

#2005-18  
December 2005

## **Financing the Canada and Quebec Pension Plans**

by

**Michael Mendelson**  
**Caledon Institute of Social Policy**

The AARP Public Policy Institute, formed in 1985, is part of the Policy and Strategy Group at AARP. One of the missions of the Institute is to foster research and analysis on public policy issues of importance to mid-life and older Americans. This publication represents part of that effort.

The views expressed herein, which are those of the author, are for information, debate, and discussion, and do not necessarily represent official policies of AARP.

© 2005, AARP.

Reprinting with permission only.

AARP, 601 E Street, NW, Washington, DC 20049

<http://www.aarp.org/ppi>

## Foreword

By law, tax dollars paid to the U.S. Social Security system that are not needed to pay current benefits can be invested only in U.S. Treasury securities. Some proposals to strengthen the system would permit the investment of a portion of these assets or reserves in equities. Proponents of such diversification argue that the anticipated higher returns on market investment would mitigate the benefit cuts or tax increases necessary to restore solvency to the system. Opponents worry about political interference in the economy. A look north to Canada, where market investment of public pension fund reserves is permitted, might prove instructive when it comes to the advantages and disadvantages of investing public pension assets.

In *Financing the Canada and Quebec Pension Plans*, Michael Mendelson of the Caledon Institute of Social Policy describes the evolution and financing policies of the Canada Pension Plan (CPP) and the Quebec Pension Plan (QPP), both of which invest their reserves in the market. He also discusses the organization and experience of the plans' investment boards and concludes with several lessons that the United States might learn from Canada's experiences with investing its public pension reserves.

The QPP has been investing in the market far longer than has the CPP. The two plans differ somewhat in their approach to investing. Mendelson notes that in addition to maximizing investment return, the QPP is perceived as having had a mandate to promote economic development in Quebec. A comparable mandate does not characterize the CPP. Mendelson's evaluation of the two plans, however, leads him to conclude that a government investing fund free of political interference is possible, "if that is what politicians want to do." Moreover, while the dual objectives of a system such as Quebec's could conflict with one another, Mendelson finds that the dual mandate in itself is not prejudicial to independence.

Mendelson also pays particular attention to reforms to the CPP—benefit cuts as well as market investment—that have led to a steady-state contribution rate for the CPP and the conclusion by independent auditors that the "CPP is presently healthy." The media have ceased talking about impending insolvency. The situation is somewhat different for the QPP, given different demographics and weaker economic growth in Quebec. Despite market investment, Mendelson observes that Quebec's pension plan will require some, apparently modest, contribution increases or benefit reductions.

*Financing the Canada and Quebec Pension Plans* is one of several AARP Public Policy Institute papers that examine aspects of social security reform in a number of countries. The other papers deal with voluntary carve-outs in the United Kingdom, recent developments with partial privatization and individual accounts in Chile, Australia's system of means-tested benefits and mandatory occupational savings schemes, and Sweden's move to defined contribution pensions.

Sara E. Rix, Ph.D.  
Senior Policy Advisor  
AARP Public Policy Institute

## Table of Contents

Foreword.....	i
Executive Summary .....	iii
Introduction.....	1
The Evolution of the Canada and Quebec Investment Funds.....	1
The Independent CPP Investment Fund .....	6
Keeping a Low Steady-State Contribution Rate.....	7
The CPP Investment Board.....	8
The CPPIB’s Mandate .....	8
Board and Management .....	9
CPPIB Investment Limitations .....	10
CPPIB Investment Practices and Performance .....	11
The Caisse de dépôt et placement du Québec.....	13
The Caisse’s Mandate.....	13
Board and Management .....	14
The Caisse’s Investment Limitations.....	15
The Caisse’s Investment Practices and Performance.....	16
Conclusion .....	17
Appendix A: Canada’s Pension System .....	20
References.....	21
Statutes.....	22

## List of Tables

Table 1.	CPP Reserve Funds, 2004 and 2005 .....	11
Table 2.	Performance of CPP and CPPIB Funds, 2000-2005.....	12
Table 3.	CPP Investment Performance Rate of Return Compared to Benchmarks, 2004 and 2005.....	13
Table 4.	Caisse de Dépôt Net Assets by Investment Type, 2003 .....	16
Table A1.	The Canada and Québec Pension Funds.....	20

## Executive Summary

### Objective

The objective of this report is to describe the financing policies of the Canada Pension Plan (CPP) and the Quebec Pension Plan/Régie des rentes Québec (QPP). Also discussed are the organization and experience to date of the investment boards of the two plans—the CPP Investment Board (CPPIB) and the Caisse de dépôt et placement du Québec.

### The Evolution of the Canada and Quebec Investment Funds

Canada has a large pension program financed from general revenues that pays benefits to all residents age 65 and over regardless of their earnings history. This general revenue-financed program guarantees a minimum income to every resident 65-plus, thus forming the bottom tier of Canada's three-tier pension system. Like the U.S. Social Security program, the CPP and QPP are public mandatory defined benefit pension plans, financed by a compulsory deduction of a proportion of earnings (including from the self-employed).

In the mid-1960s, the Canadian federal government and provinces began negotiations to set up contributory pension plans to complement the general revenue-financed plans already in place or under development. In Canada, the federal government had to enter into negotiations on pension reforms with the provinces because contributory pension schemes were an area of provincial constitutional jurisdiction.

In the negotiations, Quebec advocated a partially funded public mandatory contributory defined benefit scheme. One of the features of the Quebec proposal was the accumulation of a large pool of capital in the early years of the plan, which would be sufficient to fund several years of the plan's benefits in the absence of further contributions. Quebec eventually convinced the federal government and most other provinces of its plan's superiority. In the new arrangement worked out for the proposed contributory plan (at least for all provinces *except* Quebec), each participating province would have access to funds equal to its share of contributions minus benefits, at an interest rate equal to the average yield to maturity of outstanding Canadian government obligations of 20 years or more. The provinces would issue 20-year non-marketable bonds to the pension plan in exchange for these funds.

The federal government would administer the CPP. The negotiations also arrived at an arrangement regarding governance of the pension plan and opting-out privileges for the provinces. Any province would have the right to opt out and set up a parallel plan. Only Quebec opted out, however, and set up the QPP. Quebec could therefore decide on its own how it would invest QPP funds.

In 1965, Quebec created La caisse de dépôt et placement du Québec (The Quebec Deposit and Investment Bank), usually called the "Caisse" for short, to invest its QPP funds. The Caisse was considered to have a dual mandate: to optimize return on investment (i.e., maximize return without taking undue risk) while contributing to the economic development of Quebec. As well, the government would have substantial presence on the Caisse board and could give directions to the Caisse with respect to investment policy. Both the Caisse's dual mandate and

the perception of its lack of independence from the government have been controversial, although far less controversial within Quebec than in the rest of Canada.

In its first 30 years, depending upon whose assessment is considered, the Caisse returns were either in line with other major private investment funds or almost in line. Within Quebec, the Caisse became widely viewed as a successful instrument of economic development. Both within and outside of Quebec it was believed that the Caisse performed better than the provincial bonds held by the CPP.

This Caisse history is critical to the later development of an investment fund for the CPP. Because of the battles around the Caisse, the Canadian business community was sensitized to the issues and would not accept a CPP investment fund that was (1) anything less than fully independent and (2) did not have a clear and simple investment-optimizing mandate unmitigated by any economic development objectives. At the same time, given Caisse returns, an investment fund with diversified assets was financially attractive.

Over the first 20 years, both the CPP and the QPP functioned largely as planned, with an unchanged contribution rate of 3.6 percent on pensionable income. As part of continuing debate over pension reform in the 1970s and early 1980s, the Canadian Labour Congress—the association of labour unions in Canada—proposed a regular 5-year review of the CPP by an independent actuary. This proposal was adopted in the 1984 budget. By the time of the first 5-year review in 1986, the existing contribution rate was reported as inadequate to sustain the plans. In response, the provinces and federal government agreed to increase rates gradually at 0.2 percentage points a year. However, in 1993, the chief actuary reported that contribution rates would have to increase to 14.2 percent by 2030. This report initiated a public debate about the sustainability of the CPP.

In 1996, the federal and provincial governments implemented a three-part solution, in essence reflecting the strategy proposed by Quebec:

1. It was agreed that the contribution rate would be set at a level that would result in “steady-state” financing—that is, it would be set at a contribution level just large enough so that the rate would neither have to be increased nor decreased in the foreseeable future.
2. A separate and independent CPP investment fund was created.
3. The steady-state contribution rate was kept below 10 percent by implementing various cuts in benefits, as well as freezing the base level of income exempted from contributions (so that, due to inflation, over time a lower *real* level of income would be exempted from contributions to the CPP, thereby raising effective average contribution rates). Even with an independent investment fund and anticipated higher returns, steady-state financing at 1996 benefit levels would have required a contribution rate of about 12 percent.

The result of these three measures has been a steady-state contribution rate of 9.9 percent that is projected through 2050 and an investment fund that has been built up to 5 or 6 years of funding for all benefits, with the investment to be made through an independent CPP Investment

Board (CPPIB). These policies have by and large achieved their purpose. The most recent actuarial review of the CPP confirmed that the steady-state contribution rate of 9.9 percent, when combined with investment revenue, would be adequate to pay for benefits into the future. Since the introduction of the new measures, all talk of insolvency in the media has evaporated, although opinion polls show that public concern about the future reliability of the CPP remains.

### **The CPP Investment Board**

An Act of Parliament set up the CPPIB in December 1997. The act sets out the objectives of the CPPIB—assisting the CPP in meeting its obligations to contributors and beneficiaries and investing its assets with a view to achieving a maximum rate of return, without undue risk of loss. The act prohibits the CPPIB from carrying out any business activities inconsistent with the stated objectives. The investment board manages all CPP assets, including the existing provincial bonds still held by the CPP (which are being transferred over to the CPPIB during the next few years) and all new contributions.

A committee of representatives from the participating provinces, chaired by a private-sector executive, nominates the CPPIB directors. The federal finance minister then makes the appointments and appoints the board chair with the advice of the participating provincial governments.

The management of the CPPIB is of a professional and experiential caliber that would be expected for an investment fund of this size. At the present time, the CPPIB invests mainly through external fund managers. CPPIB administrative expenses have been running at 0.7 percent of assets managed. This is a very high management expense ratio for a fund of this size, especially when a considerable portion of its portfolio is in 20-year non-negotiable government bonds. The management cost of the CPPIB has not yet been the topic of any external assessment.

The CPPIB only began its investment program in 1999, and for the first few years it was restricted to index funds. As all of the holdings of the CPP were in provincial CPP bonds, achieving a reasonable mix of asset types required investing new funds flowing into the CPPIB almost entirely into equities. With less than C\$50 billion invested in equities, the CPPIB has not yet had any noticeable impact on the Canadian equities market.

The performance of the CPPIB to date has had some dramatic swings. Almost all new CPPIB investing has been in equities, and these investments have had a return as low as -20.9 percent in 2003, followed by a high of +31.8 percent in the next year.

As of March 31, 2005, the assets the CPPIB has managed had a 5-year average real rate of return of 4.5 percent. The CPP's 9.9 percent steady-state contribution rate is predicated at approximately a 4.1 percent real rate of return. Although the CPP has a number of sophisticated benchmarks to measure its investment performance, from a public policy perspective a rate of return sufficient to maintain the steady-state contribution rate is the critical benchmark. So far the benchmark has been exceeded.

## **The Caisse de dépôt et placement du Québec**

The original Caisse law of 1965 contained a somewhat obscure statement in Section 36 that it would not only be responsible for optimizing returns but also for the economic development of Quebec. In 2003 the Caisse undertook an internal review of its governance. This review called for several amendments to the Caisse Act, including a proposed mission statement that would clearly disallow the Caisse from investing for reasons other than the maximization of returns. The government did not respond fully to the Caisse's recommendations. It enacted a new Caisse law in January 2005, including a statement that does not resolve the ambiguity of the previous Caisse mandate. The Caisse's economic development role remains both popular and credible in Quebec.

The original 1965 act setting up the Caisse legislated a board of directors of nine members to be appointed by the government, with significant voting directors from government itself and three non-voting members including the deputy minister (permanent secretary) of finance. Under the 2005 act, there is no government representation on the board. Instead, the new legislation requires that at least two-thirds of the members of the board of directors be independent. With respect to administration, like the CPPIB, the Caisse has a highly regarded management with substantial background and experience commensurate with their responsibilities. The Caisse reports its administrative costs at approximately 0.16 percent of assets under management. Unlike the CPPIB, the Caisse uses in-house fund managers and it attributes its very low administrative costs to this.

Over the years the government of Quebec has placed many other funds under the management of the Caisse, such as the Quebec government employees' pension funds. Today the Caisse manages 19 public and quasi-public funds as well as private funds on contract (including some outside of Quebec). The Caisse managed about C\$90 billion of public sector fund assets in 2003 (and more than C\$100 billion of total assets), of which about C\$19 billion were QPP funds. For 2003 the Caisse reported its weighted average return on funds as 15.2 percent, compared to -9.6 percent in the previous year. One-, 3-, and 5- year returns on Canadian equities were 27.7 percent, -0.6 percent, and 8.3 percent, respectively, in 2003. For the same periods, returns on bonds were 7.4 percent, 8.8 percent, and 7.1 percent.

On February 16, 2005 the Caisse reported earnings of 12.2 percent in 2004. At present, the Caisse is widely seen as a successful investor.

### **Conclusion**

The contrasting experience of the CPPIB and the Caisse illustrates that it is certainly possible to set up a government investing fund that is free of political interference, *if* that is what politicians want to do. There is no inherent self-limiting quality to a government-owned investment fund that makes it impossible to set it up as a truly independent operation. It is also possible to decide if a fund should have a single mandate to optimize returns, or a more complex mandate to accomplish other goals (such as economic development). Although the presence of a dual mandate could be antithetical to performance, it is not in itself prejudicial to independence—any more than is the independence of any board compromised by a pre-established policy framework.

From a policy perspective, the most important observation arising from this review is that the benefit cuts, steady-state funding, and investment in marketable securities have resolved “elite” anxiety about the future reliability of CPP pension benefits. Aside from perceptions, independent actuarial reviews confirm that the CPP will remain viable based on steady-state financing at the current contribution level. The CPP is therefore at present healthy. Of course, steady-state financing continues to rely mainly on future workers’ contributions to pay most benefits. Since only a portion of financing is coming from investments, the CPP depends less on investment returns to remain solvent.

Compared to the CPP, the QPP is in a somewhat different position because both Quebec’s economy and demographic growth are weaker than in the rest of Canada. Quebec will require either a slightly higher contribution rate or some relatively minor benefit reductions.

In the United States, investing Social Security surpluses in tangible, marketable assets would necessitate the creation of an investment fund in which ultimate ownership would be vested in government. This prospect has raised concerns in the United States about government interference in the economy. But the lesson from the CPPIB is that there are three relatively simple elements necessary to protect the independence of an investment board for a government-owned fund. These are:

1. A legislative mandate that sets out a clear mission for the investment board and requires the board to operate in compliance with that mission;
2. Legislatively entrenched requirements for a majority of independent directors combined with a mechanism for arm’s length nomination of board members that stresses their competence; and
3. Legal requirements for periodic audits and actuarial reviews, which must be made public.

Perhaps the most innovative and surprising component of the Canadian reforms is the steady-state contribution rate. The steady-state contribution rate satisfies the desire for predictability. Rate predictability provides a sense of on-going reliability and dependable solvency. Steady-state financing was the critical missing element necessary to construct a viable package of reforms in the CPP.



THIS PAGE INTENTIONALLY LEFT BLANK

## **Introduction**

The objective of this report is to describe the financing policies of the Canada Pension Plan (CPP) and the Quebec Pension Plan/Régie des rentes Québec (QPP). Also discussed are the organization and experience to date of the CPP Investment Board (CPPIB) and the Caisse de dépôt et placement du Québec (the Caisse).

The report begins by reviewing the historical development of CPP and QPP financing policies. It then discusses the specific mandates, organization and investment policies, and experience of the CPP Investment Board and the Caisse de dépôt et placement du Québec. The final section reflects on the success to date of the reforms implemented in Canada and whether these might have application in the United States.

For those readers unfamiliar with the Canadian pension system, Appendix A contains a brief overview of the three-tiered pension system.

## **The Evolution of the Canada and Quebec Investment Funds**

Canada differs from the United States in having a large pension program financed from general revenues that pays benefits to all residents age 65 and over regardless of their earnings history. This program guarantees a minimum income to every resident 65-plus, thus forming the bottom tier of Canada's three-tier pension system. The CPP and QPP therefore play a smaller role in income replacement, especially for those with low incomes, than does the U.S. Social Security system. Like the U.S. Social Security system, however, the CPP and QPP are public mandatory defined benefit pension plans, financed by a compulsory deduction of a proportion of earnings (including from those individuals who are self-employed).

In the 1990s, there were increasingly shrill alarms about the CPP's "impending bankruptcy." In response, the CPP's financing was comprehensively reformed in the late 1990s. The alarms now have been largely stilled in Canada, so the story of CPP reform should be of interest to those concerned about restoring confidence in the future viability of Social Security. The CPP reformers had the unique advantage of looking within Canada at a parallel pension plan—the QPP—with more than 30 years of experience with its own financing mechanism. The CPP's financial reform was largely built upon lessons from the QPP—both positive and negative. So, to understand the CPP reforms, we must look back into the history of these two plans and see how Canada came to have two parallel plans with differing financing structures, and what lessons were learned from the Quebec experience.

Unlike many Western countries, Canada's network of social programs was developed mainly in the late 1960s and early 1970s, rather than in the immediate post-Depression and post-World War II periods. Beginning in 1966, several major social programs were introduced, including a universal guaranteed income for pensioners, a new national welfare program for those most in need, universal medicare, and the Canada and Quebec Pension Plans.

The precipitating event for this burst of activity was the "Quiet Revolution" in Quebec. In the early 1960s, Quebec emerged from many decades as a poorly educated, mainly rural province in which social life was dominated by the Catholic Church and business life was dominated by the Anglophone minority. Quebec started down a path towards becoming a

dynamic society committed to secularization and rapid modernization, and the creation of a Francophone business and professional class. Within the province of Quebec, reformists took charge of the provincial government, intent on using the instruments of the state to achieve their objectives. At the federal level, the new progressive political consensus in Quebec soon dominated the thinking of all of the national parties, turning the country towards an activist agenda.

As part of this new agenda, both levels of government were determined to improve the situation of the elderly. To do so, the federal government and some provincial governments were busily preparing plans for improved pensions. The federal approach was for a modest contributory public plan that would be strictly pay-as-you-go so as not to build up any investment fund. Some provinces, notably Ontario, favored mandatory private plans. However, Quebec advocated a more ambitious strategy—a public partially funded mandatory contributory scheme. One of the features of the Quebec plan was the accumulation of a large pool of capital. Since contributors would vastly outweigh beneficiaries in the first decades of operation, even a modest contributory rate would result in substantial initial surpluses that would build a large investment fund. Among Quebec's reasons for adopting this approach were its intentions with respect to the investment fund—the provincial government wanted to use the fund as an active vehicle for the realization of its political and economic goals. This was to be achieved through reinvestment in the development of indigenous businesses and support for modernization (Brooks and Tanguay 1985; Castonguay 2002).

In Canada, the federal government had to enter into negotiations on pension reforms with the provinces: the federal government could not proceed unilaterally with its plans because prior court rulings had established that contributory social insurance was an area of provincial jurisdiction. Federal laws would be ruled invalid without a constitutional amendment. A constitutional amendment, in turn, required the consent of a majority of the provinces (Simeon 1972).

In the ensuing negotiations, Quebec was able to convince the federal government and most of the other provinces that its plans were superior. One of the main features that helped bring other provinces around to Quebec's view was the attraction of easy access to capital. The provinces were faced with the need for massive, rapid expansion of their post-secondary education and health systems, which would require huge amounts of borrowing. In the 1960s, capital markets were relatively undeveloped and the provinces, especially the smaller provinces, had difficulty raising capital at reasonable prices.

In the new arrangement worked out for the proposed contributory plan, each participating province would have access to funds equal to its share of contributions minus benefits, which would be lent at an interest rate equal to the average yield of all outstanding Canadian government obligations with terms of 20 years or more (a rate as low or lower than even the wealthiest province could expect to obtain on its own). The provinces would issue 20-year non-marketable bonds to the pension plan in exchange for these funds, and the provincial bonds would then be the main assets of the pension plan. Although there would initially be a large surplus each year to put into the investment fund, it was projected that eventually the pension plan would maintain assets sufficient to pay benefits for two years in the absence of further contributions. The forecast was that an initial contribution rate of 3.6 percent (to be shared

equally between employers and employees) would have to rise to about 5.5 percent, which was considered to be easily manageable.

One unanticipated consequence of this federal-provincial arrangement was that the CPP fund ended up consisting of reasonably tangible assets in the form of provincial bonds, albeit non-marketable, as contrasted to the United States, where the federal government was able to lend Social Security funds to itself so that its assets appeared to be less “real” and more of a bookkeeping transaction.

The negotiations also arrived at an arrangement regarding the governance of the pension plan and opting-out privileges for the provinces. The federal government would administer the CPP, but any changes in policy or programs would require the agreement of two-thirds of the provinces with two-thirds of the population. In addition, any province would have the right to opt out and set up a parallel plan. Only Quebec opted out, establishing the Quebec Pension Plan. It had identical provisions as the CPP and there was complete portability between the two plans. One of the elements of the agreement was to mandate a federal-provincial review of CPP financing every 5 years, which would establish a 25-year contribution schedule, based on a public actuarial review. This provision guaranteed intense periodic public scrutiny.

The multi-party governance of the CPP implies that any changes must be consensual and part of a larger bargaining process. Although in theory the QPP could be changed unilaterally by Quebec and could vary from the CPP, it is in everyone’s interest to maintain portability. To date the CPP and QPP have remained almost identical with respect to retirement benefits and contributions. Over time the QPP has varied slightly for several years in providing somewhat more generous survivor’s benefits and easier access to disability pensions for those aged 60 to 64 (Quebec Pension Plan 2003), but the most significant difference between the two plans was Quebec’s use of QPP funds as more than a passive supply of government capital.

In 1965, Quebec set up La Caisse de dépôt et placement du Québec (The Quebec Deposit and Investment Bank) as a vehicle to invest its QPP funds. The Caisse was not given a clear mandate in the law establishing it, although one section within the chapter setting out requirements regarding investment does state that the Caisse “shall...adopt an investment policy [that] must also take into account the financing needs of the public sector and economic development of Québec” (Province of Québec 1965: Section 36). However, most observers of the Caisse have not interpreted this section as a mandate and the Caisse’s understanding of its mission has consequently been sensitive to the shifting political philosophies of the government.

In any case, the Caisse was usually considered to have a dual mandate: to maximize returns on investments while contributing to the development of the economy of Quebec. Today’s mandate and organization of the Caisse is discussed further below, but in the beginning the Caisse’s dual mandate and supposed lack of independence was highly controversial—the Caisse “met with strong though muted resistance from the Montreal financial establishment, which could not conceive of the government’s giving itself such a powerful tool. The establishment saw the project as a threat to its influence on government finances and the Quebec economy. Some also feared that the Caisse would be used by politicians as an instrument of patronage” (Castonguay 2002). In addition, at the time, the province had not developed the capacity to borrow directly on its own, and two financial institutions had a virtual monopoly on

Quebec debt financing. The Caisse would break up this monopoly by buying debt instruments directly from the province. The opposition from the financial community and the anticipation that lucrative fees would be lost was perhaps not entirely coincidental.

Despite this resistance, once set up, the Caisse quickly became a well established and significant investor in Quebec and Canada. For the first 10 years of the Caisse's existence, the "ambiguity in the Caisse's charter elicited little controversy or debate" (Brooks and Tanguay 1985: 105). The Caisse initially did not fully use its mandate to purchase equity holdings; instead much of its funds were put into Quebec bonds. Not that these purchases were unimportant—they played a significant role in propping up Quebec bonds during several political crises (such as the Front de Liberation du Québec crisis in 1970 when the War Measures Act was declared and Canadian soldiers occupied key buildings in Montreal). When the Caisse did invest in equity of publicly traded corporations, it was as a passive investor consistent with the tradition of large pension funds of the day. But the Caisse did indeed break the monopoly on government debt financing, while it became a well-accepted player within Quebec.

All of this changed in the late 1970s with the election of a Parti Québécois government that had campaigned on using the Caisse more actively as an instrument of economic development. A number of highly contentious public battles ensued, most notably a demand by the Caisse for board representation on Canadian Pacific (a large diversified Canadian holding company, mainly in transportation), since it had become one of the single largest shareholders. Canadian Pacific management hotly resisted this demand and was supported by much of the Anglophone business community nationally, but not the Francophone business community in Quebec—the latter tended to side with the Caisse. This became such a heated battle that in 1982 a measure was introduced to disallow any provincial agency from owning more than 10 percent of the shares of an inter-provincial transportation company. The bill was aimed squarely at the Caisse, but the sitting government was defeated in the 1983 election before the bill was passed. The attempt to restrict the Caisse had been an election issue in Quebec and was one of the contributing factors to the governing party's loss of most of its seats in that province.

With respect to the returns on its investments, depending upon whose assessment is considered, the Caisse either performed in line with other major private investment funds or did almost as well.<sup>1</sup> Despite all of the controversy that ensued, it was widely agreed that the Caisse investments on behalf of the QPP performed considerably better than the provincial bonds held by the CPP.

This Caisse history is critical to the later development of an investment fund for the CPP. Given these relatively recent and dramatic events, the question of whether a large government-run investment fund could be politically neutral, and the question of whether it should have an economic development as well as a profit-maximizing mandate were central to any consideration of setting up an investment fund for the CPP. Put simply, given the battles around the Caisse, the Canadian business community would not accept a CPP investment fund that was seen as anything less than fully independent and business-like. The federal government did not have the option of proceeding unilaterally—the nature of decisionmaking for the CPP meant that a

---

<sup>1</sup> Brooks and Tanguay (1985) in citing Pierre Fournier's (1979) *Les sociétés d'Etat et les objectifs économiques du Québec* argued that the Caisse performed as well as private funds. But, see Castonguay (2002) who contends that it did not perform quite as well.

consensus of most of the business and social groups was required in order to get the provinces to agree to a change. Although the last 10 years or so of Caisse history have been much less contentious, and although studies have argued that the Caisse actually did very little to exercise its economic development mandate and did nothing at all to intervene politically (Brooks and Tanguay 1985), the issues of mandate and autonomy remained when the time came to consider a CPP fund that could invest beyond government securities. That time came in the mid-1990s when the financial structure of the CPP appeared to be increasingly shaky and the anticipated higher returns from market investments were increasingly attractive.

For the first 20 years, both the CPP and the QPP functioned largely as planned in 1966, with an unchanged contribution rate of 3.6 percent. As part of continuing debate over pension reform in the 1970s and early 1980s, the Canadian Labour Congress proposed a regular 5-year review of the CPP by an independent actuary. This proposal was adopted in the 1984 budget.

However, by the time of the first 5-year review in 1986, the existing contribution rate was reported to be inadequate to sustain the plans. The main factors contributing to the inaccuracy of previous forecasts were slower growth in population than anticipated, somewhat enriched benefits, large increases in disability enrollment, and slower than projected economic growth. In response, the provinces and federal government agreed to increase rates gradually on a fixed schedule starting at 0.2 percentage points a year. However these increases proved insufficient, and the chief actuary's mandatory 1993 review raised some alarm bells (Office of the Chief Actuary 1993). The chief actuary reported that contribution rates would have to increase to 14.2 percent by 2030, not the 10.3 percent as previously discussed. (Although it should be noted that since this was a 14.2 percent contribution on *pensionable* income—income above the basic exemption and below the maximum pensionable earning limit—it was substantially less than 14.2 per cent of total income.)

This actuarial report instigated a significant public debate about the sustainability of the CPP, with many pundits and the political opposition claiming that the CPP was going bankrupt, that future generations would not be willing to pay more than 14 percent of their wages, and that the whole thing was nothing more than a complicated shell game. Confidence in the CPP was seriously undermined.

In the meantime, Quebec had already come to the conclusion that whatever solution was found, the QPP would have to preserve a significant investment fund as the Caisse continued to be seen as a vital instrument of the Quebec economy, and the investment fund was, in turn, vital to the Caisse. Quebec developed an option for steady-state financing. This is a contribution level just large enough so that it will neither have to be increased nor decreased in the foreseeable future. Steady-state financing would still leave the QPP (and CPP) largely as pay-as-you-go plans, with future benefits financed mainly by future contributions, but a pool of funds would be created just large enough so that the earnings and draw-downs from the fund itself would smooth over the demographic downturns and allow for a single unchanging contribution rate for the next 50 years. It is often argued that full financing (i.e., a fund large enough so that if the plan is dissolved at any time, there will be sufficient assets to pay all promised pension benefits) is needed because future burdens will be so high that workers will balk at paying the bill. But steady-state financing is a clever alternative that achieves confidence in sustainability without

full financing; if today's workers are willing to pay  $x$  percent, why should not future workers also be willing to pay the same  $x$  percent?

In 1996, the federal and provincial governments undertook a wide-ranging public review of the options for the CPP (Federal, Provincial and Territorial Governments of Canada 1996). The result of the consultations was a three-part solution that gathered considerable consensus throughout Canada—among business and social groups, and by most provinces. This solution essentially adopted Quebec's proposed strategy:

1. The contribution rate would be set at a level that would result in steady-state financing.
2. A separate and independent CPP investment fund would be created.
3. The steady-state contribution rate would be kept below 10 percent by implementing various cuts in benefits, as well as freezing the base level of income exempted from contributions (so that, due to inflation, over time a lower real level of income would be exempted from contributions to the CPP, thereby raising effective average contribution rates). Even with an independent investment fund and anticipated higher returns, steady-state financing at 1996 benefit levels would have required a contribution rate of about 12 percent.

#### *The Independent CPP Investment Fund*

There were several possible contributing factors to the financial community's agreement to set up a CPP investment fund.

To achieve steady-state financing it would be necessary to create an investment fund and to draw down some of the investments from time to time. An investment fund made up of non-marketable provincial bonds would certainly have been possible for this purpose, but the returns on provincial bonds would likely be less than the returns from an investment fund mandated to maximize returns in all capital markets, including equities. Moreover, the public did not seem to have confidence in the "tangibility" of non-marketable government bonds as assets. Yet, at the same time, the Caisse experience meant that Canadian business was opposed to any investment fund that did not have ironclad guarantees of its independence and a private-sector type of investment optimization mandate. Thus, the creation of an independent CPP investment fund with a legislated mandate was viewed as a viable solution.

Perhaps not entirely unrelated to the consensus around this option, capital markets had now developed to the point where provinces had easy access to capital on relatively good terms. Indeed, with the federal budget surpluses since 1995, less new Canadian government debt was coming into the market, so that provinces were finding ready buyers for the limited supply of Canadian government bonds and no longer needed CPP capital. As well, Canada's accounting system had long counted CPP assets as off book and they would now be even more clearly off book with an independent investment fund, so that the added payroll tax would be exactly offset by the transfer of cash to the investment fund and would not affect budget balances.

There was also the possibility of generous new fees coming out of this large pool of capital. As presently organized, the CPP simply converted its net surplus into provincial bonds with no private sector involvement. The creation of a new Canada Pension Plan Investment Board (CPPIB) would at the very minimum generate some turnover in the equity markets, and if the investment board contracted external investment advisors, this could also be the source of substantial consulting income—as indeed has happened.

### *Keeping a Low Steady-State Contribution Rate*

Even with an independent investment fund and anticipated higher returns, steady-state financing would have required a contribution rate of about 12 percent. The then Conservative governments of Alberta and Ontario insisted that whatever was done, the contribution rate would have to remain below 10 percent, and because of their population size, these two provinces had an absolute veto over changes in the CPP (Baldwin 2004). To reduce the contribution rate to below 10 percent various cuts in benefits were undertaken. As well, the average effective contribution rate was allowed to increase gradually with inflation by freezing the base level of income exempted from contributions (at C\$3,500) rather than continuing to index the base income exemption (so that, due to inflation, over time a lower *real* level of income would be exempted from contributions to the CPP, thereby raising effective average contribution rates and increasing the regressivity of the CPP payroll tax).

The result of the three-part solution would be a steady-state contribution rate of 9.9 percent through the 100-year forecast period<sup>2</sup> and an investment fund that would reach 5 to 6 years of funding for all benefits by 2050, with the investments to be made through an independent agency (what was to become the CPP Investment Board).

Since the institution of the new measures in the late 1990s, talk of the insolvency of the CPP has evaporated among decisionmakers. A search reveals no media reports warning of the coming insolvency of the CPP (or the QPP). The issue has not appeared on the political agenda of any of the four major parties involved in federal politics. In financial terms, the benefit cuts and contribution increase through freezing of the exemption level were by far the most important contributors to the long-term stability of the CPP and QPP. But in political terms, the concept of a single unvarying contribution rate (steady-state financing) and the existence of marketable assets were likely the most important. Perhaps not entirely unrelated, the business community is now pleased to see the CPP as a major new player buying Canadian equities and bidding up the price of other assets (like real estate), while providing some lucrative fees for private investment fund management firms.

The most recent actuarial review of the CPP confirmed that the steady-state contribution rate of 9.9 percent, when combined with investment revenue, would be adequate to pay for benefits into the future (Office of the Chief Actuary 2004). The media often refers to the sound funding of the CPP. Comments such as “Paul Martin...fixed Canada's pensions mess years ago” in the *Globe and Mail* (2005) and “Canada Pension Plan on solid ground, actuary says” in the *Toronto Star* (Daw 2004) are now the norm.

---

<sup>2</sup> The 100-year forecast is up to the year 2100, although only a 50-year forecast is considered reliable by the Chief Actuary.



However, the reforms have *not* yet changed the views of ordinary Canadians. The CPPIB commissioned a series of surveys of public opinion “to assist the CPP Investment Board in understanding public confidence in its ability to contribute to the long-term health of the Canada Pension Plan” (Ekos Research Associates Inc. 2004: 1). The first survey was to establish a benchmark in March 2002 and the final survey (out of a total of five) in April 2004. The main findings of Ekos Research with respect to confidence in the CPP were that the attitudes toward the CPP have not improved; rather they have worsened. In addition,

- “Over half still feel the CPP will run out of money by the time they retire” and
- “An increased number feel the CPP is moving in the wrong direction (although they are still outnumbered by those who feel it is moving in the right direction)” (Ekos Research Associates Inc. 2004: 25).

The general non-responsiveness of the public as revealed through survey data is in stark contrast to the anecdotal evidence from elite decisionmaking bodies. It may be that this is just a matter of lagging public opinion. As anyone familiar with modern communications knows, it is extraordinarily difficult to re-establish confidence in a brand name once it has been sullied, and the CPP had, for the previous several years, been reviled by the business press and some opposition politicians as near bankrupt and unreliable. There is nothing easy about winning back public confidence. It is likely that the CPP will have to sponsor a major communications campaign with paid advertising and some re-branding to win back the public. Despite the survey results, the reforms have accomplished the political goals of taking the issue off the table. It may be that public opinion will eventually catch up.

## **The CPP Investment Board**

### *The CPPIB’s Mandate*

The CPPIB is what is known in Canada as a “Crown Corporation,” an incorporated company with the federal government as the single shareholder. The CPPIB was established in December 1997 with the Canada Pension Plan Investment Board Act. The law sets out the objectives of the CPPIB:

- “(a) to assist the Canada Pension Plan in meeting its obligations to contributors and beneficiaries; under the Canada Pension Plan;
- (b) to manage any amounts transferred to it under section 108.1 of the Canada Pension Plan, and its right, title, or interest in any designated securities, in the best interests of the contributors and beneficiaries under that Act; and
- (c) 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 on any given business day” (Government of Canada 1997: Section 5).

The law prohibits the CPPIB from carrying out any business activities inconsistent with the stated objectives: “The Board and its subsidiaries shall not, directly or indirectly, carry on

any business or activity or exercise any power that is inconsistent with the Board's objects” (Government of Canada 1997: Section 6 (2)). The act thus prevents the CPPIB from assuming a dual mandate and any variation would require an amendment to the law.

### *Board and Management*

A committee of representatives, appointed by the finance ministers of the participating provinces and chaired by a private-sector executive, nominates the 12 directors. The federal finance minister then makes the appointments in consultation with the participating provincial ministers. The directors normally serve three-year terms (except for the first board, which was appointed on staggered terms to provide continuity when new directors were chosen). The federal minister also appoints the board chair with the advice of the participating provincial governments. The federal minister is directed by the law to “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” (Government of Canada 1997: Section 10 (4)).

Other than the requirement to seek, but not necessarily attain, regional representation, the appointment process is meant to maintain professional standards. The act does not provide for any means through which the federal minister of finance can direct or influence the board, other than through the appointment process, and that process has several checks and balances. Further, directors would be in conflict with their fiduciary responsibilities should they accept direction from the government that did not accord with their responsibility to “maximize the rate of return.”

The current board is made up of experienced executives, mainly from the financial services industry, with one former politician on the board (who was the parliamentary secretary to the minister of finance largely responsible for setting up the CPPIB and managing the CPP reform process). The board looks much like any private-sector board of a large pension fund.

Similarly, the management of the CPPIB is of a professional and experiential caliber that would be expected for an investment fund of this size. The founding CEO retired in 2004, as planned, and a new CEO was appointed in January 2005. The board of directors appoints the CEO—it is not a government appointment. The new CEO was recruited from Fidelity Investments where he was president, with 24 years of experience in the sector. The other members of the executive team reflect appropriate backgrounds (see [www.cppib.ca](http://www.cppib.ca)). At the present time, the CPPIB invests mainly through external fund managers, rather than using its own employees, so its in-house organization remains smaller than might otherwise be expected for a fund of its size.

The CPPIB reports that in fiscal 2005 “total operating expenses remained unchanged at seven cents per \$100 of invested assets” (CPPIB 2005: 18). This is a very high management expense ratio for a fund of this size, especially when a sizable portion of its portfolio is in 20-year non-negotiable government bonds. Some of the relatively high CPPIB management costs may be due to start-up expenses, but some might also be attributed to the use of external fund managers with high fees. The management cost of the CPPIB has not yet been the topic of any

external assessment. If the management expense ratio reported by the Caisse of 0.16 percent is a fair comparison (and it is not possible to be certain without a more detailed analysis), the CPPIB could potentially achieve an improvement of more than 0.5 percent on the returns of its total portfolio by switching to the more efficient structure of the Caisse. This is no small amount.

### *CPPIB Investment Limitations*

The CPPIB is subject to the following limitations on its investments:

1. The regulations require that the “Board shall not directly or indirectly invest more than 10 per cent of the total book value of the Board's assets in the securities of any one person; two or more associated persons; or two or more affiliated corporations” (Government of Canada 1999: Section 11 (1)). However the 10 percent limit does not apply to federally or provincially guaranteed securities (such as CPP bonds) and also does not apply to “a fund that replicates the composition of a widely recognized index of a broad class of securities traded on a public exchange” (Government of Canada 1999: Section 11 (1) (d)).
2. The regulations limit investment in any single real property or Canadian resource property (such as a mine) to a book value at the time of investment of 5 percent of the board's assets. The aggregate of all Canadian resource property is limited to 15 percent and the aggregate of all real property plus Canadian resource property is restricted to 25 percent of the book value of CPPIB assets (Government of Canada 1999: Section 12 (1)).
3. The CPPIB is not permitted to hold more than 30 percent of the voting shares of any corporation (Government of Canada 1999: Section (13)).
4. Section 14 of the CPPIB Act states that: “(1) The Board shall not directly or indirectly hold or invest in a derivative where the market exposure of the Board under the derivative is not covered by cash or other assets of the Board designated for that purpose. (2) The Board may hold or invest in a derivative if the purpose of the transaction is (a) to offset or reduce the risk associated with an existing investment or group of investments, or (b) to hold or invest in the derivative as an alternative to holding or investing in the underlying asset itself” (Government of Canada 1999: Section (14)). This seems to mean that the CPPIB may invest in derivatives only as a hedge against its risks associated with an asset that it holds, or as a means of leveraging investment in an underlying asset. The provision has not yet been tested in practice and it is undoubtedly subject to a variety of interpretations.
5. For the first two years of its operation, the CPPIB was restricted to investment in index funds, so that it was strictly a passive investor. This quickly became a problem for the CPPIB because of the dominance of Nortel at its highest valuations in the Toronto Stock exchange; buying the index meant buying a large share in Nortel. As a result the CPPIB was relieved of this limitation earlier than planned, and it managed to reduce its holding before Nortel's collapse. The

CPPIB still suffered substantial losses, but much less than it might have experienced.

Initially the CPPIB was also constrained by the Foreign Property Rule that limited non-Canadian holdings to 30 percent of its portfolio. However, this rule is now being eliminated (for all registered Canadian pension funds) and it will no longer apply to the CPPIB.

Overall, these restrictions are not out of the ordinary and reflect prudent limitations that could be accepted by any large fund. There has not been any negative comment from the financial community that these conditions are onerous or limit the potential long-term returns of the CPPIB, except with respect to the Foreign Property Rule and this rule is now being eliminated.

### *CPPIB Investment Practices and Performance*

The CPPIB was permitted to begin active investment in equities only in 2000, as federal regulations restricted it for the first few years to passive investment in equity markets through index funds (as noted above). Active management began in the late summer of 2000, so the fund is still in the process of implementing its investment strategy, which is far from mature. As all of the holdings of the CPP were in provincial CPP bonds, achieving a reasonable mix of asset types requires moving new funds in the CPPIB almost entirely into equities. CPPIB fund holdings as of March 31, 2004 and 2005 are shown in Table 1.

Table 1 shows both assets now held by the CPPIB and those still held directly by the Canada Pension Plan. The transfer of CPP provincial bonds and cash to the CPPIB began in 2004 and is scheduled to take three years to complete. All assets of the CPP should be held by the CPPIB by September 2007 (Canada Pension Plan Investment Board 2004: 15).

**Table 1**  
**CPP Reserve Funds, 2004 and 2005<sup>a</sup>**  
**(C\$ billions)**

Asset type	2005		2004	
	\$ Amount	% of total	\$ Amount	% of total
Bonds	28.6	35.3	30.2	42.9
Publicly Traded Stocks	45.7	56.2	30.2	42.7
Private Equities	2.9	3.6	1.8	2.5
Real Estate and Infrastructure	1.0	1.2	0.7	1.0
Cash	2.8	3.4	7.5	10.6
Money Market Securities	0.3	0.3	0.2	0.3
<b>TOTAL<sup>b</sup></b>	<b>\$81.3</b>	<b>100%</b>	<b>\$70.5</b>	<b>100%</b>

Source: CPPIB, 2005.

a. Fiscal years end on March 31.

b. Totals may not add due to rounding.

The performance of the CPPIB has had some very dramatic ups and downs, as can be seen on Table 2. Almost all of CPPIB investing has been in equities, and these have had a return as low as -20.9 percent in 2003, followed by a high of +31.8 percent the next year. The nominal fixed income returns on Table 2 are almost entirely composed of the CPP bond portfolio. Since these are not tradable, their “return” is based on an estimated fair market value for comparably termed government bonds (these were not estimated in 2000). The consolidated returns combine the results of the assets managed by the CPPIB and those remaining in the CPP. These returns are better because of the greater weight of the fixed income bond portfolio during years of poor returns on equities.

**Table 2**  
**Performance of CPP and CPPIB Funds, 2000-2005<sup>a</sup>**

Assets	2000	2001	2002	2003	2004	2005 YTD
Equities (CPPIB)	40.1%	(9.4%)	3.4%	(20.9%)	31.8%	8.2%
Nominal Fixed Income	-	9.9%	5.0%	8.4%	8.7%	3.6%
Consolidated CPP Reserves	3.2%	7.0%	5.7%	(1.5%)	17.6%	6.2%

Source: www.cppi.ca.

a. Fiscal years end on March 31.

As of March 31, 2005 the CPPIB had a five-year average real rate of return (after adjusting for inflation) of 4.5 percent (Canada Pension Plan Investment Board 2005). The CPP’s 9.9 percent steady-state contribution rate is predicated at approximately a 4.1 percent real rate of return (Office of the Chief Actuary 2004). The rate of return required to maintain the 9.9 percent steady-state contribution rate is the critical benchmark, according to the CPPIB, and the investment board has surpassed that benchmark in its first years of operation. In addition, the CPPIB has established a number of customized benchmarks, suited to its size and type of fund. It has performed well against these benchmarks as shown in Table 3.

As noted in the previous section, the decision to set up an independent CPP investment fund is distinct from the decision to go to a steady-state contribution rate. As in the past, reserve fund could as easily have been made up of non-marketable government bonds. Aside from the perception that independently held marketable assets are real assets while non-marketable government bonds are more ephemeral, the only concrete reason for going to an independent investment fund as opposed to remaining in government bonds is to obtain a higher rate of return.

With only about C\$45.7 billion invested in public equities, the CPPIB has not yet had a noticeable impact as a dominant player in the Canadian equities market. The market capitalization for the Toronto Stock Exchange alone is more than C\$1.5 trillion, with an average of C\$3.5 billion to more than C\$4.0 billion traded daily on the exchange (Toronto Stock Exchange 2005). The CPPIB’s anticipated capacity to be a dominant player in the Canadian equity market was cited by one Canadian bank as a reason for relaxing previous restrictions on foreign investments (Partridge 2005), but these restrictions are now being eliminated. Although

**Table 3**  
**CPP Investment Performance**  
**Rate of Return Compared to Benchmarks, 2004 and 2005<sup>a</sup>**

Asset Type	2005		2004	
	Actual Returns	Benchmark Returns	Actual Returns	Benchmark Returns
Canadian Equity Investments	16.2%	16.0%	34.3%	37.0%
Non-Canadian Equity Investments	4.9%	3.1%	24.5%	29.5%
Real Return Assets	11.8%	10.7%	50.5%	15.3%
Nominal Fixed Income <sup>b</sup>	5.2%	5.9%	-	-
Total Returns	10.7%	9.9%	31.7%	34.4%

Source: CPPIB, 2005.

a. Fiscal years end on March 31.

b. Benchmark first established in 2005

this potential dominance was a significant topic of discussion when the CPPIB was being set up, a search of major Canadian media finds no other comments about the CPPIB role in the marketplace.

### **The Caisse de dépôt et placement du Québec**

#### *The Caisse's Mandate*

The Caisse, like the CPPIB, is a crown corporation—meaning that it is a company owned by the province of Quebec. The Caisse is incorporated through a 1965 statute of the provincial legislature of Quebec (An Act Respecting the Caisse de dépôt et placement du Québec, 1965). As noted previously, the original Caisse law contained only a tangential statement of its mandate in an obscure part of the statute. According to this statement, the Caisse investments must take into account the economic development needs of Quebec. Indeed, this section is so little observed that both academic writers and the Caisse itself failed to note it (Lizée 2004). The Caisse is widely perceived as having had a mandate both to maximize returns on the funds it holds and to promote the economic development of Quebec (Castonguay 2002; Brooks and Tanguay 1985; The Caisse de dépôt et placement du Québec 2003b). Of course, the difficulty arises when the former is in possible conflict with the latter. Neither an informal mandate nor the 1965 statute provides guidance in resolving the possible conflict.

In 2003, the Caisse undertook an internal review of its governance (The Caisse de dépôt et placement du Québec 2003b). The review called for several amendments to the Caisse Act, including this clear mission statement:

“The Caisse's mission is to manage the collective assets of its depositors by seeking to generate returns on capital in accordance with individual investment policies. In pursuing that objective, the Caisse contributes to the economic growth of Québec” (The Caisse de dépôt et placement du Québec 2003b: 5).

The Parti Québécois government in 2003 did not act on the Caisse's recommendations, but a new Liberal government was elected and enacted a new governing statute in January 2005. This act responded to most of the Caisse's recommendations, except that it moderated the Caisse's proposed mission statement. The proposed mandate would have clearly put optimizing investment returns as the first and, in essence, the only objective of the Caisse without allowing for policy setting by the provincial government. The mandate actually included in the new statute reads:

“The mission of the Fund is to receive moneys on deposit as provided by law and manage them with a view to achieving optimal return on capital within the framework of depositors' investment policies while at the same time contributing to Québec's economic development” (Province of Québec 2005: Section 4.1).

This legislated mission contains the important proviso “within the framework of depositors' investment policies,” which would seem to allow for the government to establish a policy framework for the Caisse. The new mandate is also somewhat more ambiguous with respect to the dual mandate of economic development than what was proposed. The chair (and CEO) of the Caisse has argued that there is no ambiguity because “the best way for the Caisse to contribute to Québec's economy is to strive for, and to obtain, the best possible return on its investments, subject to a level of risk that is acceptable to the depositors' plans” (Rousseau 2005: 3). In other words, he claims that there can never be a conflict within the dual mandate because obtaining the best return is always the way to promote economic development.

The chair's argument may (or may not) be convincing. However, the evidence suggests that the government made a deliberate decision to retain its capacity to set investment policy, as well as to reflect the dual mandate of maximum return with acceptable risk and promoting economic development. By 2003 the CPPIB law was available as a model. It clearly spells out that there is only one objective for the CPPIB and it provides no room for government policy-setting—the Caisse has stated that the CPPIB was one of the comparable organizations it looked at in its review. The Caisse's economic development role remains both popular and credible with the general population in Quebec, where the Caisse is widely seen as having made a positive contribution both to economic modernization and the emergence of a Quebec business class (Castonguay 2002). In short, Quebec *chose* to retain government policymaking authority and something of an objective other than maximization of returns with acceptable risk for the Caisse, which distinguishes the Caisse from the CPPIB.

### *Board and Management*

The original 1965 act setting up the Caisse required that a board of directors of nine members be appointed by the government, without spelling out any nomination process. However, of the nine members, “two shall be chosen from among the officers of the Government or the directors of a government agency, another shall be chosen from among the representatives of associations of employees, and another shall be chosen from among the directors of cooperative associations” (Government of Québec 1965: Section 5). In addition, three government representatives were made ex-officio members of the board without voting rights: the Québec deputy minister of finance, one senior officer of Hydro-Québec's finance branch, and

one member of the Commission municipale du Québec or an officer of the Québec Ministère des Affaires municipales et de la métropole (Government of Québec 1965: Section 6).

The new act changed all this. Under the revised law, there are no ex-officio government members of the board, nor is there any longer a requirement to have four members from government departments. Instead, the new act requires that at least two-thirds of the members of the board of directors be independent, meaning that they are not government employees or employees of any of the agencies on whose behalf the Caisse manages funds, nor can they have any beneficial interest with the Caisse.

According to the new law, “Independent members are chosen in light of the expertise and experience profile established by the board of directors, if any” (Government of Québec 1965: Section 5.6). Presumably this is to facilitate the establishment of a non-governmental nomination process, as was recommended by the Caisse in its report on governance. It also removes or reduces the union presence on the board. However, it is too soon to know what nomination process will actually be put in place.

Under the Parti Québécois government, the offices of chair and CEO were combined into one position. The new act follows the recommendation in the Caisse report on governance, “the two functions [will] be separate and carried out by two different persons” (The Caisse de dépôt et placement du Québec 2003b). The government will appoint the new chair, but the board of directors will appoint the president and CEO.

With respect to administration, the Caisse has a well-regarded management team with the background and experience commensurate with their responsibilities. The Caisse reports that its administrative costs at approximately 0.16 percent of assets under management. The Caisse attributes its low operating costs in part “to its decision to rely on internal management more than other North American managers and the magnitude of its activities, which enables the Caisse to benefit from economies of scale” (The Caisse de depot et placement du Québec 2003a). These operating costs compare very favorably with those of the CPPIB.

#### *The Caisse’s Investment Limitations*

In general, the rules governing the Caisse’s investments are less constraining than those governing the CPPIB.

With regard to derivatives and similar products, the new law is explicitly permissive, allowing the Caisse to “acquire, hold, sell, invest in or conclude: options and futures contracts; currency exchange agreements; interest rate exchange agreements; credit derivative contracts; equity derivative contracts; any other instrument or contract of a financial nature determined by regulation (Province of Québec 2005: Section 33.1).

Finally, the Caisse has a special authorization that opens the door to almost any investment at all. The general provision is broad enough to allow the Caisse to:

“make any investments, operations or loans other than those which it is authorized to make under the preceding sections, subject to the following restrictions: the total amount invested in investments, operations and loans under this section shall not exceed 10% of



the Fund's total assets; and under this section, the Fund may not invest more than 1% of its total assets in one legal person, in an immovable<sup>3</sup> constituting a single undertaking, in a debt secured by any such immovable or in a loan secured by securities of one legal person or by a debt secured by an immovable constituting a single undertaking” (Province of Québec 2005: Section 34).

### *The Caisse’s Investment Practices and Performance*

Over the years the government of Quebec has placed many other funds under the management of the Caisse. The Caisse currently manages 19 public and quasi-public funds, such as the Quebec government employees pension plan funds, the workers’ compensation board fund, the fund of the public auto-insurance corporation, the pooled pension fund for the construction sector, and the Quebec public service pension fund.

As can be seen in Table 4, by 2003 the Caisse had a varied portfolio of investments. The Caisse managed about C\$90 billion of public sector assets in 2003 (and more than C\$100 billion of total assets), of which about C\$19 billion were QPP funds (The Caisse de dépôt et placement du Québec 2003a). Note that although approximately C\$10 billion is in private funds, the remaining funds are all under provincial government mandates, are public service pension funds (such as the Worker’s Compensation Board), or public-sector pension funds. In other words, although only 20 percent of the Caisse is QPP funds, 90 percent are public or quasi-public.

**Table 4**  
**Caisse de Dépôt**  
**Net Assets by Investment Type, 2003**

Fixed Income	37.5%
Short-Term Investments	2.7%
Bonds	31.2%
Mortgages	3.6%
Variable Income <sup>a</sup>	42.7%
Canadian Equity	17.5%
U.S. Equity	8.3%
EAFE Foreign Equity	9.1%
Emerging Markets Equity	1.0%
Québec International	6.8%
Other Investments	19.8%
Hedge Fund Partnership Units	1.1%
Investments and Infrastructures	3.0%
Private Equity	6.8%
Real Estate	8.7%
Asset Allocation and Currencies	0.2%

Source: The Caisse de dépôt et placement du Québec 2003a.

a. All exclude private equity except Québec International.

<sup>3</sup> An immovable, which means “immovable property,” is a fixed asset such as a building or plot of land or any other tangible but non-mobile asset.

For 2003 the Caisse reports its weighted average return on funds as 15.2 percent compared to -9.6 percent in the previous year. Also in 2003 1-, 3-, and 5-year returns on Canadian equities were 27.7 percent, -0.6 percent and 8.3 percent, respectively. For the same periods, returns on bonds were 7.4 percent, 8.8 percent and 7.1 percent. The Caisse reported earnings of 12.2 percent in 2004. At present, the Caisse is widely seen as a successful investor.

## Conclusion

The Caisse's long-term investment results over the 40 years of its history, for all the controversy that has occasionally surrounded it, have been in the same range as any comparable fund. Many analysts would argue that the Caisse has simultaneously made a significant contribution to the Quebec economy. In addition, the Caisse's role in stabilizing demand for Quebec securities during critical periods should not be ignored. Without these interventions crisis sell-offs may have occurred. The decision as to whether a government-owned investment fund should have simple return maximization (within risk limits) as its objective, or adopt wider social or economic objectives, is ultimately political. The CPPIB and the Caisse are proof that it is possible to set up a government investment fund that is free of political interference, *if* that is what politicians want to do.

From a policy perspective, the most important observation arising from this review is that the benefit cuts and CPP/QPP steady-state funding, combined with investment in marketable securities, have resolved much of the debate in policy circles about the future reliability of CPP/QPP pension benefits. Independent actuarial reviews confirm that the pension plans will remain viable based on steady-state financing for at least the next 50 years and probably the next 100 years. Further, the business community has been satisfied with the role of the CPPIB as a new, big player on the Canadian investment scene.

Undoubtedly the reforms have been a political success. However, the negative perceptions of the general public still remain. What it would take to restore public confidence is not known. In the meantime, there is no public debate about the CPP so it is likely that most people are not even vaguely aware that there has been any change in the pension plan.

Although the perception of the pension plans by the general public is negative, the perception of plan solvency among the "elite" is that it is robust. The reaction to the stock market downturn and negative results in 2001 and 2003 was remarkably laconic. The discussion of the downturn—or rather, lack of discussion—and link with plan solvency was confined to the business press, and there the reaction was mainly "what goes down, also comes up." In the *Toronto Star*, Canada's largest circulation newspaper, there were only three stories about CPP/QPP negative returns in 2003, and none were especially panicky or even on the front page. Given the ready supply of experts to calm fears and the 50-year horizon of the CPP/QPP funds, it is likely that only a very long-term sustained decline would begin to cause increased concern.

What is not definitively known is whether the plans are *actually* healthier than they were with pay-as-you-go financing. Recall that there were three decisions in the reform of the CPP and QPP—benefit cuts, a steady-state contribution rate, and investing in marketable securities. Had the only change been these benefit cuts, the pay-as-you-go contribution rate would have risen from 8.3 percent in 2004 to 11.3 percent by 2050 (Office of the Chief Actuary 2004)—

meaning that there would have been many years of lower contributions than under the current arrangements, and the maximum contribution rate would only have been 1.4 percentage points higher. Is the maximum pay-as-you-go rate of 11.3 percent unsustainable while 9.9 percent is readily sustainable?

Despite the political success of the reforms, it could be argued that the CPP/QPP plans were in reality quite financially and economically sustainable on a pay-as-you-go basis, given benefit cuts and a gradual increase in contribution rates. This would make the investment fund unnecessary. However, this conclusion ignores the fact that, like a bank or insurance company, confidence is a big part of what a pension plan needs to maintain, and confidence would likely not be achievable without all three reform measures.

None of this addresses the deeper question of the effects of plan financing on macro-economic indicators. If the CPPIB is buying existing assets, is it creating any new fixed capital in the real world, or is it just bidding up the price of assets? Will the GDP be higher, lower, or unchanged due to the creation of the CPPIB? None of these questions were discussed at all in the past debate on securing the financing of the CPP.

In the United States, investing Social Security surpluses into tangible, marketable assets has also been discussed as a policy option. Such an option would necessitate the creation of an investment fund in which ultimate ownership would be vested in government. The fund would become one of the largest holders of capital in the world. This prospect has raised concerns in the United States about government interference in the economy. But the CPPIB example has shown that it is possible, and not even especially difficult, to set up a truly independent investment board, if the government sets out to do so. The lesson from the CPPIB is that there are three relatively simple elements involved in protecting the independence of a government-owned investment board:

1. A law that sets out a clear mission for the investment board and requires the board to operate in compliance with that mission;
2. Legal requirements to have at least a majority of independent directors combined with a mechanism for arm's length nomination of board members that stresses their competence; and
3. Legal requirements for periodic audits and actuarial reviews, which must be made public.

Perhaps the most innovative and surprising component of the Canadian reforms has been the steady-state contribution rate. Prior to the emergence of the steady-state concept, policy discussion was largely confined to refinements of two archetypical rate structures for a mandatory collective defined benefit plan—full-funding (which would require an investment fund large enough to pay all accrued pension liabilities at any given time), or pay-as-you-go funding (which would result in present contributions going to pay present benefits with no investment fund except for cash management purposes). Full funding was held up in the past as the gold-standard of reliability, but achieving full funding in a mandatory economy-wide pension plan requires enormous contributions and a mega-investment fund. It also poses significant

macro-economic challenges. Alternatively, pay-as-you-go with its constant reassessment of contribution rates would seem to be built on a foundation of sand. Given nothing but these financing options, alternatives other than a collective defined benefit plan (such as individual accounts) begin to appear more attractive.

Steady-state contribution rates create predictability. Rate predictability, in turn, provides a sense of on-going reliability and dependable solvency—in short, sustainability. The introduction of the steady-state financing alternative injected a new element into the Canadian debate when confidence in the CPP was at an all-time low. Steady-state financing was the critical missing element necessary to construct a viable package of reforms for the CPP. Could the steady-state financing alternative play a similar role in the United States? Would an independent fund investing in a mix of assets be necessary along with steady-state financing to restore confidence in the U.S. Social Security system, or could this be achieved by leaving funds with the federal treasury? The answers to these questions go beyond the scope of this review, but it is hoped that posing them might provide a useful contribution to the current U.S. debate.

## Appendix A Canada's Pension System

The universal Old Age Security (OAS) and the income-tested Guaranteed Income Supplement (GIS) are the foundation tier of Canada's pension system. These are non-contributory benefits paid to all residents age 65 and over. The OAS/GIS is paid by the federal government and financed from general tax revenues, not from a payroll tax. Total spending on OAS, GIS, and related programs in 2003 was C\$27.3 billion (which is about 15 percent of all federal government spending, including debt servicing). The OAS and GIS combined guarantee each single person on a pension a minimum of approximately C\$12,400 (purchasing power equivalent to about US\$10,400 as of January 2005) and each couple on a pension with approximately C\$22,400 (purchasing power equivalent to about US\$18,800 as of January 2005) (Social Development Canada 2004). The OAS is paid to all persons 65-plus subject to residency qualifications, but is taxed back through the income tax system for those with higher incomes. The GIS is reduced by 50 percent of all income as reported on the most recent tax filing.

On the second tier of Canada's pension system are the CPP and the QPP. These are almost identical plans, with the former run by the federal government in partnership with all of the provinces and the latter run by the province of Quebec. Table A1 below is a comparison of the two plans.

**Table A1  
The Canada and Quebec Pension Funds**

	CPP	QPP
Contributors, 2003	11.3 million	3.6 million
Retirement Benefits, 2004	C\$15.6 billion	C\$4.6 billion
Disability, Survivor, and Other Benefits, 2003	C\$6.6 billion	C\$1.95 billion
Total Funds, 2004	C\$76.0 billion	C\$21.2 billion

The CPP and QPP are contributory plans, financed by dedicated payroll taxes. Since the reforms of 1998 were enacted, the payroll tax rate has steadily increased to today's 9.9 percent for those who have earnings between C\$3,500 and C\$40,500 annually. The cost of the contribution is shared equally between the employer and employee. The self-employed pay the full 9.9 percent. The basic exemption level of C\$3,500 was fixed as part of the 1998 reforms, but the annual maximum pensionable earnings of C\$40,500 is indexed to average wages and increases each year. Retirement benefits in the two plans are identical: for a person retiring at age 65 in 2005 the maximum retirement benefits were C\$9,945. Retirement benefits are equal to 25 percent of one-fifth of the last 5 years' pensionable earnings. OAS and CPP/QPP benefits are additive (except for those with higher incomes), but CPP/QPP reduces GIS benefits by 50 cents for each dollar of benefits.

The third tier of the Canadian pension system consists of private tax-assisted vehicles—mainly Registered Pension Plans (which are company pension plans) and Registered Retirement Savings Plans (which are private tax-exempt savings plans similar to 401(k) plans in the United States).

## References

Baldwin, Bob. (2004). *Pension Reform in Canada in the 1990s: What Was Accomplished, What Lies Ahead?* Working Paper #30. Ottawa: Canadian Labour Congress.

Brooks, Stephen and A. Brian Tanguay. (1985). "Quebec's Caisse de dépôt et placement: tool of nationalism?" *Canadian Public Administration/Administration publique du Canada*, Volume 28, no. 1. Kingston: Queens University Press.

The Caisse de dépôt et placement du Québec. (2003a). *Annual Report*.  
<http://www.lacaisse.com/media/ar2003.pdf>.

The Caisse de depot et placement du Québec. (2003b). *Report on Corporate Governance*. Report prepared by the Human Resources, Ethics and Corporate Governance Committee. Montreal: The Caisse de dépôt et placement du Québec.

Canada Pension Plan Investment Board. (2004). *Annual Report*.  
[http://www.cppib.ca/info/annual/ar\\_2004/main.htm](http://www.cppib.ca/info/annual/ar_2004/main.htm).

Canada Pension Plan Investment Board. (2005). *Annual Report*.  
[http://www.cppib.ca/info/annual/ar\\_2005.pdf](http://www.cppib.ca/info/annual/ar_2005.pdf).

Castonguay, Claude. (2002). *Success Beyond Initial Expectations: The Quebec Caisse de Dépôt et Placement*. 30th Anniversary Lecture to the Institute for Research on Public Policy. Montreal.

Daw, James. (2004, December 9). "Canada Pension Plan on solid ground, actuary says," *Toronto Star*.

Ekos Research Associates Inc. (2004). *CPP Investment Board: Tracking Public Confidence IV, Final Report*. [http://www.cppib.ca/info/articles/Tracking\\_Public\\_Confidence\\_4.pdf](http://www.cppib.ca/info/articles/Tracking_Public_Confidence_4.pdf).

Federal, Provincial and Territorial Governments of Canada. (1996). *An Information Paper for Consultations on the Canada Pension Plan*. Ottawa: Department of Finance.  
<http://www.fin.gc.ca/cpp/summe/summe.html>.

*Globe and Mail*. (2005, February 5). "How (not) to fix pensions."  
<http://theglobeandmail.ca/servlet/ArticleNews/TPStory/LAC/20050205/EPENSION05/TPComment/Editorials>.

Lizée, Michel. (2004). *The Mandate of the Caisse de dépôt et placement: Since 1965, Financial Return and Economic Development*. Unpublished presentation. University of Quebec in Montreal.

Office of the Chief Actuary. (1993). *15th Actuarial Report on the Canada Pension Plan*. Ottawa: Office of the Superintendent of Financial Institutions.

Office of the Chief Actuary. (2004). *21st Actuarial Report on the Canada Pension Plan*. Ottawa: Office of the Superintendent of Financial Institutions.

Partridge, John. (2005, February 9). "TD urges end to foreign content limits," *Globe and Mail*.

Quebec Pension Plan. (2003). *Adapting the Pension Plan to Québec's New Realities*. Québec City: Government of Québec.

[http://www.rrq.gouv.qc.ca/an/services/Publications/etude\\_impact.pdf](http://www.rrq.gouv.qc.ca/an/services/Publications/etude_impact.pdf).

Rousseau, Henri-Paul. (2005). *The Caisse, Business Financing and Québec's Economic Development*. Address by Chairman and Chief Executive Officer, Caisse de dépôt et placement du Québec to The Canadian Club of Montreal.

Simeon, Richard. (1972). *Federal Provincial Diplomacy: The Making of Recent Policy in Canada*. Toronto: University of Toronto Press.

Social Development Canada. (2004). *The CPP and OAS Stats Book 2004: Statistics Related to Canada Pension Plan and Old Age Security Programs*.

<http://www.sdc.gc.ca/en/isp/statistics/pdf/statbook.pdf>.

TD Economics. (2005). *Time to Eliminate the Foreign Property Rule for Canadian Registered Pension Plans*. Topic Paper. Toronto: TD Bank Financial Group.

[http://www.td.com/economics/topic/gm0205\\_fpr.pdf](http://www.td.com/economics/topic/gm0205_fpr.pdf).

Toronto Stock Exchange. (2005). *Stats for the Month of January, 2005*. Press release.

Weaver, R. Kent. (1999). *The Politics of Pension Reform in Canada and the United States*. Chestnut Hill, MA: Center for Retirement Research at Boston College.

[http://www.bc.edu/centers/crr/wp\\_1999-04.shtml](http://www.bc.edu/centers/crr/wp_1999-04.shtml).

Weaver, R. Kent. (2003). *Whose Money is it Anyway? Governance and Social Investment in Collective Investment Funds*. Chestnut Hill, MA: Center for Retirement Research at Boston College. <http://www.bc.edu/crr>.

## **Statutes**

Government of Canada. (1997). *Canada Pension Plan Investment Board Act*.

<http://laws.justice.gc.ca/en/c-8.3/20749.html>.

Government of Canada. (1999) Canada Pension Plan Investment Board Regulations.

<http://laws.justice.gc.ca/en/c-8.3/sor-99-190/41771.html>.

Province of Québec. (1965). *An Act respecting the Caisse de dépôt et placement du Québec*.

<http://www.canlii.ca/qc/laws/sta/c-2/20030530/whole.html>.

Province of Québec. (2005). *An Act respecting the Caisse de dépôt et placement du Québec*.

<http://www.canlii.org/qc/laws/sta/c-2/20050616/whole.html>.