



# A Model That Works

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## Governance in Crown Corporations: A Model That Works

Presentation by

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to the

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Good afternoon. It is a pleasure to participate in this conference to share with you the experiences of the CPP Investment Board in developing and implementing what we believe is an innovative governance model for a Crown corporation.

I will begin by providing some brief background on the CPP Investment Board and our legislated mandate before sharing with you the structure, shape and texture of our governance model, the steps taken to win the confidence of Canadians in it, and how our governance is currently perceived by informed stakeholders.

First, the background.

The Canada Pension Plan itself was founded in 1966 by the federal and provincial governments, principally to provide Canadians with retirement income after their working years, as well as benefits to their dependents.

The plan was born as a pay-as-you-go scheme. That worked well for 30 years with contributions from employees and employers exceeding the cost of benefits.

But 30 years later, the plan was in serious financial difficulty, with benefit payments exceeding contributions. A study by the Chief Actuary heralded worse trouble ahead with the CPP reserve fund expected to run out of money by 2015, and contribution rates projected to skyrocket to keep the plan afloat.

The federal and provincial governments accepted the challenge of putting the Canada Pension Plan back on a sound financial footing. After extensive public consultation, the governments took several decisive actions.

One was to increase contributions from six per cent of pensionable earnings in 1997 to 9.9 percent by 2003. The effect of this change, according to the Chief Actuary's most recent report, is that contributions should exceed benefit payments until at least 2021.

This will enable the Canada Pension Plan to build a much needed contribution cushion to help pay pensions after 2021 when the baby boomers enter retirement in full force.

Another important change was the decision to invest these excess funds in capital markets until they are required.

To do that, the federal and provincial governments decided in 1997 to create a Crown corporation governed and managed in such a way that qualified investment professionals would make the actual investment decisions.

That is how the CPP Investment Board came into existence.

Incorporated by special legislation in December 1997, our board of directors was put in place in October 1998, and the first CPP dollar was invested in March 1999.

That's the general background. The key point to retain for the purpose of this discussion today is the wish of federal and provincial finance ministers to set up a professional investment management company at arm's length from both levels of government.

Today, the CPP Investment Board has \$14.3 billion in assets under management, all of which is invested in public and private equities.



With billions of dollars of public funds being managed by investment professionals, there must be a strong governance process in place to ensure accountability and appropriate disclosure.

There is, as the federal and provincial finance ministers insisted right from the start.

Our legislation, the CPP Investment Board Act, makes strong governance demands.

We have two – and only two – objectives.

First, to manage funds received from the Canada Pension Plan in the best interests of the contributors and beneficiaries.

Second, to invest to maximize returns without undue risk of loss – having regard for the Canada Pension Plan's funding status and ability to meet its financial obligations.

To make sure these objects are met, the legislation provides that the board of directors should have a sufficient number of directors with proven financial ability or relevant work experience.

In other words, board expertise closely aligned with the investment mandate of the organization.

But how could directors with the requisite expertise be found and appointed?

This is where the federal and provincial finance ministers devised an innovative process that has much to commend it.

To seek out the best candidates, the finance ministers created a nominating committee to which they each appointed one member. The nominating committee consists of both public and private sector representatives, and is chaired by a private sector CEO.

The committee's job is to identify and recommend a list of qualified candidates.

The federal finance minister appoints members from the list in consultation with the provincial finance ministers.

This consultation is itself a check on partisanship. At any particular time, federal and provincial governments are led by different political parties that are never shy about challenging each other.

This process has produced a board of independently minded directors with investment, business and financial expertise that relates to the organization's responsibilities and provides knowledgeable management oversight.

It has also produced a rich roster of candidates to serve on board committees and as committee chairs. Let me use the audit committee as an example.

In December 2000, the former Auditor General produced a report that criticized the lack of financial literacy on the audit committees of Crown corporations.

The Auditor General stated in the report that he expected audit committees would have appropriate skills and experience to carry out their role and their duties effectively. What he found was that half of audit committees operated below an effective level.



Our nominating process has recruited directors with considerable financial literacy.

As a result, our audit committee consists of an actuary, two chartered accountants, a retired banker and a former investment banker. Any of them could serve us well as committee chair.

This flexibility is the direct result of a nominating process that focuses solely on the qualifications of candidates.

Our legislation also requires what should be standard components of good governance today, such as procedures for identifying, disclosing and resolving potential conflicts of interest, and a code of conduct for directors, officers and employees.

The responsibilities of the board, its investment committee and its audit committee are also spelled out in legislation and regulations. In addition, our regulations require considerable disclosure of governance matters.

In my opinion, any good board of directors would chose what is mandated in our legislation.

We have made a concerted effort to build on these legislative and regulatory requirements to achieve best practices. We chose to add a human resources and compensation committee and a governance committee to deal with certain issues in greater depth without tying up the full board.

For example, we have published a 170-page governance manual that deals with a long list of policies and procedures -- board and committee terms of reference, the strategic and business planning process, director compensation, travel and expense policy, the board effectiveness assessment process, and procedures for personal trading by directors, officers and employees.

In our view, you cannot really have effective governance without written policies that have been developed, discussed and approved by the board, and are subject to annual review.

Building on legislative and regulatory imperatives involves a lot more than written policies.

It also means, for example, putting in place a rigorous process of self-evaluation. We have two processes. One is for the board to evaluate its own performance as well as that of the Chair and board committees. The other is for each director to evaluate his or her own performance and that of colleagues.

In both cases, each director completes an extended questionnaire. To ensure confidentiality, an outside consultant collates the responses, which are then reviewed by our governance committee. The committee chair reports the findings to the board with any recommended action.

We also have a rigorous evaluation process for the CEO that confirms another tenet of good governance – management accountability to the board.

The board – not government – appoints the CEO. This is unusual for a crown corporation at both the federal and provincial level and is consistent with the private sector governance model.

We require the CEO to sign a board-approved written job description so that there is no misunderstanding about his responsibilities or his accountability to the board.

The performance objectives of the CEO are set at the start of each fiscal year as part of developing the strategic plan and annual business plan and budget.



During the year, the board has an in-camera session after each board meeting at which there is the opportunity for the directors to discuss management performance.

I find these candid in-camera discussions very helpful. One gains a reliable sense of how the board, as a group, feels about various issues and processes, as an alternative to one-on-one discussions. I urge those of you involved in the governance of crown corporations to consider similar informal discussions after the formal board meetings, if you do not already do so.

Returning to the evaluation process, the CEO writes an annual self-evaluation relative to the approved objectives.

The CEO's report is submitted to all directors, who complete a questionnaire related to it. As Chair, I consolidate the questionnaire responses for discussion at an in-camera board meeting. I then have a one-on-one review with the CEO.

These robust processes for evaluating the CEO, the board and individual directors help to keep the focus on best governance practices in the interests of our stakeholders.

It is important to stress that these processes are not simply a matter of filling out questionnaires. What they do is force us to focus on the effectiveness of governance and management ... and to search for possible improvements.

Another example of how we have gone beyond legislated and regulatory governance requirements is our commitment to public accountability and reporting.

We are accountable to Parliament through the federal minister of finance, who tables our annual report.

We are accountable to the federal and provincial finance ministers through the filing of our quarterly financial statements with them.

The federal and provincial ministers review the legislated and regulatory requirements for the CPP Investment Board every three years as part of their mandatory review of the Canada Pension Plan.

And we are required to hold a public meeting in each province that participates in the Canada Pension Plan once every two years to discuss the most recent annual report.

We held our first round of public meetings in January 2001, and the CEO and I will be on the road again next month with public meetings scheduled in Vancouver, Calgary, Winnipeg, Toronto, Halifax, St. John, Charlottetown and St. John's.

If you would like further information on these meetings, please visit our web site.

Our board has adopted a more proactive approach to disclosure and reporting than even the federal and provincial governments envisaged.

For one thing, we publicly release our quarterly financial results to the news media and post them on the web site. The CEO also holds a quarterly conference call with interested media.

For another thing, we publicly announce all new investments and the formation of new partner-like relationships with external investment managers and other suppliers.



Far more fundamental is our disclosure policy. Recently, we approved a policy that declares (and I quote): “Canadians have the right to know why, how and where we invest their Canada Pension Plan money, who makes the investment decisions, what assets are owned on their behalf and how the investments are performing.”

This is a bold disclosure policy that has shaped our new web site launched earlier this month.

On that site you will find, for example:

- extensive background on the origins of the Canada Pension Plan and the CPP Investment Board
- board-approved policies, including those dealing with governance, investment, codes of conduct, conflicts of interest guidelines, procurement, and personal trading by directors and staff
- a full list of all public equities owned by the CPP Investment Board
- a summary and market valuation of the fixed-income securities held by the Canada Pension Plan
- a summary of private equity holdings
- historical investment results
- a discussion of current and pending investment strategies
- details on investment firms and other suppliers retained to implement investment and operating strategies
- the process and criteria for partnering opportunities by outside firms, and
- biographies on all directors and managers.

The financial information and the list of holdings are updated quarterly. Furthermore, new developments of interest to Canadians are posted as soon as possible after their approval by the board of directors.

As you can see, we have taken several important steps to win the confidence of Canadians in the governance model created by the federal and provincial governments, and enhanced by the directors.

In my view, the scope and detail of our public disclosure on the web site, through press releases and at the public meetings irrevocably commit us to maintaining best governance practices. If we don't, Canadians will find out quickly and let us know.

Which brings me to my final topic – do Canadians really care about the governance of a Crown corporation like the CPP Investment Board?

Yes they do, very much so.

Earlier this year, the CPP Investment Board commissioned an attitudinal study of five key stakeholder groups – actuaries, financial planners, trade unions, public policy research and advocacy groups, and pensioners.

These groups have keen interests in the Canada Pension Plan and how its excess funds are invested to help pay future pensions.

Basically, we wanted to know how Canadians felt about the Investment Board's mandate and investment strategies ... and their relevance to the long-term financial strength of the Canada Pension Plan.

Stakeholders were questioned at length about the governance model. The independent research found that they understand and support it.



They approve of appointing individuals with investment, business and financial expertise as directors, although the unions would be happier if we also had general public representatives on the board.

Our directors work in the public interest. They do not represent any particular group, and most of them are independent professionals, rather than corporate executives.

Canadians are impressed by the efforts to ensure arm's length independence from governments in making investment decisions.

However, they are concerned that as the assets managed by the CPP Investment Board grow, it will be susceptible to both political and business pressures to invest in ways other than the maximization of returns and preservation of capital.

The \$14 billion under management today is projected to reach between \$125 billion and \$150 billion in 10 years, depending on how much of the bond portfolio held by the Canada Pension Plan is transferred to us as bonds mature.

Some stakeholders are concerned that our current governance structure will not be sturdy enough to withstand political interference over the long term.

Having said that, some stakeholders believe that we should accommodate their own preferences within our legislated investment mandate, such as investing to create jobs or to achieve other social agenda and public policy objectives.

What is considered to be political or business intervention appears to depend on the stakeholders' perspective.

Let me say that the current directors of the CPP Investment Board do not share the concern about political interference as the assets under management grow.

First, we applaud the conscientious manner in which the federal and provincial governments crafted our mandate to prevent that from happening. They sought good governance advice and followed it. The arm's length relationship of the CPP Investment Board to governments is exactly what they wanted.

Second, our regular and detailed reporting to the federal and provincial finance ministers gives both levels of government the opportunity to stay informed.

Third, our regular and detailed reporting to the public means that Canadians interested in our affairs should be able to detect any deviation from our mandate.

And fourth, my fellow directors are serving on the board because they accept and endorse the commitment to the arm's length relationship. So does the management team.

In conclusion, let me add that the CPP Investment Board is an interesting example of a work-in-progress with respect to innovative governance at a Crown corporation.

We fully understand that a governance model, no matter how carefully constructed and maintained, cannot guarantee organizational success.

We are flattered, of course, to have won the Conference Board of Canada/Spencer Stuart governance award for the public sector in 2002.



But something can, and no doubt will go wrong at some point that will put our governance practices to the test.

After all, the governance manual for Enron contained lofty language and ethically rich principles. Writing it down and practicing it are clearly not the same thing.

One test is how quickly policies, procedures and processes enable you to anticipate, uncover and fix problems before they infect the corporate culture and cause damage.

A second and usually more difficult test is deciding what should be publicly disclosed ...and how any problems and solutions are explained to interested stakeholders.

We are determined to win and hold public confidence in our governance because what the CPP Investment Board does is important to the financial future of 16 million Canadians who contribute to or benefit from the Canada Pension Plan.

Thank you for your attention. I welcome your comments and questions.