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Backgrounder

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Making Ponzi a Prudent Man: Establishing the CPP Investment Board

by

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The conduct of the new Canada Pension Plan (CPP) Investment Board will be a key determinant of public confidence in the plan. This confidence matters for a number of reasons but, at a point when CPP contributions are about to rise markedly, one stands out. To the extent that participants see a link between their contributions and future benefits — which many, at present, do not — their contributions will feel more like purchases of a fringe benefit and less like a tax. Such an attitude can mitigate the extent of the job destruction we can otherwise expect from the contribution hike.

Background

Thirty years ago, the federal and provincial governments established a mandatory work-related pension plan, the CPP, on a pay-as-you-go basis. Such plans have been compared to Ponzi games, and for good reason. They have no or negligible real investments from which to pay pensions. So they depend on a perpetual inflow of new money in quantities that allow payouts that are larger than participants could achieve by making equivalent investments in real assets. Like multilevel marketing schemes and chain letters, such plans are unsustainable, because the supply of new participants willing and able to contribute ever-higher amounts of money eventually dries up.

The prospect of a future collapse of the CPP is a concern not only because of the dislocation and suffering involved in a radical wind-up of the plan, but also because, to the extent that people expect no benefit from the CPP, their contributions are a tax: a wedge between employer and employee that cuts purchasing power, discourages work, and increases the attraction of the underground economy. And the worse are these destructive effects on the job market, the more they undermine the CPP's contribution base, exacerbating the problem.

An Assessment of the CPP Reform Package

By funding the CPP more fully, the recent reform package marginally improves the deal the plan offers young Canadians on paper. And, potentially more important, it could raise the confidence of young Canadians that they will actually get the benefits they are promised. But since Canadians would have faced an enormous adjustment if the CPP were totally

"deponzified" by having its promises fully funded, the reform package is not very ambitious. It aims at a fund that would never amount to more than about one-fifth the present value of the plan's obligations.

This low funding ratio stands as a warning to participants that they risk never seeing their benefits. Given the size of the contribution hike Canadians face as the rates rise and the base expands, the potential destructive effects of such fears on the job market and on Canada's political climate more generally are considerable. Rightly or wrongly, the CPP Investment Board will be a focus of those fears, and allaying them will be one of its principal challenges.

Key Features of the Package

Mandate

Section 5 of the reform legislation rightly makes the best interests of contributors and beneficiaries and the objective of achieving a maximum rate of return central to the plan. Because the CPP's funding will still be low, the payment of benefits each day will always depend mainly on the collection of premiums the day before — that is, the liability will be much larger than the fund. The Investment Board's job will be to try to shrink that gap.

In this light, it is not clear why the draft regulations require the board to establish and review a written statement of policies, standards, and procedures "having regard to all factors that may affect the funding of the CPP and the ability of the CPP to meet its financial obligations." In particular, it is not clear that liquidity of investments will be a significant matter for years to come, since the fund is most unlikely to be tapped to meet CPP obligations.

Concerns about the regulations aside, however, this low funding ratio simplifies the fund managers' job. That job — which should be reflected in the benchmarks the board chooses for its performance — is to invest for growth: high returns over the long term, to fund the plan as completely as it can, which is critical to building and maintaining public confidence in the CPP.

The Board

How should we structure the Investment Board to achieve that objective? Experts in governance have spelled out the importance of a board that draws clear lines between its functions and those of the management that it hires and that regularly evaluates both its success in meeting its investment goals and its own performance. Because there will be no institutional representation of participants' interest at the table, these provisions are especially important.

Drawing on practice in other areas, such as central banking, where achievement of a long-term goal may require insulation from shorter-term pressures, I have some concern about the proposal that directors' terms be for three-year, indefinitely renewable, periods. Longer terms, with more limited opportunity for renewal — such as a five-year term with one renewal or a single nonrenewable eight-year term — may produce directors who are more able (and who are seen to be more able) to focus on their long-run duties to CPP participants.

High quality requires attractive remuneration. This is a sensitive issue, but one that should be manageable at the board level. Payments to directors should be high on a *per diem* basis, but lower on an annual basis since, after the initial setup, their work will be part time. (Were they full time, board members might start looking for things to do, and begin to encroach on management's responsibilities.)

Accountability

Good accountability and reporting are also key to maintaining confidence. The provisions for audits of the board by its own auditors and audits of the CPP by the auditor general seem,

especially in conjunction with the chief actuary's periodic reports, to be adequate.

One notable absence is a requirement for formal reporting to the legislatures of the participating provinces. Continuing dissatisfaction with the CPP may spur future debate about whether some provinces should follow Quebec out of the plan. That pressure could be defused by increasing its visibility and accountability to provincial legislatures.

The CPP will also be under constant pressure to violate its fiduciary duties for the sake of regional or other types of development. At least some board members — the chair and the chief executive officer, in particular — will need to be able to communicate effectively their devotion to the interest of participants. Showmen / women with a deft political touch would help in this regard.

Investment Practices

With respect to investment practices, the draft legislation's requirement to replicate indexes looks sensible. It responds to concerns about politically driven or otherwise imprudent investment practices, and it reflects a realistic assessment of active management's limited ability to get consistently better returns. The provision that the board "shall substantially replicate the composition of one or more widely recognized broad market indexes" seems flexible enough to avoid the problems of small or illiquid floats, especially during the initial three-year period.

If these problems look likely to be acute later, there will be one more good reason to farm the money out to separate managers. Their individual decisions will be less disruptive to markets and offer less opportunity for shrewd trading at their expense than would the decisions of one big fund.

This line of enquiry leads naturally to consideration of the foreign investment limit. Here, I observe only that the draft provision that allows the board to use derivatives "where the intended effect of the transaction is to offset or reduce the risk associated with an existing investment or group of investments" appears to open the door to using derivatives to provide effective foreign exposure. It is incongruous that an act purporting to put the best interest of participants foremost contains limits on foreign investment; I hope that the board will do what it can to maximize returns despite the restriction.

Finally, I worry about the provisions for provincial financing. It is not clear why provincial debt issued to the CPP should continue to be nonnegotiable. Nor is it clear what the draft regulations mean by "substantially the same" interest rate as a public issue would bear, or what provisions regarding terms and rates might be set aside by agreement between the board and a province. Since the CPP's role as a source of subsidized finance for the provinces has helped to undermine confidence in the plan, some revision of these regulations might be in order.

Conclusion

Rightly or wrongly, the CPP Investment Board will be a central focus of Canadians' concern

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about the CPP's reliability. Confidence in the CPP's promises matters because, among other things, it can mitigate the job losses Canadians will face as a result of the premium hikes. The stakes are high, but so are the rewards of designing a board that will bolster Canadians' confidence in the pension plan and put the ghost of Ponzi behind us.