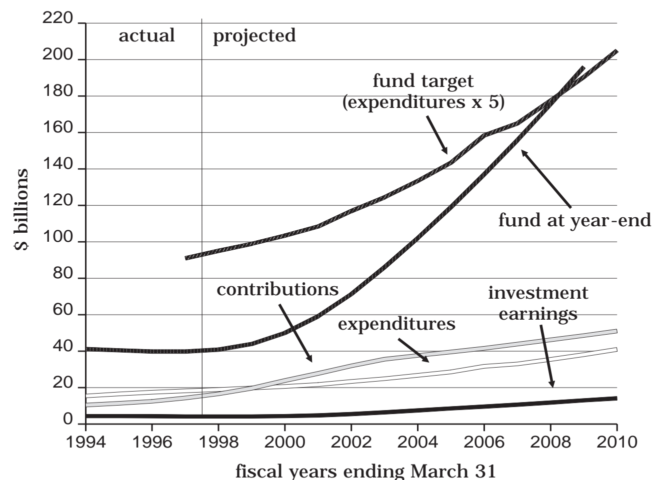
Some Basic Thoughts

Some critics suggest that the proposed CPP changes are inequitable because they do not go far enough or because they go too far and would impose an intolerable burden on working Canadians.

Even with the proposed changes, the CPP would continue to have a high ratio of unfunded liabilities, mainly because of accumulated liabilities for the pensions and other benefits now being paid and for future benefits accumulated from past service by participants who are not yet drawing benefits. To the extent that these past service liabilities were not covered by the CPP investment fund, they would give rise to continuing intergenerational transfers in the pension system. These transfers would, however, be reduced substantially by the reforms to the CPP, particularly by the partial funding proposals and the mandate of the CPP investment board.

The argument against pay-as-you-go financing of public pension programs is based on considerations of growth, interest rates, national savings, and legitimacy of claims for public pensions. Whenever the prospective rate of real economic growth is less than the real rate of interest, there is a case for some funding of a public pension program in advance.[12] Although the ultimate pension burden for a decade's retirees falls on the national income produced during that decade, whether a program is funded or not, the size of the income of the decade and the legitimacy of claims depend on the degree of funding.[13] A pre-

Figure 3: ***The CPP Fund, Hypothetical Projection with Proposed Reforms***



Note: In contrast to the projections used in the 1995/96 CPP Annual Report (see Figure 2), my projections assume:

- A reduction of expenditures (according to the 1997 agreement) by 2 percent in fiscal year 1997/98, 4 percent in 1998/99, 6 percent in 1999/2000, and 9 percent in 2000/01 and thereafter.
- An increase in the contribution base by 1 percent in 1997/98, 2 percent in 1998/99, 4 percent in 1999/2000, and 5 percent in 2000/01 and thereafter.
- Contribution rates scaled up from the 25-year schedule on the basis of the 1997 agreement.
- Rates of investment earnings scaled down from the actual 10.6 percent of 1995/96 gradually to a 6.0 percent nominal rate in 2016, representing a balance of lower rates due to lower inflation assumptions and the increased real rate of return target set in the 1997 agreement.

Source: Author's calculations, using Figure 2 and the assumptions noted above.

funded program can increase national savings, national investment, real economic growth, and the size of the gross domestic product (GDP) from which the pension transfers have to be made, and with a larger future national income, any given set of pension benefits is a smaller proportionate burden on the nation. Moreover, the moral, if not legal, support for pension transfers to a generation is strengthened by clear evidence of the effort it has made toward "paying" for its pension claims.

The burden of the proposed 9.9 percent contribution rate is often exaggerated. It is a rate applied to the contribution base, which is less than the total income of a large fraction of Canadians for four reasons. First, the maximum contribution base is marginally less than the average industrial wage because it excludes the bottom end of the wages and salaries received. Second, at least a quarter of employed Canadians receive wages and salaries larger than the average industrial wage. Third, *total* income exceeds average industrial salaries and wages because other sources of income (interest, dividends, property incomes, pensions, annuities, farm income, and so on) do not enter the CPP contribution base.

Fourth, individuals' contributions to the CPP are included in the calculation of their nonrefundable tax credits, reducing their personal income taxes, both federal and provincial.[14] In effect, taxpayers receive a federal credit of 17 percent, which also reduces their provincial income tax; thus, a 9.9 percent contribution at the average industrial wage would be about 7.3 percent of pre-tax wage or salary income. A self-employed person whose only income was equal to the average industrial wage would make a CPP contribution of slightly less than 9.9 percent of his before-tax employment earnings; given the tax credit, that amount would work out to between 7 and 8 percent of earnings (depending on his other tax deductions).[15]

Although the cost of the CPP is considerable, so are the benefits, particularly when the nonpension benefits are taken into account. And the myth that everybody is going to pay nearly 10 percent of their income for poor benefits is, in my opinion, just that — a myth, an exaggeration.

For CPP benefits that arise from future participation, all participants — today's near-retirees, middle-aged, and young — would pay the same contribution rate for as many years as they make future contributions. On average, this amount would total more than the cost of their CPP retirement and supplementary benefits arising from future participation. Thus, all future participants to some degree

Box 2: ***Objects and Management of the Investment Board (proposed legislation)***

OBJECTS AND POWERS

Objects

5. The objects of the Board are

(a) to manage any amounts that are transferred to it under section 111 of the Canada Pension Plan in the best interests of the contributors and beneficiaries under that Act; and (b) to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss, having regard to the factors that may affect the funding of the Canada Pension Plan and the ability of the Canada Pension Plan to meet its financial obligations....

MANAGEMENT

Board of Directors

Board of directors

7. The Board shall be managed by a board of directors of up to 12 directors, including the Chairperson.

8. (1) Subject to this Act, the board of directors shall manage or supervise the management of the business and affairs of the Board.

Specific duties

(2) Without limiting the generality of subsection (1), the board of directors shall

(a) establish written investment policies, standards and procedures in accordance with section 35 [reproduced in Box 5];

(b) establish procedures for the identification of potential conflicts of interest and procedures to resolve those conflicts;

(c) establish a code of conduct for officers and employees of the Board; and

(d) designate a committee of the board of directors to monitor application of the conflict of interest procedures and the code of conduct.

would contribute to the buildup of the plan's investment fund and the proportionate reduction of its unfunded liabilities. The equity of such participation raises important issues, which are not, however, the subject of this Commentary.

The Proposed Act

The proposed Canada Pension Plan Investment Board Act envisions a board that would manage the fund at arm's length. Several important issues deserve highlighting before I go on to discuss some in greater depth.

The Structure

The central organizing sections of the proposed act are set out in Box 2.

In Whose Interest?

The board would "manage any amounts transferred to it…in the best interests of the contributors and beneficiaries" of the CPP. Notice the italics I have added here. In lay terms, the management of the investment fund is to be for provision of pension and supplementary benefits to participants in the CPP and for no other purpose. The benefits from the fund would be shared among participants, according to the strict published rules applicable to the various parts of the program, not used for some other purposes, deemed good or bad by some other criteria.[16] The funds are not to be used as a substitute for taxation for the general revenue funds of the federal or provincial governments.

Under a narrow interpretation, the performance of the CPP investment fund would directly affect the contributors rather than the beneficiaries of the CPP. The benefit structure has been determined by the CPP Act (even if it is amended by the legislation arising from the agreement). A good investment performance would reduce the contributions necessary to pay for the predetermined benefits. Also according to the proposed amendments to the act, increases or additions of benefits would require permanent or temporary increases in contributions to pay for them. (More about this

below.) On a broader view, however, the success of the investment fund would affect the sustainability of the entire CPP program and its acceptability by Canadians.

Prudence and Performance

The powers of discretionary management of the fund would be given to the board, which would "invest its assets with a view to achieving a maximum rate of return, without undue risk of loss." This is a mandate to invest in a mixed portfolio with a moderate risk-reward profile, to seek higher rates of investment earnings than can be achieved by a portfolio of government bonds. But it is not a mandate to load up on junk bonds or penny mining stocks.

Prudence and investment management of the much enlarged fund would be interrelated. To achieve higher returns on assets than are available from long-term government bonds, the assets would have to be held in forms that involve higher risks. There is no simple maximum return on investments that prudent trustees could seek as an objective. Risk tolerance would depend on the pension deal, the time horizon of both the fund and pension program, and the diversification that becomes possible. The goal of the investment returns would be qualified by economic conditions, changing risk-reward experiences, and the availability of assets with differing risk-reward profiles.

Generally speaking, a portfolio that aims at higher investment returns is subject to more variations and risk in performance. But pension funds, because of their size, duration, and flexibility, can tolerate a significant degree of variation and risk in the interests of higher rather than lower long-run average rates of investment earnings. Although the CPP would not be subject to the Pension Benefit Act (except as specified by the regulations imposed specifically by the governor-in-council),[17] the principles of its regulations would be based on the prudent investor philosophy, which now dominates federal and provincial pension benefits acts.

The Directors

The 12 men and women who would form the board of the CPP fund (see Box 3) would clearly have huge responsibilities. Recommendations for their appointment would come from the minister of finance in a selection process explicitly based on consultation with representatives and ministers of the participating provinces and perhaps with individuals who are knowledgeable about pension programs. Thus, the responsibility of federal and provincial ministers for the appointments would be firmly established. If good directors emerged from the process, their authority would be enhanced by this "laying on of hands." (Unfortunately, so would be the authority of bad directors, although subsection 10 (6) of the proposed act provides for their removal for cause.)

Experience

The proposed act envisions directors well-qualified for the task of managing a large fund. Subsection 10 (10)'s specification of remuneration at a level similar to that "received by persons having similar responsibilities and engaged in similar activities" would provide the scope that may be required to attract good, experienced people.

In addition, the legislation sets out the intention of having enough directors "with proven financial ability or relevant work experience" for the board to "achieve its objectives." Beginners need not apply; seasoned men and women would be required.

Conflicts of Interest

Members of federal and provincial legislatures and the civil service are precluded from being directors on the proposed investment board, so the directors would be persons in the private sector, and many, perhaps even the chairperson, part-time appointees also engaged in other investment activities. Potential conflicts of interest would be inherent in their work (and

Box 3: ***Directors and Their Duty of Care (proposed legislation)***

Directors

10. (1) Each director shall be appointed by the Governor in Council, on the recommendation of the Minister, to hold office during good behaviour for such term, not exceeding three years, as will ensure, as far as possible, the expiration in any one year of the terms of office of not more than one half of the directors.

Committee to advise Minister

(2) The Minister may establish a committee to advise the Minister on the appointment of directors. The committee shall consist of a representative designated by the Minister and a representative of each participating province designated by the appropriate provincial Minister for that province.

Consultation with participating provinces

(3) The Minister shall consult with the appropriate provincial Ministers of the participating provinces before making any recommendation to the Governor in Council with respect to the appointment of directors and before making an appointment under subsection (8) [in case of a midterm vacancy].

Factors for consideration in appointments

(4) Before making any recommendation to the Governor in Council with respect to the appointment of directors, and before making an appointment under subsection (8), the Minister shall have regard to the desirability of having directors who are representative of the various regions of Canada and having on the board of directors a sufficient number of directors with proven financial ability or relevant work experience such that the Board will be able to effectively achieve its objects.

Reappointment

(5) A director is eligible for reappointment for one or more additional terms of office....

Remuneration and benefits of directors

(10) A director is entitled to receive from the Board such remuneration and benefits as may be fixed by the by-laws, which remuneration and benefits shall be fixed having regard to the remuneration and benefits received by persons having similar responsibilities and engaged in similar activities....

Duty of Care

Duty of care

14. (1) Every director and officer of the Board in exercising any of the powers or a director or an officer in discharging any of the duties of a director or an officer shall

(a) act honestly and in good faith with a view to the best interests of the Board; and

(b) exercise the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances.

Special knowledge or skill

(2) A director or officer of the Board who in fact possesses, or by reason of profession or business ought to possess, a particular level of knowledge or skill relevant to the director's or officer's powers or duties shall employ that particular level of knowledge or skill in the exercise of those powers or discharge of those duties.

could also arise for some managers of the board).

Since there is no escaping some actual conflicts of interest, they must be expected and arrangements made, in advance of the establishment of the board, to deal with them. Therefore, article 22 of the legislation sets out provisions for identifying and disclosing conflicts of interest and for voting in their presence. The details need not be reported here; it is sufficient to note the severity of the provisions. Directors operating simultaneously on the board and private affairs would have to meet the requirements of the act meticulously.

The Duty of Care

All the directors would have to exercise their sizable powers and responsibilities using the prudent person principle: "the care, diligence and skill that a reasonably prudent person would exercise in comparable circumstances." This is the fundamental fiduciary power and responsibility, based on the law and jurisprudence on fiduciaries. (Some details are examined in the next section.)

In addition, those directors and officers who had special knowledge or skill would have an extra burden of fiduciary responsibility.

This provision may be a deterrent to recruiting good directors. However, less-knowledgeable or less-skilled directors could not hide behind the specialists. Every director would have a duty of care.

Fiduciary Powers and Responsibilities

As just noted, the directors of the CPP investment board would be trustees and thus have fiduciary powers and responsibilities. The proposed act provides some specific details applying to the CPP, but the foundations lie in the general laws and jurisprudence regarding fiduciaries. Thus, it is worth reviewing some of the general literature on the subject.

David Wentzell provides useful guides. He writes:

> 1. A fiduciary relationship will exist between two parties, the fiduciary and the beneficiary, when the fiduciary has a power, the exercise of which affects the rights or interests of the beneficiary, coupled with a duty of loyalty in the exercise of the power.
>
> 2. A trustee is a fiduciary....
>
> 3. The administrator of a pension plan is a fiduciary....
>
> 4. A fiduciary is required to exercise his power with diligence, skill and care of an ordinarily prudent person in like circumstances.
>
> 5. The general standards of care in fiduciary relationships are applicable to pension fund fiduciaries.[18]

Wentzell comments further on the jurisprudence regarding fiduciaries and pensions. A fiduciary with investment powers is subject to more onerous standard of care than that of an ordinary trustee. The application of prudence for investment funds has to be exercised in the light of the circumstances, such as market conditions, the quality of the investment, the length of time the investment will be held, the nature of the trust, and the interests of the beneficiaries.

With respect to investments and the degree of prudence required to be exercised, Wentzell quotes a famous paragraph from the *Cowan* v. *Scargill* case judgment in England:

> That duty includes the duty to seek advice on matters which the trustee does not understand, such as making of investments, and on receiving that advice to act with the same degree of prudence. The requirement is not discharged merely by showing that the trustee has acted in good faith and with sincerity. Some of the most sincere people are the most unreasonable....Accordingly, a trustee who takes advice on investments is not bound to accept and act on that advice, he is not entitled to reject it merely because he sincerely disagrees with it, unless in addition to being sincere he is acting as an ordinary prudent man would act.[19]

Noting that "[t]he principles of the *Cowan* case are applicable in Canada," Wentzell, who was writing in 1987, concludes:

> The first Canadian pension fund cases concerned with the fiduciary obligations implicit in the pension deal are now coming before the courts. It is not surprising that the established laws of trust are applied to these fact situations....Pension fund administrators, investment advisors, and others in a fiduciary role must recognize that their position carries the heavy burden of loyalty and the high standard of care of the fiduciary.[20]

Governance, Structures, Process, and Accountability

The prospective structure and operations of the CPP investment board reflect the recent pension fund literature from Canada, particularly work by Ambachtsheer and Ilkiw.

In a 1996 report prepared for the federal-provincial Working Group on CPP Investment Policy, Ambachtsheer presents two possible choices for the governance regime of the board. The first is a legislated governance model (LGM) under which federal and provincial ministers would be responsible for the fund's performance, its asset-mix policy and implementation would be encoded in the CPP Act, and a government unit would administer policy. Alternatively,

> [U]nder the Independent Governance Model (IGM), the Fed-Prov Ministers would create the CPP Investment Board Act. This Act would set out the investment goals of the CPP Fund. It would also set out the responsibilities, authorities, and accountabilities of the CPP Board of Trustees, as well as its required composite characteristics in terms of skills, experience and representativeness. The Act would also set out the necessary appointment processes. The Board of Trustees are accountable to CPP stakeholders. The Board of Trustees selects and monitors a management team to operate the Investment Board as an independent institution.[21]

Ambachtsheer strongly prefers the second model, which the proposed act has accepted.

> The potential rewards from choosing the…(IGM) option are considerable. They include higher perceived legitimacy by CPP stakeholders, greater opportunities to build organizational excellence, enhanced informational and operational efficiency of Canada's stock and bond markets, enhanced long term return potential, and greater flexibility to respond to new economic and capital market circumstances.[22]

Ilkiw summarizes current wisdom on the desirable hierarchy of the fiduciaries of a pension plan.

> While all fiduciaries must act prudently, they don't have the same expertise or level of responsibility. *Governing fiduciaries* — members of corporate boards and boards of trustees — are ultimately responsible for ensuring pension assets are prudently invested. Governing fiduciaries usually employ *Managing Fiduciaries* — often in the form of an investment committee — to provide advice and oversee policy implementation. Meanwhile managing fiduciaries employ a number of *Operating Fiduciaries* with specialized knowledge and skills to implement and manage investment policies on a day to day basis.…*Non-fiduciary agents* like actuaries, lawyers and investment consultants advise fiduciaries on investment related issues.[23]

Ilkiw continues his point in a consideration of process, which is what is envisioned for the proposed CPP investment board.

> Governing fiduciaries are most likely to satisfy their duties if they learn to delegate.…The…[desirable] structure is characterized by the prudent and profitable downward delegation of decision-making, and the informative and timely upward reporting of compliance and performance.[24]

In another paper, Ambachtsheer provides decision assessment procedures for a pension fund's investment policies. The fundamental starting point should be an explicit, quantifiable statement of those policies.

The appropriateness of all policy decisions and their mode of implementation, Ambachtsheer says, must be reviewed regularly (probably at least annually). "An ongoing monitoring process as to pension fund management effectiveness is an essential component of exercising prudence." The process should include rigorous comparison of policies and performance of each of the main portions of the fund against predetermined capital market benchmarks, as much as possible on a quantitative basis. Finally,

> [A] qualitative assessment…[must be made] as to whether the original assumptions that led to the chosen asset mix policy and investment management structure continue to be valid. It follows that if this assessment leads to a "no" conclusion, the policy fiduciaries [the governing fiduciaries, in Ilkiw's terminology]…have a responsibility to take action to remedy the situation.[25]

Fiduciary accountability also involves, as Wentzell notes, the method of reporting to the beneficiary and the mechanisms to hold the fiduciary accountable for his actions.[26]

All these considerations show up in various sections of the proposed act — particularly in the choice of the independent governance model and in the reporting provisions.

Although section 34 (see Box 4) is probably not modeled directly on Ilkiw, the authority and structure of the board it proposes would be comparable with his proposals for better pension fund management.

The proposed reporting provisions — for the board's investment committee, for the in-

Box 4: *Reporting Requirements for the Investment Board (proposed legislation)*

Investment Committee

Duties of investment committee

34. The investment committee shall…

(b) approve the engagement of independent managers empowered with discretionary authority to invest the assets of the Board;…and

(d) require management to implement and maintain appropriate procedures to

(i) monitor the application of the Board's investment policies, standards and procedures, and

(ii) ensure that the Board's agents comply with this Act and the Board's investment policies, standards and procedures; and

(e) review, evaluate and approve management's procedures referred to in paragraph (d)….

Annual Report [of the Board]

Annual report required

51. (1) The Board shall…within 90 days, after the end of each financial year provide the Minister and the appropriate provincial Ministers with an annual report on the operations of the Board in that year and the Board shall make copies of the report available to the public….

(3) The annual report shall contain…

(c) a certificate, signed by a director on behalf of the board of directors, stating that the investments of the Board during that year were in accordance with this Act and the Board's investment policies, standards and procedures;

(d) a statement of the Board's objectives for that year and a statement on the extent to which the Board met those objectives;

(e) a statement of the Board's objectives for the next year and for the foreseeable future;

(f) a statement of the Board's investment policies, standards and procedures.

vestment board itself, for actuarial evaluation, and for the CPP overall — are multilayered and interdependent.[27]

They are also strict. For example, the proposed act's requirements for the board's annual report include, in addition to the usual provisions, some unusual clauses (see article 51 in Box 4).

Powers, Regulations, and Policies Regarding Investments

The federal-provincial agreement and the proposed act would give the proposed CPP investment board power and prudent discretion on the one hand but potential constraints on the other. Both provide for potentially powerful regulations for the exercise of governmental power over the board.[28] Whether it is intended that these governmental powers be exercised vigorously or gently, comprehensively or selectively, cannot be yet determined. What is certain is that given the statement of intentions in the agreement and the potential power of regulations, the relevant governments together, could be very heavy handed in controlling the activities of the Board.

Considering the evidence now available, the intention appears otherwise; the independent governance model appears to dominate the proposals. It is important, however, that the general intentions and the main details of the regulations be made known at the same time as the legislation is being considered. The CPP investment board would not be able to get off on the right foot and pursue a sustained program of pension fund excellence if it were subject to uncertain and perhaps intolerable regulations.

Investment Policies

What would the proposed board's investment policies be? Not much information is available at the time of writing (August 1997). The relevant portions of the proposed act are sec-

Box 5: *Investment Policies and Regulations (proposed legislation)*

Investments

Investment policies, standards and procedures

35. Subject to the regulations, the board of directors shall establish, and the Board and its subsidiaries shall adhere to, investment policies, standards and procedures that a person of ordinary prudence would exercise in dealing with the property of others....

REGULATIONS

Regulations

53. (1) The Governor in Council may make regulations

(a) specifying which provisions of the Pension Benefits Standards Act, 1985 and any regulations made under that Act apply to the Board and its subsidiaries and adapting those provisions in the manner that the Governor in Council considers appropriate for the purpose of applying them to the Board and its subsidiaries;

(b) respecting the investments the Board and its subsidiaries may make; and

(c) prescribing anything that this Act provides is to be prescribed or is to be determined by regulation.

Application

(2) A regulation made under subsection (1) has no force or effect until the appropriate provincial Minister of each of at least two thirds of the participating provinces having in total not less than two thirds of the population of all of the participating provinces has approved the regulation.

tions 35 and 53 (see Box 5). But article 35 is now a simple statement of the prudent person principles to govern the board.[29] The federal-provincial agreement does state the intention that the CPP investment board be subject to "broadly the same investment rules" as other pension funds in Canada (see Box 1). Since both federal and provincial pension benefits acts are based on the prudent person principle, paragraph 53 (1) (a) appears to be a convenient way of implementing the commitment to "the same investment rules."

Foreign Holdings

The federal-provincial agreement also specifies that "the foreign property limit for pension funds will strictly apply." Under this rule, the proportion of foreign assets in a pension fund portfolio is limited to 20 percent, but some pension funds have apparently found legal means to overcome this barrier to some extent. Thus, the word "*strictly*" is a weighty commitment.

A strong case can be made for easing the rule, in the interests of pensioners.[30] In my opinion, the limit is too confining. It unduly restricts the opportunities for achieving higher income for Canadians. It circumscribes the possibilities of portfolio diversification, which are fundamental to good management of risk. And for the prospective board, it would reduce the discretion to manage the investment fund in the interests of the CPP participants. Indeed it is paradoxical that the investment board is expected to achieve high earnings without undue risk while the foreign property rule would make the attainment of these goals more difficult.

Domestic Investment

The federal-provincial agreement also declares the intention that the board's initial policy be to choose "domestic equity investments "passively, mirroring broad market indexes." Although this approach is to be re-evaluated at the next CPP review (before the beginning of 2001), the authority for the initial three-year policy would presumably have to be dealt with under the regulations. Difficult issues would be involved.

"Passively" seems to mean that the board should not attempt to select individual equities for its portfolio, or to take an active position as a shareholder in the affairs of corporations whose equities it acquires." (Because the prospective regulations on the board are not public at this time, it is not clear

whether it is to be prevented from exercising any of its shareholder rights.)

"Mirroring broad market indexes" needs clarification. Which indexes are to be mirrored? Would the CPP equity fund attempt, as near as possible, to acquire and maintain specific equities included in the index and in proportion in which they are included indices, or would some discretion be expected? Would prudent financial management delegate portfolio targets to the managers of stock market indexes? Doing so would make no sense because designers of market indexes have objectives that differ from those of the managers of pension funds. Could more appropriate indexes be designed and implemented for pension fund management? Or is mirroring to be only a rough guideline, to be used subject to fiduciary responsibility and discretion of the CPP investment board management?

Even as a general investment policy, the use of indexes is controversial. According to the empirical record in the United States, active fund managers have not outperformed indexes by enough to cover the costs of the information search and analysis that should have produced value beyond the indexes.[31] In the extreme, if most investment funds followed an indexing policy, little information search and analysis would take place, and the performance of the indexes themselves would deteriorate. Such an outcome seems unlikely at this time, however. The mythology of the financial investment business is sufficiently biased toward beating the market that intensive information search and analysis is likely to persist into the future.

Provincial Bonds

Both the federal-province agreement and the proposed act provide for the transitional and long-term treatment of provincial bonds in the new CPP investment policy. Some firm but gradual transitional provisions are essential to making the change acceptable to the participating provinces. (The relevant statements in the federal-provincial agreement are in Box 1. The relevant part of the proposed act is section 90, which deals primarily with the proposed board's purchase of new provincial bonds; a small but important portion of the legislation is reproduced in Box 6.)

Most of the assets of the existing CPP fund are provincial bonds issued in the past. Although the bonds had 20-year maturities when issued, and carry interest rates fixed at that time (based on the federal government's contemporary long term borrowing rates), the existing portfolio consists of bonds with a variety of maturities and interest rates. Some carry much higher interest rates than are now current and some lower rates. (These conditions were of some advantage to some of the provinces at the time of issue since the rates the CPP would give them were somewhat less than they had to pay the market.) Since 1992, all the maturing provincial bonds have been redeemed by the CPP.

After some transitional arrangements are complete, new issues of provincial bonds to the CPP investment board would pay market rates, and provincial governments would not have any privileged access to selling to the CPP investment fund.

The transition arrangements are important, and their effect on the potential performance of the investment board should be explained. Given the option for provinces to roll over existing CPP borrowing at maturity for another 20-year term, the question is whether that choice would be attractive to the provinces. Presumably the rollover interest rate would be at market level, which would differ among provinces depending on their credit ratings (in other words, they would no longer receive the benefit of relatively low federal rates).

The new arrangements would gradually eliminate any portfolio gains or losses for the CPP from the difference between past and current interest rates on provincial bonds. The fund might thus be slightly better off than under prior arrangements in that the average interest rates on its provincial bond portfolio would track public bond rates, which are higher than federal rates.

Box 6: *Replacement Security and the Interest Rate for New Provincial Bonds (proposed legislation)*

(4) Subsections 110 (3) to (6) of the [Canada Pension Plan] Act are replaced by the following:

Replacement security

(3) On the maturity of a security of a province held to the credit of the Canada Pension Plan Investment Fund that was issued before January 1, 1998, the Minister of Finance shall purchase another security issued by that province if

(a) the Minister of Finance is requested to do so, in writing, by the appropriate provincial Minister of that province at least 30 days before the date of maturity; and

(b) the operating balance in the Canada Pension Plan Account exceeds the amount that the Minister of Finance estimates will be required to meet all payments under subsection 108(3) in the month in which the security comes to maturity and in the two months immediately following that month....

Term to maturity

(5) The replacement security shall be for a term of 20 years.

Interest

(6) the replacement security [of a province] shall bear interest at a rate fixed by the Minister of Finance. In fixing that rate, the Minister of Finance shall choose a rate that is substantially the same as the interest rate that the province would be required to pay if it were to borrow the same amount for the same term through the issuance of a security on the public capital market.

As for the agreement's intention of allowing the provinces, for the first three years, "to have access to 50 per cent of new CPP funds that the Board chooses to invest in bonds,[32] the effects are uncertain. Given that the new portfolio would begin with a large bond component, the board might want to use its new money mainly for investment in equities, rather than provincial bonds. If it choose to add bonds, it would have to offer to purchase provincial bonds up to half of the total increment prorated among the provinces (as under existing policy and the CPP Act, sections 110 and 111). But the provinces that have strong bond ratings might not want to take up the option because they could do no worse by market issues, which would give them more flexibility of debt management than they would have with replacement securities. Thus, the effect this option could have on the board's investment performance should be estimated.

The long-term limit on the fund's investment in provincial securities would be a boundary condition only (the fund could not be forced to hold provincial securities beyond the limit). But no provision proposed at present would forbid the fund from holding a proportion of provincial bonds in its portfolio that was smaller than that of pension funds in general.

In any case, the key issue is not the holding of bonds themselves but whether the CPP investment board could use derivatives and/or enter into swap agreements. Consider, for example, that the Ontario Teachers Plan, which is required to hold $20 billion of nonmarketable Ontario debentures, long ago swapped a significant portion of those debentures for equity returns and by so doing was able to quickly move the fund to a more appropriate asset mix and improved investment returns.[33]

Real Rate of Return

The federal-provincial agreement states that "investing the fund in the market could generate a return of 3.8 percent above the rate of inflation." Is this assumption reasonable?

Before dealing with the substance of this claim, I should clarify a few technical points. First, the return would be a compound, not a simple, average, and it would probably vary around that average, being sometimes below and sometimes above, perhaps for several years in a row. Second, the presumption is that inflation would be measured by the com-

pound average trend of increase in the consumer price index (CPI) as calculated by Statistics Canada. If the average compound ratio of increase in the CPI was 2.0 percent per annum, then the average assumed nominal target investment return would be approximately 5.9 percent per annum (1.038   1.02 – 1.000 ≅ 0.059). Since year-to-year variations in the real rate of return and the CPI rarely occur in perfect symmetry, the year-to-year variations in the nominal rate of return would differ from those in the real rate of return on the investment portfolio.

The Evidence

What is the evidence in support of the earnings assumptions? Before answering the question, I have to make some assumptions about what the investment policy would be. (The issues of active or passive portfolio policies, the details of diversification, and index policies are important, but they can be put aside for the moment.)

My first assumption is that the board would choose a balanced 50:50 portfolio mix of equities and fixed-income securities. (It might do otherwise, but such an assumption is both reasonable and simple for evaluating the earnings expectations on the investment portfolio; it permits illustration of the main issues.[34] It also appears reasonable to assume that the board would operate on a moderate risk-reward profile,[35] which suggests that the equity portfolio would be weighted toward (though not exclusively in) blue-chip stocks. Fixed-income securities would not be limited to least-risk categories, but the fund would not be loaded up with junk bonds. The current foreign property rule means that at least 80 percent of the portfolio would be in Canadian securities. Given the depth of the markets and the desirability of the best-possible diversification, it might be preferable to fill the foreign-content portion of the portfolio with equities rather than bonds. And since the fund could be oriented toward long-term investments, the long-term record of returns should provide the markers.

Ambachtsheer's Conclusions

Ambachtsheer indicates that, under current and immediately foreseeable conditions, a good portfolio of risk-free federal government bonds could readily achieve a real rate of return of 4 percent per annum. He does not favor a CPP investment board's seeking additional premiums by "active management" of a bond portfolio (that is, by trading bonds on speculation of the movements in bond prices and yields), but he does recommend a policy to seek additional returns by taking on nondiversifiable risk.

> Such additional compensation shows up as a "default premium" in marketable debt securities such as corporate and provincial bonds. It shows up as an "equity risk premium" in publicly traded common stocks. There is typically a further "illiquidity premium" built into the returns on investments for which there is no ready market. Real estate and venture capital investments are examples. Compensation for taking on the types of risks described above can range from as low as 0.25 % to 5% and higher.
>
> A typical Canadian pension fund asset mix today is 50% stocks, 45% bonds and 5% in direct investments such as real estate and venture capital. Such a mix should earn a minimum long term risk premium of 1 % over the "risk free" asset pool described above.[36]

Thus, his bottom line is that, under current and immediately prospective circumstances, a pension fund such as the CPP fund should be able to attain, without undue risk, a real rate of return of 5.0 percent per annum or more — considerably higher than the 3.8 percent assumed in the February 1997 federal-provincial agreement.

Other Evidence

Several other pieces of evidence suggest that a real rate of return of 3.8 percent (or a nominal rate of return of 5.9 percent) is a rather conservative extrapolation for the CPP investment board's portfolio for the immediate future.

Table 1: *Average Real Rates of Return, Annual Compound Percentage Change*

	Increase in CPI	Nominal Change[a]			Real Change[a,b]		
		Common Stock Index	Canada Long Bonds	US Common Stocks in C$	Common Stock Index	Canada Long Bonds	US Common Stocks in C$
				(percent)			
5-year periods							
1982–86	5.20	13.72	21.57	23.45	8.10	15.56	17.25
1987–91	4.40	6.38	10.65	10.98	1.89	5.99	6.30
1992–96	1.59	13.90	12.42	19.28	12.11	10.66	17.41
10-year periods							
1977–86	7.66	16.53	10.63	17.19	8.24	2.76	8.85
1987–96	2.99	10.08	11.53	15.06	6.88	8.30	11.72
15-year periods							
1967–1981	7.43	10.57	3.42	7.68	2.93	−3.73	0.23
1982–96	3.72	11.28	14.78	17.79	7.29	10.67	13.56

[a] Changes are compound annual averages.

[b] Real values are net of CPI increases.

Source: Canadian Institute of Actuaries, *Economic Statistics: Report on Canadian Economic Statistics, 1924–1996* (Ottawa, 1997), tables 2A, 2B.

- The Canadian Institute of Actuaries' report,[37] one of the most widely used and respected records of Canadian investment earnings, reports real rates of return on indexes of various assets and median returns of pension fund assets over long periods of years (see Tables 1 and 2). The data provide somewhat mixed evidence. In most subperiods since 1967, the indexes of the most common kinds of assets had real returns well over the 3.8 percent target for the CPP fund. It is important to realize, however, that real rates of return were exceptionally high by historical standards during the 1992–96 period.

  Pension funds moved more erratically. During the late 1960s and 1970s, periods of high, increasing, and unstable inflation in Canada, their performance was below that target, but during the most recent 10- or 15-year periods, they have gone well above it. Averaging the good and bad, as in the 25-year average real return, the median return is almost up to the 3.8 percent target.
- The Bank of Canada publishes sets of relevant financial statistics. Its series on long-term government of Canada and provincial bonds (see Figure 4) reflects the very high nominal yields of the early 1980s, when inflation rates were high, and the low nominal yields since 1993, when inflation has been low. Although real rates of return have varied since 1980, they have been consistently positive on government long bonds and exceptionally high by historical standards since 1991. (The figure also shows the persistence of an average differential between government of Canada and provincial long bonds.)
- The most recent version of Statistics Canada's overview of retirement income programs provides summary information on the investment portfolios of registered pension plans (RPPs).[38] Since the mid-1980s, the mix of portfolios has shifted substan-

Table 2: *Pension Plan Asset Median Returns*
(geometric annual averages)

	Increase in CPI	Nominal Returns	Real Returns
10-year periods			
1967–76	6.08	7.70	1.01
1977–86	7.66	11.52	3.59
1987–96	2.99	9.17	6.00
15-year periods			
1967–81	7.43	8.86	1.33
1982–96	3.72	10.07	6.12
25-year period			
1972–96	5.90	9.70	3.59

Source: Canadian Institute of Actuaries, *Economic Statistics: Report on Canadian Economic Statistics, 1924–1996* (Ottawa, 1997), tables 4, 8.

tially toward equities, though the largest part was still in bonds in 1994, the latest year reported. Since 1991, when the limit on foreign holdings of assets by pension funds was eased to the present 20 percent, there has also been a switch in the mix toward foreign assets (both equities and bonds); by 1994, the proportion had reached 13 percent. Although this publication does not provide information on the rates of investment earnings of RPP funds, it does strongly point to the balanced fund mixture of the portfolios.

- The Statistics Canada overview also provides summary data for the CPP for fiscal years 1983/84 through 1993/94. During this period, the CPP fund average high nominal rates of investment income — 9.75 percent for the 11-year period (actually, a little higher in the later than in the early years). This average reflects the unusually high nominal rates of interest on federal government and provincial bonds through much of the period, a fact also reflected in the Chief Actuary's report and the Bank of Canada data already reported. Because of the long maturity of many of the existing bonds in the fund, the average rate of interest earned by the CPP fund will continue to be high for several more years, even though the rates on new loans are lower now than even in the early 1990s. The average real rate of interest on the fund during the 11-year period was about 5.9 percent compounded.

Conclusion

All of this evidence suggests that the real rate of return on pension funds will probably decline during the next decade but from exceptionally high levels. Thus, the 3.8 percent real rate of return target for the CPP investment fund appears cautious and conservative and could be easily attained, particularly in the short run. Considerable year-to-year variations around the average are, however, the record of pension funds in Canada.

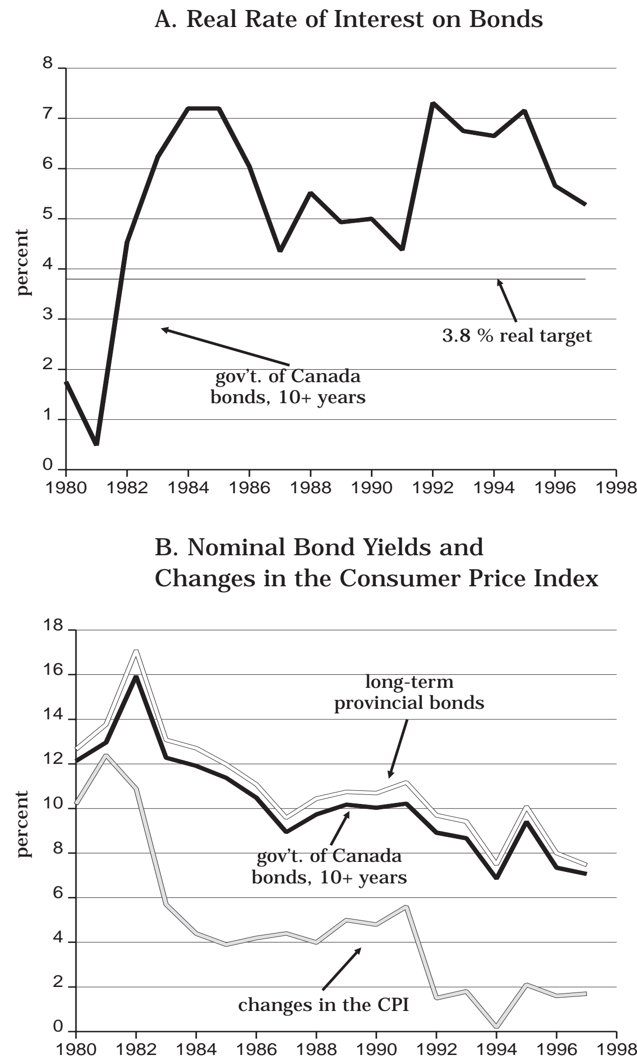
How Large an Investment Fund?

How large would the proposed CPP investment fund be? How quickly would it grow? Would a fund of that size warp markets? Under the proposals, the CPP investment fund would increase substantially during the next decade or so and continue to grow in the long run. By how much and how soon depends on several factors that an analyst can only assume at this time.

One can, however, make some educated guesses about the general shape of the projections for the size and timing of fund growth, as I sketched in Figure 3, modifying the projections in the 1995/96 CPP report to take account of the probable effects of changes in the contribution base, the contribution rates, the benefit programs, and the expected rates of investment return.

Because the new CPP fund would start from a declining trend and because the increases in contributions and reductions in expenditures would be implemented gradually, it would increase rather slowly during the first

Figure 4: ***Real and Nominal Bond Yields and Changes in the Consumer Price Index***



Note: Nominal bond yields are as of January of each year. The CPI curve reflects year-to-year changes.

Sources: Bond yields: *Bank of Canada Review*, various issues; CPI: Canada, Department of Finance, economic reference tables.

few years. Then the pace of increase would accelerate rapidly during the first decade or so of the twenty- first century. Afterward it would continue to grow at a more moderate pace, reflecting the new steady-state limit on contribution rates combined with the accelerated growth rate of expenditures and the deceleration of the growth rate of contributions due to changes in the structure of the population. Under my projection, the five-times-expenditures target would be reached about fiscal year 2009/10 and slightly exceeded for a few years thereafter; in absolute amounts, the fund would grow from about $40 billion in 1995/96 to about $196 billion in 2009/10, an increase of some $156 billion.

Under assumptions other than mine, the fund might grow somewhat less and somewhat more slowly (as, for example, in the Chief Actuary's projections). It might even fall short of the five-times-expenditures target. The pattern of slow, then more rapid, then less rapid growth would, however, still emerge; the increment of the fund in a decade would still be of the order of $100 billion; and the same qualitative policy issues would arise as in my projection.

Would a fund of such a size become too large and powerful a force in the Canadian economy or in equity markets? Could the capital markets absorb the increases on reasonable terms? Might the CPP demands for equities drive up their prices and reduce the rate of return for itself and for other investors? Might the balance of savings and investment flows in Canada be adversely affected by increased public saving?[39] The available evidence suggests that most of these worries should not be of major consequence.

Assume, for example, that the CPP fund attains the target of five times annual expenditures (as I have projected them) at the end of fiscal year 2004/05 with a total of $145 billion. Further assume that half the fund is held in equities and half in bonds. Table 3 sets out one case in which the 20 percent foreign content is divided equally between equities and bonds and another in which the same amount is employed entirely in foreign equities.

The additional sums in bonds would be trivial in relation to the size of the markets. Even if Canadian governments are able to stop absolutely the growth of their debts, the com-

bined federal and provincial debts, mainly financed by bonds, would still be more than $700 billion. If foreign bonds were acquired (case 1), the increments in holdings would be so small in relationship to international bonds outstanding as to be virtually invisible in market influence.

The increase in domestic equity holdings would be more important but probably a small issue nevertheless. A $72 billion equity fund seven or eight years from now would be only a modest fraction of even today's capitalization of the stocks listed on the Toronto Stock Exchange. That capitalization is bound to increase, even if new use of equity finance is not encouraged by additional CPP investment. (Innovations to use equity financing more are likely to be encouraged by improved capital availability.) Moreover, any increase in the fund's equity portfolio would be gradual, taking place over a decade at least.

If the foreign content of the portfolio were held entirely in foreign equities, the absorption of equities in Canadian markets would, of course, be less and in foreign markets more. Even so, the foreign equity holdings would be only a drop in the bucket of foreign equities available.[40]

Table 3: *Hypothetical Growth of the CPP Investment Fund*

End of Fiscal Year	Bonds	Equities	Total
		($ billions)	
Case 1: Foreign Content Divided Equally between Equities and Bonds			
1993/94	41	0	41
2004/05	72.5	72.5	145
Domestic	58	58	116
Foreign	14.5	14.5	29
Net additions in 11 years			
Domestic	17	58	
Foreign	14.5	14.5	
Case 2: All Foreign Content in Equities			
1993/94	41	0	41
2004/05	72.5	72.5	145
Domestic	72.5	43.5	116
Foreign	0	29	29
Net additions in 11 years			
Domestic	31.5	43.5	
Foreign	0	29	

Independent Amendments to the CPP Act

The legislation also proposes significant changes to the CPP Act with respect to the actuarial examination and the CPP annual report, changes that would be interdependent with the reporting requirements for the CPP investment board and thus form a complete package. It would be a strict and comprehensive system.

The new provisions for actuarial examination of the CPP (see Box 7) would integrate the performance and projections of the investment fund into the actuarial examination, reflecting the presence of the new board. The provisions for specifying a self-employment contribution rate for setting out the manner of calculation would be important additions to the requirements. They should help to demystify the actuarial evaluation of the CPP in the future.

The proposed amendment with respect to the financial review of the CPP (see Box 8) would impose more frequent reviews and tougher standards than the existing requires.

The new requirements for the ministerial review would be severe by the standards of pension plan finance (and of government finance more generally). This strictness is significant. Although the required actuarial examination is an important matter, it is nevertheless advisory; the ministers carry the responsibility. Admittedly, projections are forecasts subject to error and revision, but the reporting requirements about the numbers and their basis are tough and open. The required review would have to be held every three years (the current requirement is every five years). Although the targets are not specified for the contribution rate and the asset-to-expenditure ratio, the principles of the dual

Box 7: *The Actuarial Examination of the CPP (proposed legislation)*

96. (1) Subsection 115 (1) of the [*Canada Pension Plan*] Act is replaced by the following:

Chief Actuary to report every three years

115 (1) The Chief Actuary of the Office of the Superintendent of Financial Institutions shall, during the first year of each three year period for which a review is required by subsection 113.1 (1) [every three years after 1997], prepare a report setting out, as at a date not earlier than December 31 of the year before the three year period, the results of an actuarial examination of the operation of this Act based on the state of the Canada Pension Plan Account and the investments of the Investment Board.

Contents of report

(1.1) The Chief Actuary shall, in the report,

(a) state the estimated revenues of the Canada Pension Plan Account and the estimated investment income of the Investment Board for each of the 30 years immediately following the date of the examination, and the estimated amount of all payments under subsection 108 (3) in each of those 30 years;

(b) state, for each fifth year of a period of not less than 75 years from the date of the examination, an estimate of the percentage of total contributory salaries and wages and contributory self-employed earnings that would be required to provide for all payments under subsection 108 (3) [some administrative costs] in that year if there were no balance in the Canada Pension Plan Account at the commencement of that year and the Investment Board had no investments;

(c) specify a contribution rate, calculated in the prescribed manner, in respect of self-employed persons for years after the 3 year period in which the report is prepared; and

(d) set out the manner in which that contribution rate was calculated.

Note: The underlines, which are in the text of the July 1997 draft legislation, mark words and phrases changed from the existing act. Entirely new paragraphs and clauses are not flagged in any way.

targets are stated. What is not clear is which one would be primary. The answer appears to be the contribution rate, not than the asset to expenditure ratio, but the matter is not obvious. Whether the two targets would be compatible in the future is also uncertain because the forces determining the two are different.

The requirement that the ministers report on the financing requirements of increased or additional CPP benefits would be unusually severe, but welcome in my opinion. The history of public pension plans in many countries, including Canada, reveals increases in or additions to benefits with no or inadequate provision to meet their costs. Especially noteworthy is the history of ignoring the unfunded liabilities that arise in that manner. The unfunded liabilities of the CPP from past management have been one of the greatest sources of difficulty with the plan. One intention of the new federal-provincial agreement is to improve and stabilize the funding ratio; consistent with this objective is the imposition of strict additional financing requirements on future increases or additions to benefits.

Of course, Canadian governments could ignore or water down the financial requirements in increasing or adding benefits, but such actions would be clearly exposed if the proposed amendments are made. Professionals in the actuarial, retirement benefits and social policy fields would have information to fulfill their watchdog functions, and the media could have a field day.

Protecting the Pensioners' Interest

The federal-provincial agreement and section 5 of the legislation state that the sole objective of the CPP investment board would be to pursue "the best interests" of CPP contributors and beneficiaries (see Boxes 1 and 2). The foreign asset constraint is the only indication of other considerations for investment policy

Box 8: ***The Triennial Financial Review of the CPP***

94. (1) Subsection 113.1 (1) of the [*Canada Pension Plan*] Act is replaced by the following:

Review every three years

Once every three years after 1997, the Minister of Finance and ministers of the Crown from the included provinces shall review the financial state of the Canada Pension Plan and may make recommendations as to whether benefits or contribution rates or both should be changed....

(4) Subparagraph 113.1 (4) (*b*) (iii) of the Act is replaced by the following:

[The ministers shall consider:]

(iii) the ratio of the projected assets of the Canada pension Plan over the projected expenditures of the Canada Pension Plan,...

(5) Subsection 113.1 (4) of the Act is amended... by replacing paragraph (c) with the following:

[The ministers shall also consider:]

(c) the financing objectives of having a contribution rate that is no lower than the rate

(i) that, beginning with the year 2003, is the lowest constant rate that can be maintained over the foreseeable future, and

(ii) that results in the ratio of the projected assets of the Canada Pension Plan at the end of any given year over the projected annual expenditures of the Canada Pension Plan in the following year being generally constant; and

(d) that changes to the Act that increase benefits or add new benefits must be accompanied by a permanent increase in the contribution rates to cover the increased costs of the increased or new benefits and by a temporary increase in the contribution rates for a number of years that is consistent with common actuarial practice to fully pay any unfunded liability resulting from the increased or new benefits.

Note: The underlines, which are in the July 1997 draft legislation, mark words and phrases changed from the existing act. Entirely new paragraphs and clauses are not flagged in any way.

(though the governments reserve the powers to impose regulations).

Nevertheless, on the basis of experience with public pension programs in many industrial countries, including Canada, experts express several worries about situations that could present problems for the proposed CPP investment fund. They can be roughly grouped in three categories: the addition of secondary objectives; failures in the government treatment or presentation of the fund; and provincial bickering over its use.

Secondary Goals

Giving pension funds secondary goals for social, political, and moral purposes is a common phenomenon. For example, the QPP has a secondary goal of promoting economic development goals in Quebec, in addition to its primary objective of the interests of pensioners. In the United States it has been argued that pension funds should pursue secondary goals of economically targeted investments for community and developmental purposes, as well as the interests of pensioners. Proscriptions against investment in so-called sin industries or in undesirable corporate citizens have been widely mooted.[41]

I believe, however, it is neither necessary nor desirable to impose social investment objectives on CPP fund, however meritorious those ends might be. Although I share many social concerns, they can be adequately pursued directly by means other than rules about asset-holdings, which can create undesirable confusion. The proposed CPP investment board would have enough difficulty meeting its responsibilities to contributors and beneficiaries. To add other social objectives to the mandate would make it extremely onerous for prudent management to pursue, monitor, and enforce accountability and to adjust the pension policy as circumstances and opportunities emerge in the future.

Moreover, as Ambachtsheer says,

> Simply by supplying retirement savings to issuers of stocks and bonds, pension funds contribute to economic development and job creation. If pension funds should somehow be doing more than this, what is the 'more'? Secondary investment goal advocates usually respond with examples such as putting more money into the housing market, or building more infrastructure, or investing in venture capital in geographically specified areas.[42]

Ambachtsheer raises further questions.

> Why is there a perceived shortage of funds in certain sectors and areas? Is a given sector and/or area currently simply unattractive from an investment perspective? Or is there a systematic market failure problem? One wonders if there is any real merit in trying to resolve these difficult questions in the process of creating a CPP Investment Fund.

None of the above denies that the creation of a large new investment institution in Canada could not end up positively impacting such sectors as housing, infrastructure and venture capital; it likely would. However this would naturally come about by a CPP Investment Fund serving the financial needs of CPP participants, and not because it was assigned potentially conflicting investment objectives.[43] Nevertheless, the developers of the CPP investment fund should make explicit mention of the issue of secondary investment goals in the act, the regulations, or the by-laws on investment policy. If nothing was said, the CPP investment board would be endlessly harassed by debates about social investment and moral issues. By saying something that makes these other considerations clearly subservient to the interests of the CPP participants, policymakers could leave the board better able to defend itself.

Government Failure

The worry over the treatment of public pension funds in government finances and taxation are threefold. The first is the potential for manipulation of funds by governments to improve their image or to disguise the real state of their finances. The ambiguous treatment of Social Security funds in assessing the deficits of the US government is a notable example of this phenomenon.

Second, the contributions to public pension plans may be — or be seen to be — a tax grab by governments rather than participation in a social saving and insurance program.[44] The world record of governmental meddling and abuse of public sector pension funds sounds a note of alarm. Vigilance in the pursuit of the public interest in the CPP investment fund will ever be needed.

Third, quite apart from deliberate manipulation is the real possibility of misunderstanding, even misinformation, about pension funds and government debts.

The proposed legislation suggests provides protection against some such worries. The objects of the board (section 5) give paramoun-

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tcy to the interests of CPP participants. The powers and responsibilities of the directors (sections 8 and 14) give force to the prudent management laws and judicial precedents. The guides to regulations (section 53) are those applying to other pension programs, especially public sector employee programs, which are firmly established as in the interests of the contributors and beneficiaries, and federal-provincial agreement is required. The federal-provincial agreement accepts the intention of a moderate risk-reward profile for the investment portfolio and specifically recognizes diversification as a sound principle of management. Public accountability and disclosure are featured throughout the legislation, including in the proposed amendments to the CPP Act.

The Canadian record of fiduciary responsible governmental management of mixed portfolio market funds has been generally good over the long term. Consider, for example, the records of the Caisse de dépôt et placement du Québec, the public servants' and teachers' pension funds in Ontario, Nova Scotia, Alberta, and British Columbia, the Ontario Municipal Employees Retirement System, the pension funds of health care workers in Nova Scotia and Ontario; and several university funds.

None of these has, however, been without some blemish and occasional worry: examples include the reported mobilization of Caisse resources as a support for a postreferendum defense of Quebec government finances; and the participation of some public sector funds in the recent Canadian boom and bust in commercial real estate. Even more worrying has been the dissipation of the Alberta Heritage Fund in various ventures of good works for Albertans. Also, the records of both the federal and provincial governments show much procrastination in fixing ailing public sector pension programs. Nevertheless, the overall, sustained record has been encouraging.

Besides quite good past performances, other factors add confidence about the future management of public sector pension programs in Canada. Both federal and provincial pension benefits acts have been strengthened during the past decade and a half, embodying the prudent person principles for fiduciaries. The theory and design of excellent pension fund management have developed impressively in Canada as elsewhere. The information base for research and analysis has been greatly improved, as have computer-based tools for management and evaluation of pension funds. With an aging population, the public interest in pensions has intensified.

Provincial Competition

Considering the Canadian record of federal-provincial finance, a particular worry for the CPP investment board might be arguments about fair sharing among the provinces. Complaints could arise about the fund's investing in enterprises that are mainly located in some provinces, about its acquiring property in some provinces but not others, about its purchasing the bonds of some provinces, municipalities, and public utilities but not others. And some provinces might try to promote their interests by attempting to influence the board's investment policies and regulations.

Except for reasonable transitional arrangements dealing with provincial bonds in the CPP fund, the legislation appears to give paramountcy to the interests of CPP participants without imposing or providing for provincial interference. This is as it should be. Of course, the responsibility for the CPP program as a whole must continue to be exercised jointly by the federal and provincial governments.

Macroeconomic Effects

What effect would the proposed changes have on national saving, investment, the stock of capital, productivity, and national income? The proposed changes in the CPP and the other pension changes introduced in the 1996 and 1997 federal budgets would probably result in cross-currents. The buildup of the CPP investment fund would directly increase the public portion of national saving; whether or not there would be some indirect offsets from

decreased government saving or the discouragement of private saving is less certain. However, the other 1996 and 1997 budgetary changes — the seniors benefit and the changed limits and conditions on RPPs and registered retirement saving plans — will reduce private saving.[45] Thus, is not possible at this time to be sure what net effects on the whole package of changes would have on national saving and so on. What is clear is that public saving would be a larger portion of the total and that the intention is to have that additional public saving managed more like private saving than government budgets.

In the short run, the increases in CPP contributions would also have fiscal effects. These contributions are equivalent to payroll taxes earmarked for the particular purposes of providing the provision of pensions. The acceptability of these increases is moot. In any case, they would be, in themselves, an element of macroeconomic fiscal drag in the immediate future. That effect would have to be factored into the overall fiscal policy.

Conclusion

The objects of the CPP's new investment policy are sound, and the proposals for achieving them are realistic and promising. The balance of prudence and performance has been given a good deal of attention. The CPP Investment Board will have strong fiduciary responsibilities, and it should be able to make a substantial contribution to the security of the CPP. Canadians should, however, obtain a good deal of clarification of investment policies, and regulation before the new policy and the board are launched. The balance between management at arm's length from governments and ultimate government power and responsibility has been difficult to achieve in the public pension funds of many developed countries. To achieve the right balance is an important challenge for Canada.

Notes

1 The draft of July 3, 1997, replaced an earlier draft of February 14, 1997. The later draft differs in some important respects. It strengthens and clarifies the fiduciary powers and responsibilities of the investment fund board. It makes explicit the powers of appointment and delegation. It provides an appropriate criterion for compensation of the board. It clarifies the investment objective. It removes a proposed government directive mechanism. It eliminates an open-ended provision for the board to be given other duties. It provides for expert as well as intergovernmental consultation.

2 Canada, *Securing the Canada Pension Plan: Agreement on Proposed Changes to the CPP* (Ottawa: Department of Human Resources Development and Department of Finance, February, 1997).

3 Technically, under the act, even Quebec is an "included province" for amendments of substance to the CPP legislation. Thus, for the July 3, 1997, draft legislation discussed here, Quebec is not a "participating province" only for sections 10, 12, 43, 47, 52, and 53. The application of the act to employees in Quebec is relieved under provisions for any province providing a comprehensive pension plan to opt out of certain provisions of the *CPP Act*.

4 Canada, *Securing the Canada Pension Plan*, p. 6.

5 Canada, Department of Human Resources Development (HRDC), *Annual Report of the Canada Pension Plan, 1995-1996* (Ottawa, 1996), p. 36.

6 The targets are actually somewhat ambiguous. The proposed act states the principles of dual targetry (for contribution rates and for the asset-to-annual expenditure ratio) without specifying rates, ratios, or a timetable. The document of the agreement sets targets of up to 9.9 percent as the steady-state contribution rate indefinitely, beginning in 2003, and a ratio of five times expenditures (benefits) for the reserve fund (assets) without specifying a date for the latter. Whether the attainment of these two targets would be compatible by 2010 and whether they would remain compatible thereafter depends on many factors, which I examine later in the *Commentary*.

7 Canada, HRDC, *Annual Report of the Canada Pension Plan*, p. 36.

8 Some analysts suggest the proposed CPP investment model cannot simultaneously meet both targets. Providing that the rate of investment return is specified, given the initial conditions, one can obtain a unique solution for a constant asset/expenditure target in the future and an annual but variable contribution rate or for a constant contribution rate and an asset/expenditure ratio that varies over time. Both ratios can be tracked over time as a function of the rate of investment return, but it is not likely that both quantitative targets will be met at the same time in the future. If the program has been priced conservatively and the investment performance is good, it may be that a contribution rate of less than 9.9 percent at some time in the future would be compatible with an approximately constant asset/expenditure target in the future. Only by experience and probably some adjustment from time to time will both the targets be approximately attained.

9 The 1995/96 amounts are from Canada, HRDC, *Annual Report of the Canada Pension Plan*, p. 36.

10 The estimate is that the supplementary benefits of the CPP program — death, survivor's, and disability benefits — are about one-third of total program costs. Thus, if the full cost of the CPP program, as revised, is 7.0 to 7.5 percent of the contribution base, the retirement portion would cost 4.7 to 5.0 percent of the contribution base, and the supplementary benefits 2.3 to 2.5 percent of the base. See James E. Pesando, *From Tax Grab to Retirement Saving: Privatizing the CPP Premium Hike*, C.D. Howe Institute Commentary 93 (Toronto: C.D. Howe Institute, June 1997), p. 10.

11 All these figures are approximate because they depend on the discount rate one uses to value the accumulated liabilities.

12 For a recent statement of the case, see Pesando, *From Tax Grab to Retirement Saving*.

13 See David W. Slater, "Reforming Canada's Retirement Income System," *Canadian Business Economics* 4 (Fall, 1995): 44–58; and Robert L. Brown, "Reforming Canada's Retirement Income System: Is Pre-Funding the Answer?" *Canadian Business Economics* 4 (Winter, 1996): 3–12.

14 The taxation of pension saving can be looked at another way. One theory of taxation is that saving should not be subject to double taxation — that income should not be taxed when saved and again when the resulting income is earned or received. This theory, which supports advocacy of consumption taxation, suggests that income going into saving, including into CPP saving, should not be taxed; thus, the tax credit relief for CPP contributions should be regarded not as relief but as the reduction of a bad tax.

15 Another argument that is sometimes heard is that an employed person would pay only half of the total contribution (4.95 percent of the contribution base) out of before tax-income and the employer the other half. In the long run, however, the employer's contribution comes out of wages too.

16 See David Wentzell, "The Law of Fiduciaries in the Context of the Pension Deal," Appendix J of *In Whose Interest? Report of the Ontario Task Force on the Investment of Public Pension Funds* (Toronto, 1987). He notes (p. 345):

> Subject to the provisions of specific legislation to the contrary, the fiduciary relationships of a pension deal are governed by the ordinary principles of the law of fiduciaries. This approach

> has recently received the sanction of the Chancery Division of the Court of Queen's Bench in England in the case of *Cowan v. Scargill* (1984) All E.R. 750. The case involved the UK coal miners' pension fund. The union trustees took the position that the fund should adopt an investment policy that supported the English coal industry....The policy would require the divestiture of all overseas investments and prohibit any investment in energy industries in direct competition with coal. The union trustees refused to approve the investment policy for the fund unless it met these criteria. The question before the court was whether this refusal was a breach of the union trustees' fiduciary duties.

In other words, the court was being asked whether the general law of trusts applies to the trusts of pension funds. Its answer was "an emphatic yes," says Wentzell, who quotes it as saying there is

> no reason for holding that different principles apply to pension fund trusts from those which apply to other trusts. Of course, there are many provisions in pension schemes which are not to be found in private trusts, and to these the general law of trusts will be subordinated. But subject to that, I think that the trusts of pension funds are subject to the same rules as other trusts. (Ibid.)

Noting that "the fact that members may have contributed to a pension fund trust...places an extra importance upon the requirement that the beneficiaries' interests be served," Wentzell continues:

> In our view the approach does not vary if the pension plan is a defined contribution plan rather than a defined benefit plan. The beneficiaries' interests are paramount....
>
> The court also provided a review of the guiding principles of trust law we have already discussed. The trustee must carry out the object of the trust. The trustee must only delegate the exercise of his discretion when expressly authorized. The trustee must not profit personally from his office. The trustees must maintain even treatment of his beneficiaries. The words of the judgement are useful as a summary of the law of England and Canada. (Ibid.)

17 Pension benefits acts, which are intended to regulate employer-based pension programs, deal with some issues that do not apply to the CPP, such as the mortality of employers, full funding requirements, and portability and vesting. Thus, it would not be appropriate to apply the full range of these acts' requirements to the CPP. Paragraph 53 (1) a of the proposed legislation makes it possible to select the relevant provisions of the federal *Pension Benefits Act* to apply to the reformed CPP.

18 Wentzell, "The Law of Fiduciaries in the Context of the Pension Deal," p. 344.

19 Ibid., p. 348.

20 Ibid., p. 351.

21 Keith Ambachtsheer, "Moving to a Fiduciary CPP Investment Policy: Two Possible Paths" (paper prepared for the federal-provincial Working Group on CPP Investment Policy, June 1996, and distributed, with a foreword dated June 1997, with *The Ambachtsheer Letter*, July 11, 1997), p. 1.

22 Ibid., p. 2.

23 John H. Ilkiw, *The Portable Pension Fiduciary* (Toronto: Maclean Hunter, 1997), p. 6. Keith Ambachtsheer and Illkiw's colleague, Don Ezra, are authors of a forthcoming book, *The Excellent Pension Fund* (New York: Wiley, forthcoming).

24 Ilkiw, *The Portable Pension Fiduciary*, p. 6.

25 Keith Ambachtsheer, "Prudence and Pension Fund Investment Management," Appendix L of *In Whose Interest?*, pp. 368–375.

26 Wentzell, "The Law of Fiduciaries in the Context of the Pension Deal," p. 348.

27 For example, paragraph 51 (3) e requires the board's annual report to include "a statement of the Board's objectives...for the foreseeable future" but does not specify the number of future years to be covered. However, the actuarial report that would be required every three years under the amended *CPP Act* specifies projections for 30 years for some elements of the program and 75 years for others. Furthermore, the annual CPP report would have to take account of the latest actuarial report.

28 The February 1997 draft legislation proposed a power for the governor-in-council to issue Directives was deleted from the July draft.

29 The earlier draft of the act had a potentially hands on power for government regulation of the board's investment policies; it was deleted in the July draft.

30 See Ambachtsheer, "Moving to a 'Fiduciary' CPP Investment Policy," p. 11; and idem, *The Ambachtsheer Letter*, September 1995.

31 Malcolm Hamilton, of William Mercer Ltd., made this comment in response to a draft of this paper. See also Ambachtsheer and Ezra, *The Excellent Pension Fund.*

32 Notice that this intention is stated in the agreement but not in the draft act. The matter would presumably be dealt with by means of regulations or investment instructions to the board.

33 I am indebted to Malcolm Hamilton for this point.

34 Considering that the CPP benefits are indexed to the CPI and that the proposed board would have the ability to cope with instabilities, some observers (for example, Ambachtsheer and Ezra, The Excellent Pension Fund) suggest that the asset mix for the CPP fund could reasonably be as high as two-thirds equities and property and one-third fixed-income securities. They may be right, but for the illustrations in this *Commentary*, I prefer to use a more conservative half-and-half mix, which nicely demonstrates the main issues of returns, risk, and uncertainty.

35 The theory of portfolio diversification and management recommends that a portfolio should include something of every possible kind of asset: corporate and government bonds, junk bonds, equities, gold, real property, options, and so on. Mindful of their fiduciary responsibilities, most pension plans follow more conservative policies.

36 Ambachtsheer, "Moving to a 'Fiduciary' CPP Investment Policy," p. 10.

37 Canadian Institute of Actuaries, *Economic Statistics: Canadian Economic Statistics, 1924-1996 (Ottawa, 1996).*

38 *Statistics Canada, Canada's Retirement Income Programs: A Statistical Overview, cat. 74-507-XPB (Ottawa, 1996).*

39 *The relationship of saving with public and publicly assisted pension programs has been much studied, with ambiguous results. Among the best recent studies are Martin Feldstein, "The Missing Piece in Policy Analysis: Social Security Reform," American Economic Review* 86 (May 1996): 1–15; Martin Browning and Annamaria Lusardi, "Household Saving: Micro Theories and Micro Facts," *Journal of Economic Literature* 34 (December 1996): 2797–2858; and John Sakelhaus, "Public Policy and Saving in the United States and Canada," *Canadian Journal of Economics* 30 (May 1997): 253–275.

40 In his paper for the federal-provincial Working Group on CPP Investment Policy, using different but comparable assumptions about the growth of the CPP investment fund, and a diversified portfolio typical of Canadian pension funds, Ambachtsheer estimates that by 2016,

- [a] CPP Fund...would hold:
- About 8% of the Canadian money market.
- Approximately 25 % of outstanding Canadian government bonds
- About 3% of outstanding Canadian corporate bonds.
- Approximately 15% of the traded Canadian equity market (the TSE 300 "float"). ("Moving to a 'fiduciary' CPP Investment Policy," pp. 12-13.)

41 See Peter M. Petason, *Will America Grow Up before It Grows Old?* (New York: Random House, 1996), chap. 3. For worries about the scope of pension fund investment, see J. Bruce Macdonald, "An Actuarial Monograph on the Canada Pension Plan," prepared for the federal Department of Human Resources, in June 1995, and released under an Access to Information request, pp. 93–94.

42 Ambachtsheer, "Moving to a 'Fiduciary' CPP Investment Policy," p. 5.

43 Ibid.

44 See Pesando, *From Tax Grab to Retirement Saving*.

45 See David W. Slater, *The Pension Squeeze: The Impact of the March 1996 Federal Budget*, C.D. Howe Institute Commentary 87 (Toronto: C.D. Howe Institute, February 1997).

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