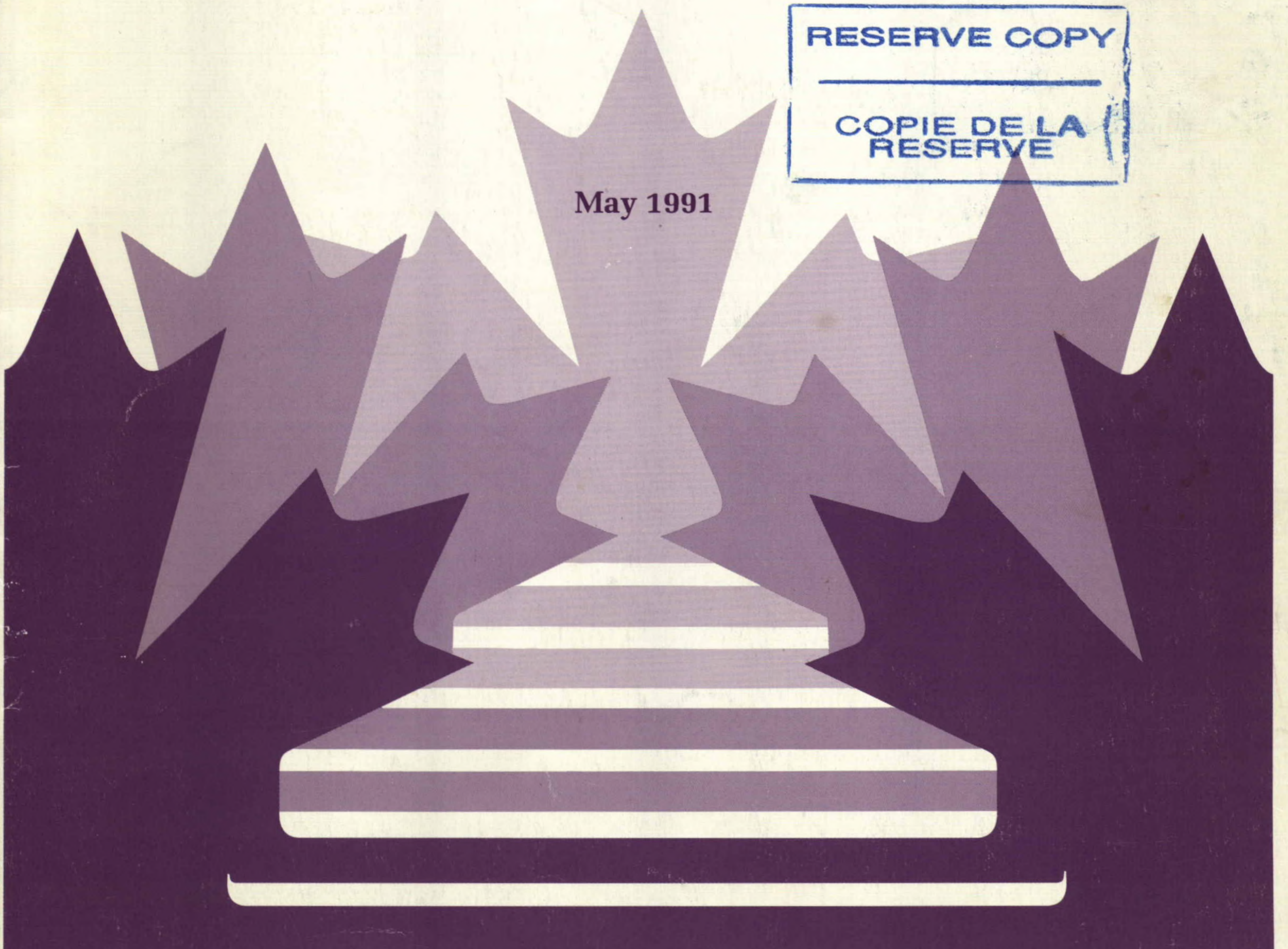
Report of the Committee on the Investment of the Canada Pension Plan Fund

**A Report to the
Minister of National Health and Welfare**

from the

Canada Pension Plan Advisory Board

May 1991



Canada Pension Plan advisory board

Régime de pensions du Canada conseil consultatif

The Honourable Benoît Bouchard, P.C., M.P.,
Minister of National Health and Welfare,
House of Commons,
OTTAWA, Ontario
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Dear Mr. Bouchard:

At its forty-fourth meeting on May 9 and 10, 1991, the Canada Pension Plan Advisory Board gave approval to a report presented by the Committee on the Funding of the Canada Pension Plan.

I now submit this report on behalf of the Advisory Board for your consideration.

Yours sincerely,

Louis Erlichman

Louis Erlichman,
Chairman.

enclosure

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Foreword

The Canada Pension Plan (CPP) Advisory Board is a statutory body whose members are private citizens appointed to represent employees, employers, self-employed persons and the public. Its role is to review the operation of the Canada Pension Plan, the adequacy of coverage and benefits payable thereunder and the state of the Canada Pension Plan Investment Fund.

A study was undertaken by a Committee of the CPP Advisory Board to examine the past and current policies with respect to the investment of the CPP Fund, to investigate alternative policies and to analyze their potential impact on the Fund and the Canadian economy. The purpose of this study was to determine whether a change in investment policy would be warranted.

In view of the uncertain impact of a significant change in CPP investment policy on Canadian markets, and considering the fiscal effect that a change in the CPP investment policy would have on the provinces, the Committee recommends that no change should be made, at this time, in the policies of the Canada Pension Plan Investment Fund.

I am pleased, therefore, to release to the public the Report of the Committee on the Investment of the Canada Pension Plan Fund.

Minister of National Health and Welfare

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Introduction

At its October, 1989 meeting, the Canada Pension Plan Advisory Board approved the following Terms of Reference for a Committee to review the investment of the CPP Fund:

1. To examine past and current policies with respect to the Investment of the CPP Fund;

2. To investigate alternative policies and analyze their potential impact on the Fund and the Canadian economy;

3. To make recommendations.

The Committee has met several times to consider these questions, and gratefully acknowledges the assistance of Health and Welfare Canada, the CPP Actuary and Mr. John Osborne, who performed consulting services, in the preparation of this report.

The Current Situation

From its inception, the Canada Pension Plan has been partially funded. The funding policy is currently to have, in the long-run, a reserve fund equal to two year's benefits. Currently, the Fund value is $41 billion equal to 3.2 years benefits.

The Canada Pension Plan is a joint federal/provincial programme. Any amendments to the Plan require approval of the federal government plus the approval of two-thirds of participating provincial governments, representing two-thirds of the total population of such provinces.

Funds in excess of three months' benefit payments and administrative expenditures are offered to the provinces based on their proportion of total contributions to the CPP over the preceding 10 years.

Provinces taking all or part of the funds offered to them must give the Fund in return provincial securities with a 20 year maturity, with interest rates based on a weighted average of current rates of federal securities of maturities of 20 years or greater.

Any funds not taken up by the provinces must be taken up by the federal government and invested in federal securities.

Over 90% of the CPP Fund has been taken up by the provinces, an indication that these funds have been made available at a cost somewhat below the cost of alternative funds. Table 1 indicates the current borrowers from the CPP Fund.

There are no limits in the CPP legislation on provincial government use of the funds. A survey of provincial authorities indicates considerable diversity between provinces in their policies. Some of the provinces simply roll their CPP funds into general revenue, while others direct it into a wide range of public investments. These are outlined in Table 1.

Table 1
Canada Pension Plan Investment Fund as of March 31, 1991

Borrowers	(000's)
Provincial Governments only	
Newfoundland	781,175.0
Prince Edward Island	168,166.0
Nova Scotia	1,428,780.0
New Brunswick	1,058,357.0
Quebec	136,076.0
Territorial Governments only	3,726.0
Federal Government	
Canada	3,492,216.0
Others	
Ontario	
Province	15,807,120.0
Housing	1,230,440.0
Municipal Improvement	5,156.0
	17,042,716.0
Manitoba	
Province	1,873,412.0
School Capital	132,225.0
Development	25,485.0
	2,031,122.0
Saskatchewan	
Province	74,047.0
Housing	317,304.0
Land Bank	184,436.0
Agricultural Incentives	169,843.0
Telecommunications	118,009.0
Industrial Development	65,464.0
Crown Investment	49,879.0
Municipal Financing	55,779.0
Water Supply Board	21,030.0
Economic Development	14,986.0
Universities Commission	1, 740.0
Water Resources Commission	657.0
Power Corporation	612,903.0
	1,686,077.0

Table 1 (Cont'd)

Borrowers	(000's)
Alberta	
Province	245,049.0
Municipal Financing	4,265,722.0
Resources Railway	25,000.0
	4, 534,771.0
British Columbia	
Province	1,404,497.7
School Districts Capital	1,349,351.0
Regional Hospital Districts	1,055,657.3
Hydro	555,126.0
Educational Institutions	456,419.0
Railway	185,327.0
Building	165,041.0
Transit	85,798.0
Systems	26,507.0
Ferry	14,758.0
	5,298,482.0
Total	37,661,664.0

In the case of the borrowers under "Others", although the funds are borrowed under various provincial authorities, the principal and interest payments are guaranteed by the provinces concerned.

Table 2 shows the importance of the CPP Fund as a source of provincial revenues.

Table 2
Canada Pension Plan Investment Fund – Investment in Securities[1] of the Province as a Proportion of Direct Provincial Liabilities[2]

Province	March 31, 1990 (%)	March 31, 1988 (%)
Newfoundland	12.80	13.98
Prince Edward Island	21.23	22.17
Nova Scotia	27.21	20.53
New Brunswick	25.89	18.45
Quebec	0.57	0.26
Ontario	38.30	34.13
Manitoba	29.14	15.59
Saskatchewan	28.67	14.07
Alberta	40.35	25.62
British Columbia	90.90	27.12

Source:
1. Canada Pension Plan Investment Fund: Health and Welfare Canada
2. Cansim: Statistics Canada

A failure by some provinces in recent years to take up their full allocation is an indication that interest rate trends are making CPP funds relatively less attractive.

The current legislation offers the provinces considerable leeway in investing their CPP funds (though they are fully responsible as guarantors of repayment). It offers the federal government no leeway in its use of the proportion of the CPP which is left to it. These funds must be invested in federal securities.

A 1975 Report of the CPP Advisory Board recommended that the provinces be charged a rate of interest tied to the rate that each province must pay on the "open market", so that the CPP Fund would no longer be "subsidizing" provincial fund-raising.

The Issues

The questions that arise from the Committee's Terms of Reference are:

1. Whether alternative investment policies for all or part of the CPP Fund could significantly improve the actuarial/financial future of the CPP (i.e., lower costs to future contributors),

2. Whether alternative investment policies would have other positive economic impacts on Canada, and

3. If a change in investment policy is warranted, what legal/political hurdles must be surmounted to change the policy.

Alternative Investment Policies

There are a number of alternative policies against which the current CPP investment policy could be compared. The most obvious alternative is the investment policy followed for the Quebec Pension Plan investment fund, which is invested (along with funds from the Quebec Government and Public Employees retirement funds, the Quebec automobile insurance plan, the Quebec Workers' Compensation system and the Construction Industry pension plan) by the Caisse de Depôt and Placement du Québec (CDPQ).

The investment policy of the CDPQ is laid down in legislation. The CDPQ is allowed to invest in bonds, real estate, preferred and common stock and even foreign securities. The restrictions on the fund are not far different from those placed on the investment policies of private pension plans. It also has less clearly defined economic development goals, which will be discussed below. The actual breakdown of CDPQ investment is outlined in Table 3.

Table 3
Summary of Investments – Caisse de depôt et placement du Québec as at December 31, 1990

Total Funds
Summary of Investments as at December 31, 1990
(in millions of dollars)

At book value %	Breakdown of portfolios	At par value	At book value: General Fund	At book value: Individual Funds	Total	At market value	Net change in 1990 (at book value)
	Bonds						
	Government issued						
25.36	Gouvernement du Québec	9,234.5	5,830.9	3,171.6	9,002.5	8,773.8	466.0
2.00	Government of Canada	710.5	302.7	408.9	711.6	713.8	(393.7)
2.33	U.S. Government	1,929.5	483.1	343.8	826.9	857.1	(546.9)
2.76	Other Governments	999.9	593.5	386.6	980.1	955.1	662.1
32.45		12,874.4	7,210.2	4,310.9	11,521.1	11,299.8	187.5
	Government guaranteed						
	Gouvernement du Québec						
8.84	Hydro-Québec	3,238.1	1,797.6	1,343.2	3,140.8	3,053.6	783.5
0.99	Other	356.1	185.7	165.7	351.4	346.0	53.9
0.39	Government of Canada	140.5	85.6	53.6	139.2	133.7	(40.5)
0.06	Other governments	20.5	10.5	10.0	20.5	21.0	(11.9)
10.28		3,755.2	2,079.4	1,572.5	3,651.9	3,554.3	785.0
	Guaranteed by grants						
0.60	Colleges	213.5	104.8	109.5	214.3	209.4	(66.9)
1.12	Hospitals	397.6	147.6	248.2	395.8	302.9	25.6
0.19	Universities and affiliated schools	69.7	44.2	23.6	67.8	66.6	(53.6)
0.04	Social service centers	12.6	9.1	3.4	12.5	12.5	(0.3)
1.62	School Boards	576.4	310.0	264.8	574.8	579.8	5.0
0.01	Other	5.1	1.6	3.4	5.0	5.4	(1.0)
3.58		1,274.9	617.3	652.9	1,270.2	1,266.6	(91.2)
	Municipalities and School Boards						
2.87	Municipalities and municipal bodies	1,037.0	626.6	393.0	1,019.6	1,007.2	130.1
0.33	School Boards	117.7	64.9	51.2	116.1	114.5	(17.8)
3.20		1,154.7	691.5	444.2	1,135.7	1,121.7	112.3
0.23	Corporate	84.6	53.1	30.1	83.2	79.9	(346.0)
49.74		19,143.8	10,651.5	7,010.6	17,662.1	17,322.3	647.6
	Shares and convertible securities						
	Canadian securities						
2.19	Metals and minerals	-	391.2	386.6	777.8	563.0	81.8
1.57	Gold and Silver	-	275.3	283.5	558.8	693.8	80.8
2.29	Oils and Gas	-	402.5	411.9	814.4	845.8	187.5

Table 3 (Cont'd)

0.99	Paper and Forest Products	-	171.6	178.1	349.7	325.6	44.3
1.63	Consumer Products	-	282.9	295.7	578.6	822.3	(5.3)
2.33	Industrial Products	-	402.3	426.0	828.3	901.6	33.7
0.22	Real Estate and Construction	-	42.7	35.5	78.2	53.1	9.6
0.87	Transportation	-	153.4	155.5	308.9	351.3	67.7
0.46	Pipelines	-	80.9	82.4	163.3	207.7	22.9
2.96	Utilities	-	526.5	524.1	1,050.6	1,153.8	126.8
1.90	Communications	-	312.8	362.6	675.4	811.6	237.1
1.83	Distribution and Services	-	320.3	329.1	649.4	760.3	102.5
4.57	Financial Services	-	813.7	810.2	1,623.9	1,925.0	215.4
1.32	Management Companies	-	231.4	235.7	467.1	556.4	78.1
0.03	Toronto Index Participation Units (TIP)	-	9.8	-	9.8	8.9	9.8
25.16		-	4,417.3	4,516.9	8,934.2	9,980.2	1,292.7
	Foreign Securities						
7.46	Participation deposit units of the specific foreign equity investments portfolio	-	1,409.6	1,238.6	2,648.2	2,415.6	677.7
1.98	Other foreign equity investments	-	284.4	420.2	704.6	716.8	(78.0)
9.44		-	1,694.0	1,658.8	3,352.8	3,132.4	599.7
34.60		-	6,111.3	6,175.7	12,287.0	13,112.6	1,892.4
	Mortgages						
	Residential						
2.04	Insured	-	266.6	456.5	723.1	718.1	138.5
0.45	Conventional	-	23.0	136.2	159.2	157.6	(149.9)
2.49		-	289.6	592.7	882.3	875.7	(11.4)
2.43	Commercial	-	307.1	554.9	862.0	850.2	21.8
0.76	Industrial	-	80.4	189.8	270.2	266.0	31.7
-	Other	-	-	-	-	-	(16.6)
5.68		-	677.1	1,337.4	2,014.5	1,991.9	25.5
	Real estate investments						
4.86	Participation deposit units of the specific real estate investments porfolio	-	852.2	871.2	1 723.4	1 849.9	135.5
4.86		-	852.2	872.9	1 725.1	1 849.9	135.5
94.88	Total long-term investments	-	18,292.1	15,396.6	33,688.7	34,278.0	2,701.0
4.21	Short-term investments	1,513.7	974.2	520.8	1,495.0	1,495.9	(1,004.5)
0.91	Deposits in the General Fund-net	-	-	323.4	323.4	323.4	302.9
100.00	Total*	-	19,266.3	16,240.8	35,507.1	36,097.3	1,999.4

* Total investments of the General Fund have been reduced by total demand deposits of the Individual Funds.

Source:
Financial Statements and Financial Statistics 1990 – CDPQ Annual Report 1990

Table 4 compares the rates of return of the CPP Fund with those of the CDPQ between 1971 and 1989. On average, the CDPQ has had an annual rate of return on investment 1% higher than the CPP fund. Its rates of return have been somewhat more volatile than those of the CPP Fund, but not sufficiently volatile to have a serious negative impact on the funding of a long-term retirement income programme.

There is no guarantee that an investment policy patterned on that of the CDPQ would continue to generate higher returns in the future. In fact, in the last couple of years, the CPP Fund has done relatively well compared to the CDPQ.

Table 4
CPP and RRQ: Comparative Rates of Return (Based on Book Value)

Year	CPP	RRQ
1971	6.7	7.3
1972	7.0	7.4
1973	7.0	7.4
1974	7.2	7.9
1975	7.4	8.3
1976	7.7	9.0
1977	7.9	9.3
1978	8.1	10.0
1979	8.4	10.5
1980	8.9	10.8
1981	9.6	11.2
1982	10.3	11.3
1983	10.6	11.1
1984	10.9	11.7
1985	11.0	13.8
1986	11.1	13.4
1987	11.2	11.3
1988	11.3	9.8
1989	11.6	11.8
Average 1971-1989	9.2	10.2

If, however, a change in investment policy were able to increase the annual fund rate of return by 1%, estimated by the Actuary of the CPP Fund (Table 5) suggest the following impact on future costs:

If all CPP Funds were transferred as of 1991 into a higher earning fund, the rate of CPP contributions could be lower in 2016 by 0.25% (approximately $1.7 billion a year less in contributions).

If only future contributions to the CPP Fund were transferred to a higher earning fund, the long-term effect would be virtually identical, lowering contributions by 0.15% by the year 2016.

If only the federal government share of new investments in the CPP Fund were transferred to a higher earnings fund, the rate of CPP contributions could be lower in the year 2016 by 0.05%

A higher rate of return for the full fund would therefore have a small but significant impact on the cost of future benefits to contributions. ?

The Committee also reviewed studies which looked at the investment performance of two other alternative models for investment funds, the Alberta Heritage Savings Trust Fund (AHSTF) and the Ontario Municipal Employees Retirement System (OMERS).

The AHSTF was established in 1976 to invest a portion of Alberta oil and gas revenues, primarily in Alberta-based capital projects. Since 1982, however, all net revenues have been diverted to Alberta's General Revenue Fund. Since 1987, new contributions to the AHSTF have been suspended. Assets were in excess of $14 billion at that time.

OMERS is the largest private pension fund in Canada. Since 1975, it has been allowed the freedom to invest on the same basis as any private sector pension plan. As at 1983, 41% of the market value of its portfolio was in common stocks (compared to 25.5% of the CDPQ and only around 5% for the AHSTF).

While we lack the data to do a long-term comparison of rates of return for OMERS and the AHSTF, a shorter-term comparison done on a basis not strictly comparable to Table 4 indicates that more flexible funds are able to generate higher rates of return than funds which are tied to a strictly controlled investment.

It would also appear from these results that CDPQ rate of return performance is competitive with those of the other large funds considered.

Table 5
Impact of Various Funding Scenarios

	Contribution Rate (%)				Investment Earnings ($M)			
Year	A	1	2	3	A	1	2	3
1991	4.60	4.60	4.60	4.60	4 319	4 326	4 352	4 188
1992	4.82	4.81	4.81	4.81	4 393	4 404	4 448	4 235
1993	5.04	5.02	5.02	5.02	4 441	4 454	4 515	4 261
1994	5.26	5.23	5.23	5.23	4 477	4 490	4 572	4 279
1995	5.48	5.44	5.44	5.44	4 500	4 514	4 619	4 302
1996	5.70	5.65	5.65	5.65	4 518	4 530	4 662	4 335
2001	6.80	6.75	6.70	6.70	4 617	4 627	4 941	4 777
2006	7.90	7.90	7.80	7.75	4 711	4 755	5 357	6 003
2011	9.05	9.05	8.90	8.85	5 937	6 089	7 086	7 094
2016	10.25	10.20	10.00	10.00	8 344	8 604	99 99	10 097

Scenario A: existing plan with the "15-year formula" applying in 1992. The "15-year formula" is based on a constant annual rate of change determined so as to produce an account/expenditure ratio 2.0 after 15 years.

Scenario 1: the same as Scenario A, except that new investments not taken by the provinces were loaned to the federal government at a rate of interest 1% higher than that assumed under Actuarial Report #11.

Scenario 2: the same as Scenario 1, except that the interest rate assume on all new investments is increased by 1% starting in 1991.

Scenario 3: the same as Scenario 2, except that all outstanding investments at the end of 1990 would be re-invested at a rate of interest 1% higher than the one assumed for 1991 in Actuarial Report #11.

Other Economic Impacts

A more active investment strategy for a public fund has important economic implications beyond different rates of return.

It has been suggested that access to capital at lower than market rates has reduced fiscal discipline for certain provincial governments and encouraged provincial government spending. Such a proposition is impossible to test. Certain provinces have clearly earmarked CPP funds for important capital investment.

It could also be argued that, since provinces receive access to CPP funds in proportion to their contributions to the extent that the cost of funds are being subsidized, it is the residents of each province who are receiving the benefit of those subsidies. In effect, the fact that their CPP contributions are being loaned to their province at preferential rates is offset by their lower provincial taxes.

An important factor to consider, given the size of the CPP Investment Fund, is its potential impact on markets and the economy. A more actively invested fund would be a very major player in Canadian markets. In 1987, for example, the CDPQ was the largest single equity investor in Canada.

The size and influence of the CDPQ has been a very controversial issue. It would appear that the CDPQ has played a role, like that of the CPP Fund, in reducing the cost of financing Quebec public debt, particularly in times of political uncertainty.

There is also a strong perception in Quebec that the CDPQ has taken an active role in promoting Quebec economic development, though some studies would indicate that it has in fact taken a relatively passive role. The fact that its common stock holdings have been quite concentrated and there has been a couple of highly-visible interventions would seem to have created the perception of a more active role.

The AHSTF has been far less active in its investment activities, in particular showing little inclination to support diversification of the Alberta economy from its narrow energy-driven base.

Leaving aside the history of the CDPQ and the AHSTF, a more active investment role for the CPP Fund would have important implications.

Complaints by private sector pension investors, that there are too few sound Canadian equity issues to absorb the pension fund capital available, have led the federal government to ease the limits on foreign investment of pension funds. This would indicate that extra equity investment from the CPP Fund is not necessary for Canadian equity requirements and could in fact crowd-out private pension funds.

If funds were allocated to equities for small start-up companies, there would be concern over the security of the investment and its impact on the Fund's long-run financial viability. There is, in fact, nothing stopping provincial governments from undertaking a more active investment policy within the current system.

Ultimately, the issue is whether a public (or publicly appointed) body actively investing all or part of the Fund would have a positive economic impact, or simply be a distortion of the workings of the marketplace. This is an ideological/political judgment. It might be questioned whether the rest of Canada has a sufficiently-strong sense of community to support a body with nationalistic economic goals like those of the CPDQ.

Political/Institutional Implications of a Change in Investment Policy

The CPP Fund has provided an attractive source of financing for the participating provinces in the 25 years of the CPP.

The CPP is a joint federal/provincial programme, requiring the approval of two-thirds of the participating provinces with two-thirds of the population for any amendment. Current provincial Fund investment policies are mixed, though all basically use the revenue to finance public sector activity.

While changing CPP investment policy to provide for more active investment policies might raise returns and reduce future contributor costs by a significant amount, this would come at the expense of provincial governments who would have to support the change in policy. Not only would it have a fiscal impact on the provinces, but a national investment policy would reduce its provincial government's ability to use the Funds for what it would see as its own provincial priorities.

It is also difficult to foresee federal/provincial agreement on the institutional form of the body investing the Fund. At best one can foresee lengthy and painful negotiations. It is hard to see a basis upon which provincial governments would agree to such a change.

It is also possible, without provincial agreement, to change the investment policy for the Funds left to the federal government. Since the federal share is less than 10% of the total Fund, and only a small proportion would be expected to be invested aggressively, it is questionable whether a more active policy is worthwhile. The impact on ultimate contribution rates would be very small.

It is therefore the view of the CPP Advisory Board not to recommend a change in the policy for investment of the CPP Fund at this time.

Members of the Canada Pension Plan Advisory Board May 1991

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