In the Crucible: The Governance Model of the Canada Pension Plan Investment Board at a Time of Global Financial Crisis

Notes for remarks by

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Thank you Bill for that kind introduction.

Canada is blessed with all kinds of natural resources, and The C.D. Howe Institute is one of them. You do outstanding work, and it is my pleasure to be here.

It is very difficult to describe the depth, scope or severity of the global financial crisis, or of its full effect on the capital markets or economy, but at least two things are certain. One, this crisis is very real. And two, it is presenting significant challenges for policymakers, businesses and individuals across the spectrum, and around the world.

For the CPP Investment Board, the crisis has created near-term declines in the value of the portfolio, to be sure, but it is also creating significant long-term investment opportunities. Because of its scale, a very long investment horizon and ample liquidity, the CPPIB is one of the few investors today with the ability to acquire the kinds of very attractive assets that have come available over the past year.

This is evident in our recent offer to acquire a $6 billion portfolio of prized infrastructure assets in Australia and the UK. We believe this investment will contribute significant cash flow to the CPP over time, and I know our investment teams are actively evaluating a number of other opportunities of comparable scale and potential.

But the crisis has also created another kind of opportunity for us; one that it is more geared to the perspective of the Board of Directors. It's not one we were looking for, quite frankly, and that is: the opportunity to "stress-test" our governance model – as well as our investment strategy and accountability framework -- under extreme conditions.

I won't hold you in suspense -- it has held up remarkably well. More on that in a moment. But first a little history is in order to understand the origins of the CPP Investment Board and the uniqueness of our model.

In the mid 1990s, Canada was facing a national pension crisis. Actuarial projections showed that even with scheduled contribution rate increases, the Canada Pension Plan would be unable to fully pay benefits by 2015.

In response, the federal and provincial governments worked together to create a new funding mechanism for the CPP.

Their solution had three elements:

1. Modest reductions in future benefits;

2. An accelerated increase in the contribution rates from 5.6 % in 1996 to 9.9 % in 2003 in order to create a sizeable reserve fund; and

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

This much is well known. But what is less understood is that there was a catch.

In public consultations during the reform process, Canadians made it clear that while they were willing to accept a higher contribution rate to help sustain the CPP, they were distrustful of leaving their pension fund under political control.

A deal of sorts was struck.

Canadians would consent to the benefit reductions and contribution increases, *provided* that government would consent to a governance model that provided for a professional investment organization operating at arm's length and according to a purely fiduciary-driven commercial mandate.

Somewhat remarkably, the Provincial and Federal governments agreed, not just with what Canadians were proposing, but with each other, and a joint Federal-Provincial governance model was born.

This was the defining moment in the reforms of the CPP and the creation of the governance model that has earned the CPP Investment Board -- and indeed, Canada -- broad and favorable recognition in global pension and policy circles, as well as from the IMF, OECD, US Congress and delegations from a host of other countries who have come to study the Canadian model.

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

Accepting this allocation of risk and responsibility, the reformers created a "maximum-strength" governance model designed to strike a balance between independence and accountability, and they gave the CPP Investment Board a clear and singular mandate to "maximize investment returns without undue risk of loss."

Finally, they enshrined this mandate in governing legislation that can only be amended by a consensus of the federal government *and* two-thirds of the provinces representing two-thirds of the population. This is an even higher level of consensus than the one required to amend Canada's constitution.

So how has this singular protection held up in the crucible of a global financial and economic crisis? Before answering this question, let's do a quick scan of what is happening in other jurisdictions.

I have described Canada's governance model for its national pension plan. Other countries have different governance models for different types of funds, each with its own mandate or, in some cases, **<u>mandates</u>** in the plural.

For our purposes, the question isn't whether one model is better than another, but rather, to what extent governments have been compelled to redirect mandates or override governance models to meet current challenges?

A quick survey of recent events is instructive in this regard.

- In Ireland, the government has directed the National Pension Reserve Fund to invest 10 billion pounds in the country's banks. Established during Ireland's boom years, the Pension Reserve Fund was never intended to finance banks and was supposed to grow without drawdowns until after 2025.

- In Norway, the Norwegian Pension Fund-Global, formerly known as the Norwegian Petroleum Fund, was created to preserve some of the economic value of a diminishing natural resource for future generations. Future generations, however, became present ones recently when Norway approved a multi-billion dollar stimulus package to be paid out of Fund reserves.

- In Mexico, the Mexican Pension Fund Association, or Amafore, announced an agreement with the pension industry regulator that will see its members channel all new retirement contributions and returns on existing assets under management to local securities, infrastructure and housing projects for the remainder of 2009.

And in Russia, China and elsewhere, economic stabilization or national reserve funds are being tapped to help support flagging economies.

I do not cite these examples to criticize, nor to question the wisdom of these actions. Rather, I cite them to make the observation that the pressure is on governments to find liquidity, and everything is on the table.

So, what of Canada?

We are fortunate. Financially and economically, Canada appears better positioned to weather this storm than any other industrialized country. And yet we too have been hit hard:

- Unemployment is at 7.7 percent, the highest level in five years, and the pace of job losses is now on par with that of the United States;

- Credit is tight as foreign and non-bank lenders have withdrawn from the market;

- Ontario's manufacturing base is under siege, Alberta's oilsands projects are under water, and BC's forest products industry is out in the cold; and

- The value of the S&P/TSX index is down by 34.7% percent in the twelve months ended March 31, 2009.

Surely in this environment we might have expected pressure from government to help close our national infrastructure deficit, provide liquidity, buy government debt, help create Canadian jobs, or pursue some other social, economic or political objectives.

And yet, we have seen none, heard none and felt none. And that should be a credit to the Federal and Provincial Finance Ministers who serve as the stewards of the CPP, and a comfort to the 17 million Canadians who depend on it to help fund their retirement years.

I suspect there are at least four reasons for this:

1. Our stewards understand and respect the fundamental deal their predecessors made with Canadians at the time of the CPP reforms;

2. They understand the value we derive from the clarity of our mandate and our arms-length relationship to government – these are crucial advantages that enable us to pursue a long-term investment strategy, and gain access to the best available investment opportunities, particularly as against Sovereign Wealth Funds;

3. They understand that we are already working to support one of Canada's most important social programs and economic pillars: the Canada Pension Plan; and

4. They know that we will invest in Canadian infrastructure, provide liquidity to the markets, buy Canadian securities and so on only if it makes sense to do so – on the merits -- for our long-term investment returns. To do otherwise would violate our governing legislation, increase investment risk and mark a departure from the governance model that has served Canadians so well.

I've spent a fair bit of time on our governance model because it is so central to the strength of the CPP. In the time remaining, let me touch on a few other areas that have been equally tested by recent events: Our investment strategy, the sustainability of the CPP and our accountability framework.

Investment strategy. The past twelve months have been, bar none, the most devastating period for investors since the Great Depression, especially for those with excessive leverage or a short time horizon. More than $3.4 trillion in capital has been destroyed in just the North American public equity markets alone.

We have not been immune to the downturn in global asset values. As a long-term investor managing a broadly diversified portfolio of approximately $109 billion, we have a strategic weighting towards equities, and that weighting is reflected in our results for the past year. But the CPP Fund is different from other funds. We are neither heavily leveraged nor short-term. To the contrary, we have an investment horizon measured in decades and generations, rather than quarters or years. We know with a reasonable degree of certainty that approximately $28 billion in net contributions will flow into the

Fund over the next 11 years. And because we are not subject to withdrawals or redemptions, we do not have to worry about funding unanticipated cash outflows.

These and other advantages enable us to invest for the long-term in ways few other investors can. Nonetheless, markets are dynamic and we recognize that every strategy must evolve over time as facts and circumstances change. We took a hard look at our investment strategy in 2008 and made some tactical shifts to adjust to a changed environment. But fundamentally, we continue to believe our approach is right and our strategy is both sound and appropriate for a Fund with our long-term liabilities and structural advantages.

Sustainability. According to the most recent 2007 report of Canada's Chief Actuary, the CPP, as constituted, remains sustainable throughout the 75-year period of the report. The sustainability of the CPP is determined by the net projected impact of a host of factors. Among these, as you would expect, powerful macroeconomic inputs such as birth and mortality rates, wage growth, inflation, immigration and employment levels have a broader impact on a national Fund like the CPP than the investment returns generated by the CPP Investment Board. The same is true for the role investment returns play within a partially-funded plan like the CPP as compared to fully-funded plans.

While we are just one part of the overall mix, we are doing our part to help. Since the Board adopted a strategy to pursue returns above a market-based benchmark in order to "maximize returns without undue risk of loss", our investment teams have delivered $ 5.3 billion in value-added investment returns over the most recent two full fiscal years 2007 and 2008. We will report the results of fiscal 2009 at the end of May. And we are doing all this for just cents on every $100 of assets in the Fund. More important, we have built deep investment and risk management capabilities, a global reputation as a sophisticated investor and diversified portfolio well-geared to the long-term nature of the CPP.

Looking ahead, I have no doubt we will see periods when our returns will be below the long-term average real rate of return needed to help sustain the Plan, and other periods when we will be well above it. Over time, I am confident we will deliver on our part to help sustain the Plan.

Accountability framework. I want to talk about two highly topical elements of our accountability framework: management compensation and transparency. Let’s talk about management compensation first.

As I discussed earlier, the CPP Investment Board has certain structural advantages -- such as our scale and time horizon -- that enable us to pursue a value-added investment strategy. Central to this pursuit is building a diversified investment portfolio that takes advantage of opportunities across an array of investment strategies and asset classes. Doing this successfully requires that we compete with the world’s savviest and most respected investors to recruit and retain the very best investment professionals available.

So how do we design a compensation plan that enables us to achieve our mission in a manner that respects our public accountability and that is fair, reasonable and responsible?

First, we have a very clear set of incentives that are understood by our management, consistent with our investment risk limits, measurable against a clear benchmark and transparent to our stakeholders. Second, we pay for performance, as most firms intend to do, but we do it over rolling four-year periods that reflect the long-term nature of our investment strategy using the CPP Reference Portfolio as our benchmark. The Reference Portfolio is a hypothetical – but fully investable -- low-cost, low-complexity portfolio that reasonably could be expected to generate the minimum return needed to help sustain the CPP. It is the strategy we would have pursued if we hadn’t adopted a value-added approach aimed at doing better than the minimum.

Accordingly, the performance incentives of our investment professionals are directly related to several key factors including: first, the value created above and beyond the market based benchmark; second, the overall return of the CPP Fund, thirdly, incentives apply only on the portion of value-added gains remaining after we have covered our costs; and lastly and most importantly, these factors are calculated on a rolling four-year period.

Even then, compensation is subject to various floors and ceilings to ensure that it remains fair – on both the upside and the down – and enables us to keep our best people in bad markets and in good ones.

We believe that these measures create significant alignment between our investment professionals and the long term investment mission of the CPP Investment Board and the future retirement needs of 17 million Canadians.

Transparency. By legislation and by choice, the CPP Investment Board is committed to transparency. Our disclosure policy states that we believe 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. We believe this approach has helped to build trust, confidence and accountability for the CPPIB and we will continue it, even – or especially – in times like this when returns are poor and the news is a bitter pill to swallow.

So where does that leave us?

The CPPIB's governance model works. It has served contributors and beneficiaries very well over the past 10 years, it has earned kudos from policymakers and Fund fiduciaries around the world, and it has held firm under the pressure of crisis – not by its ability to withstand pressure, but by the respect it has earned. We take no credit for the governance model – it was the work of smart policymakers and far-sighted elected officials who ten years ago designed a model that is passing the stress-tests of today – but the clarity it provides remains one of our greatest advantages.

Beyond governance, our structural advantages of scale, certainty of cash flows and our long time horizon are real and being put to good use, along with the capabilities of our global investment teams and partners. Fiscal 2009 was a difficult year for the Fund but we remain on track to help sustain the Plan over the long-term.

The CPPIB and the CPP Fund have been "built to last". Seeing both through the current crisis will require constant vigilance with respect to the governance model; discipline and agility in equal measure to manage the challenges, and capitalize on the opportunities, in front of us; and a steadfast commitment to the long-term strategies, values and objectives of our organization.

Thank you for your kind attention. If time permits I would be happy to take your questions.