OECD Principles of Long-Term Investment Financing by Institutional Investors
Comments from Canadian Pension Plans

Thank you for the opportunity to comment on the draft OECD Principles of Long-Term Investment Financing by Institutional Investors. The signatories to these comments represent six Canadian pension plans with over $700 billion in assets under management representing 24 million members. All of the signatories have long-term liabilities and extensive experience financing long-term investments.

It should be noted at the outset that there are numerous initiatives globally that are attempting to solve the challenge of aligning long-term investors with broader public policy objectives (OECD, UN, EU, IIF, etc) and that a coordinated effort is more likely to lead to coherent advice to policy makers and better overall outcomes.

Despite the advantages of long-term investing, governments, regulators, investors and others will not take a long-term view without the right frameworks in place. We commend the OECD in recognizing the importance of long-term investing in meeting institutional objectives as well as the broad interests of society. We also commend the OECD for recognizing that environmental, social and governance are long-term investment risks that may affect an institutional investor's portfolio. We support the overarching objectives of these principles—assisting policy makers in designing a framework that promotes long-term investment by institutional investors. In general, however, we find that the draft principles place too much reliance on regulations to promote long-term investing. As we state below, and wish to emphasize, we believe that an increased reliance on the prudent person principle, applied to managing assets in the context of meeting liability obligations, will be more effective at curtailing impediments to, and thereby promoting, long-term investing than will increased regulation.

We note there are a number of approaches to long-term investing, including (i) holding private assets, such as infrastructure and real estate over the long-term to earn stable cash flows that help mitigate liability risks; (ii) countercyclical or value investing through public and private markets which can act as shock absorbers to reduce extreme market valuations (high or low); and (iii) active ownership of public and private investments that through collaboration with the board or management promote long term value creation. All three approaches can benefit investors and society and will hereafter be referred to collectively as long-term investing. The OECD draft could be clearer on which of the approaches to which the relevant principles are directed to ensure proper alignment between investment and public policy objectives.

We also note that governments must recognize that institutional investors' fiduciary responsibility is to their members or beneficiaries. We support public policy goals, such as financial stability and job creation, as attainment of these objectives leads to a more stable macroeconomic and investment environment. Decisions by institutional investors, however, must be made on the basis of return and risk and in the context of each investor's investment objectives and mandate. We believe, however, frameworks can be developed to better align public policy goals with the requirements of long-term investors.

Rather than becoming too prescriptive, we suggest the OECD outline a few broad principles and provide guidelines on how the principles may be implemented by policymakers, regulators, and investors that accommodate their different circumstances and objectives.

For the purposes of our comments, we have categorized the preconditions for long-term investments into two broad categories:

1. Investor related concern over the emphasis on regulations and policies to promote long-term investments
2. Investment related concern to promote and facilitate a favourable environment for long-term investing

1. Investor related concern over the emphasis on regulations and policies to promote long-term investment

To increase long-term investments, we believe the principles should address regulation and policies on four fronts:

(i) Emphasizing sound governance structures based on the prudent person principle

A number of the principles outlined in the draft refer to the supervision and monitoring of investors and investments by appropriate authorities. We assume, for pension plans, this refers to a board or group of trustees (or the boards of organizations whose assets are managed by us).

We are cautious on over-reliance on regulations and policies as the solution to mitigating risks or encouraging risk taking, especially when it comes to long-term investing. Such policies are often developed without taking into account that institutional investors have heterogeneous investment objectives. The investments themselves often have unique risks. Regulators and policy makers should emphasize the need for sound risk management practices and capabilities while promoting strong governance practices, at both the investor and investment (i.e. company or asset) level. Increased reliance on the prudent person principle, applied to managing assets in the context of meeting liability obligations, will be more effective at curtailing impediments to and thereby promoting long-term investing than will increased regulation.

The role of the board is to establish long-term investment policies that meet their investment objectives within their defined tolerance for risk. They should focus on governance, risk monitoring and oversight, and reviewing investment strategy and performance. Investment decisions should be delegated to qualified managers (internal or external) who have a more detailed understanding of the assets and markets. Boards should set remuneration policies that align with long-term investment objectives and that attract and retain qualified investment managers.

Alignment of compensation for long-term investments is a challenge. As such, performance-based remuneration should be appropriately balanced between short-term and long-term factors. Compensation programs also need to consider the incentives that they engender. For example, traditional private equity and infrastructure fund managers receive performance-based compensation based on realized returns. This motivates them to sell assets—particularly well-performing ones—more quickly than investors with a compensation system that is aligned to their long-term investment horizon and based on annual mark-to-market returns (which has its own set of challenges).

(ii) Minimizing the tension between solvency requirements and long-term investments

Policies and regulations should aim to strike a balance between solvency or filing requirements, where valuation focuses on current market value, and the economic benefits of holding investments which are intended to be held for the long-term, regardless of the current market environment. For example, shorter-term regulatory filings to assess funding adequacy may lead to an over-emphasis on short-term decision-making and managing short-term risks at the expense of focusing on investments that can be expected to be profitable over the long-term. Balancing this is the need to ensure obligations are met over the short and long term. Clearly, the larger the mismatch between assets and liabilities, the less capacity there will be to allocate to long-term investments. Policies to minimize the mismatch have to go hand-in-hand with policies to promote long-term investing.

To the extent possible, principles should provide guidance on sound approaches to valuation during difficult market conditions. For example, asset valuations could take both investment horizon and current market conditions into account to help mitigate the inherent pro-cyclicality of solvency requirements (i.e. market value should not necessarily be defined in terms of the liquidation of all of an institution's assets). In this light, sole reliance on marked-to-market asset valuation methodology may not be appropriate. On the other hand, not pricing systematic risk (i.e. inadequate capital buffers) can lead to systemic risk and subsequent crises.

(iii) Reducing existing barriers to increasing long-term investments

Rather than intervene with more regulation or policy, it is important to first examine if there are existing impediments that prevent markets from being able to allocate capital efficiently and if so, remove such inefficiencies. For example, investment restrictions that deny pension funds their full voting rights as shareholders in electing directors of public and private companies should be removed. Another example is the quantitative limit which prohibits pension plans from owning more than 10% of their net assets in the issued securities of a stable government. The prudential rules would result in the appropriate diversification of such securities by a single pension plan. Once again, using a prudent person approach, rather than a quantitative "one size fits all" approach through regulations, will help encourage the right policies that reflect the uniqueness of each investor.

(iv) Taking a holistic view on regulations considering potential unintended consequences

Regulations aimed at mitigating one risk, may exacerbate or create other risks or have undesirable consequences. For example, Solvency II regulations designed to mitigate systemic risk as a result of the 2008 credit crisis may reduce the attractiveness of stable assets, such as infrastructure, given the risk capital required to hold them. The Basel III rules are also making it more difficult to fund long-term investments. Higher risk capital requirements are making it more difficult for banks to lend long-term, whereas many investments, such as infrastructure, are very long horizon in nature. The resulting funding mismatch exposes the investor to unnecessary funding risk.

2. Investment related concern to promote and facilitate a favourable environment for long-term investing

To increase long-term investments, policymakers and regulators can also help establish favourable environments for institutional investor in three ways:

(i) Increasing certainty of after-tax, real cash flows over the investment horizon

Policy and regulation should be stable and consistent across jurisdictions as this allows investors to confidently make long-term investment decisions. Policy frameworks that promote on-going consistency in the application of rules that exist at the time of the investment decision provide more certainty in the ultimate after-tax real cash flows, thereby reducing the return required by institutional investors. For example, changes in taxation rates and/or administrative practice and regulatory policies (e.g. utility and renewable regulation) add risk and uncertainty to investments. Investors also need to be able to rely on the rule of law in particular in terms of international investments. Many infrastructure investments are essentially long-term contracts; the potential for governments to change the economics of established contracts will require higher returns.

Policymakers and regulators should ensure that infrastructure investment have inflation-protection embedded in the returns to equity holders to enhance certainty of real returns.

(ii) Adequate supply of long-term investments, particularly inflation-indexed bonds

Institutional investors with inflation-indexed liabilities (e.g. some pension plans) would benefit from an increased proportion of government debt issuance in long-term inflation-indexed bonds. Holding more inflation-linked bonds improves investors' ability to manage asset-liability mismatch risks, allowing them to increase exposure to long-term investments. The greater issuance of long-term inflation-linked bonds would also have a signalling effect that a government is committed to controlling inflation.

(iii) Development of investment structures that improve transparency and enhance liquidity

To make infrastructure assets more attractive, governments should consider which parties are best suited to assume the different types of risks associated with long-term investments. For example, greenfield, or development, infrastructure is one of the largest needs of many countries, but is the most difficult for some institutional investors (e.g. pension plans) to invest in, especially in emerging markets. The risks (permitting, expropriation, construction, demand/volume) are inconsistent with the risk tolerances of most institutional infrastructure investors. Governments should assume the risks that they are best placed to take (e.g. expropriation, change of law), in particular, in emerging markets. Governments could also assume certain operational or performance risks with respect to brownfield projects by providing minimum performance guarantees or priority cash flow distributions which will reduce risk and therefore the required returns for investors.

Investing in long-term assets requires a depth of skill and resources to manage these investments and their particular risks. To make infrastructure assets more accessible to smaller investors, barriers (e.g., taxation, regulation) need to be removed to allow larger, experienced plans to manage long-term investment pools on behalf of smaller investors. This will also have the benefit of increasing the amount of capital available for long-term assets.

Both investors and governments will benefit from having a general framework for structuring infrastructure investments in a manner that is transparent and consistent. This will enhance investors' understanding of the risks and costs of such investments. A range of vehicles would allow investors to enter the market at their target risk appetite. We also need to have mechanisms to ensure ability to exit, if warranted.

While we feel that promoting new and young firms and SME's is a worthwhile policy objective, it does not fit into the category of long-term investing from an investor's perspective and is therefore beyond the scope of this document. The requirements from a policy and regulatory standpoint, however, are similar. To promote investments in these areas, similar investment structures can be created to target different risk appetites and to provide transparency and scale.

Thank you for the opportunity to submit our collective views and thoughts on this important topic. We look forward to further engagement and discussion on long term investing.

Respectfully yours,

Canada Pension Plan Investment Board
Ontario Teachers' Pension Plan Board
Ontario Municipal Employees' Retirement System
Caisse de dépôt et placement du Québec
British Columbia Investment Management Corporation
Alberta Investment Management Corporation