



# TD Economics

## Topic Paper

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### TIME TO ELIMINATE THE FOREIGN PROPERTY RULE FOR CANADIAN REGISTERED PENSION PLANS

#### HIGHLIGHTS

- **Foreign Property Rule forces registered savings plans in Canada to incur unnecessary risk**
- **Rationale for FPR no longer exists, and arguments for abandoning it are compelling**
- **Ottawa should take action on FPR in 2005 Budget**

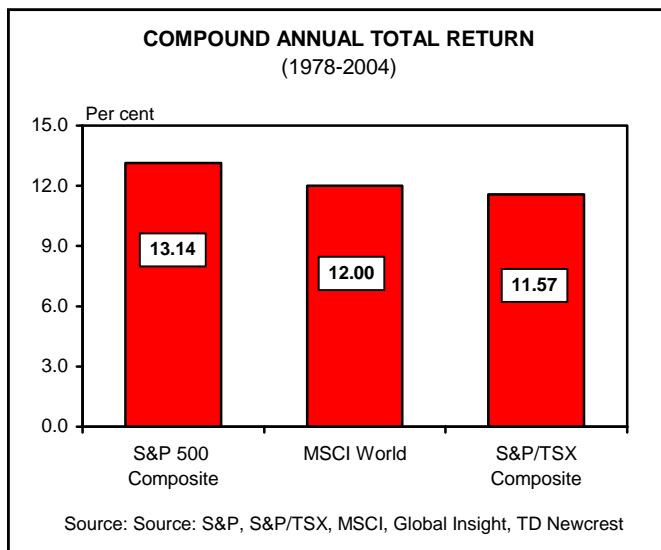
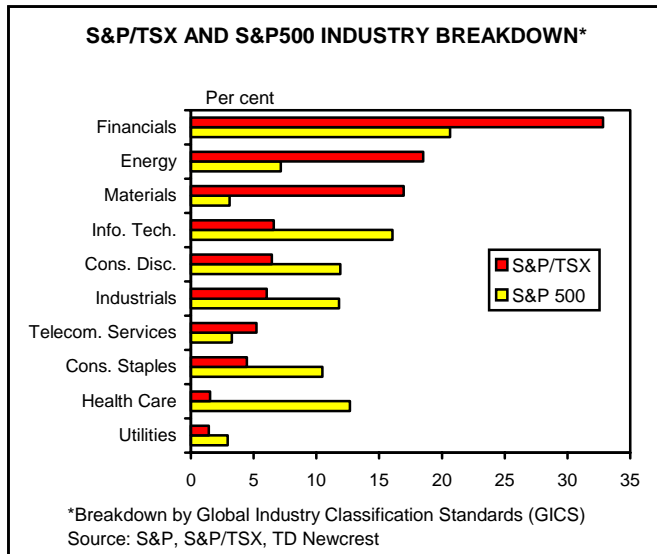
The Foreign Property Rule (FPR) restricts the portion of savings allocated to foreign assets in Canadian Registered Retirement Savings Plans (RRSPs) and Registered Pension Plans (RPPs) including the Canada Pension Plan (CPP). In their annual Top Ten list (*TD Newcrest Top 10 Predictions Report: 2005*, published Feb. 2, 2005), TD Securities' Index Products group identified raising or repealing the FPR as a highly desirable, but low-probability event for 2005. Their skepticism about the prospects for near-term action is understandable. Although the Liberal minority addendum to the December 2004 pre-budget consultation report of the House of Commons Standing Committee on Finance recommended "immediately raising the RRSP and CPP foreign content limits", the proposal did not appear in the main (consensus) document or in any of the other parties' minority reports. This suggests there may be some disagreement across party lines, which does not bode well in a minority parliament. However, we share our TD colleagues' enthusiasm for the idea. Indeed, it's hard to see what there is not to like in the Liberal proposal.

TD Economics urges Finance Minister Goodale to act upon the FPR in the 2005 Budget. Moreover, we believe that Canadians would not allocate more than 50 per cent of their retirement savings to foreign assets, so, in practical terms, there is little to distinguish between raising the limit and eliminating it altogether.

#### Why the FPR has to go

From the original 10 per cent in 1971, the FPR was raised to 20 per cent in 1994 and then the current 30 per cent in 2001. The rule means that Canadian RPP managers and RRSP holders have to maintain at least 70 per cent of their funds in Canadian assets – an allocation that is way out of line with the relative size of Canadian financial markets globally. The Canadian market for government debt accounts for less than 3 per cent of the world market for sovereign debt. Similarly, the Canadian stock market makes up about 2 per cent of the world equity market, and in addition, is highly concentrated in particular sectors, as the chart at the top of the next page makes clear. Factor in the underperformance of the S&P/TSX versus other major global equity indices over the last 25 years, and it's clear that the FPR triply compromises Canadian investors' ability to construct well-diversified portfolios that maximize risk-adjusted returns.

Given these disadvantages, it's not surprising that investors have looked for ways to skirt the FPR. They have several options. The simplest is to purchase a mutual fund that has 30 per cent or less of its holdings in foreign assets. These funds are still considered "Canadian content" for tax purposes. So, if an investor were to put 30 per cent of his money directly into foreign assets and the remaining 70 per cent into mutual funds that maximize their foreign content, he could boost the foreign content of his portfolio to 51 per cent. Another way of getting around the FPR is to buy futures contracts that are backed by Canadian assets (satisfying the Canadian content rule) but linked to the performance of foreign bond or stock markets. A related alternative is a clone fund, where the portfolio mimics the performance of foreign equities without taking on actual equity ownership.



Interestingly, despite the availability of these strategies, most Canadians' foreign property holdings fall well below the 30 per cent limit. There are no official estimates of foreign content in RRSPs, but bank surveys suggest that only a tiny fraction of Canadian RRSP investors maximize their foreign content, while far more have no foreign content at all in their portfolios. Trusted RPPs allocate about 25 per cent of the book value of their investments to foreign assets, but this figure reflects a combination of little or no foreign content in many small plans and close to the full 30 per cent for most large plans. In fact, some of the larger company pension plans have achieved a foreign content exposure of more than 30 per cent through the use of some of the derivative-based strategies noted above.

So, if a majority of Canadians has chosen not to take advantage of even the 30-per-cent limit, and those who want more foreign exposure have found ways of circumventing the rule, why bother changing it? Because the strategies for evading the FPR are complex, increase risk, limit the types of investments that can be made and involve higher management fees. Typically, only larger employer pension plans have the resources to make use of these opportunities. As a result, the application of the foreign property rule is patently unfair for the vast majority of pension savers.

### Rationale for the FPR no longer exists

The original intent of the FPR seems to have been to provide a (cheaper) source of financing for Canadian industry. A related argument refers to the idea of a "patriotic duty" – the line of reasoning being that, since Canadians bear the burden of the tax deferral feature of registered savings plans, they should also share in the bulk of the savings benefit. A third concern is that raising the FPR limit would result in an exodus of capital from Canada and put downward pressure on the Canadian dollar.

With respect to the first argument, there is ample evidence that Canadian firms today have almost unfettered access to world capital markets and that their cost of capital is determined on those markets. Similarly, the notion of a "patriotic duty" makes sense only if Canadians really are the winners – and, they are not. In fact, *no* segment of Canadian society wins under the FPR. The rule raises the risk profile of retirement savings and lowers the rate of return. As Canadians are made poorer, they have less money to invest in Canadian businesses and spend on Canadian products. As for the impact on Canadian financial markets, it's hard to see how some downward pressure on the Canadian dollar would be a problem at this point, given the currency's 30-per-cent appreciation over the past two years. And, in any case, the net outflows triggered by the removal of the FPR would be small relative to the amount of capital that enters and exits the country on a daily basis.

Indeed, it's important to recognize that, while eliminating the FPR would result in a larger portion of registered retirement savings being allocated to foreign assets, the ratio would not come anywhere close to 100 per cent. The reason is that investors typically demonstrate a strong "home-country bias" in their asset allocation. The United Kingdom provides a good example of this phenomenon. The U.K. government eliminated foreign property restrictions more than 30 years ago, yet U.K. pension funds still

allocate almost 75 per cent of their holdings to domestic assets despite the fact that the U.K. market makes up only about 10 per cent of the global market. Ultimately, the domestic market is the one that investors know best and are most comfortable with. Canadians are no different in this respect. And, investing at home has the added virtue of eliminating exchange rate risk – something Canadians should appreciate all the more, after two years of watching the returns on their U.S. dollar-denominated investments eroded by a falling U.S. dollar.

### Benefits of removing FPR significant

Meanwhile, the arguments for eliminating the FPR are as compelling as the case for maintaining it is weak. In a 2000 paper, “Estimating the costs of Canada’s foreign property rule”, Kevin Milligan and Michael Smart calculated that increasing the then-20-per-cent FPR limit to 30 per cent would raise the annual rate of return on registered investments by 0.31 per cent – which corresponds to a 9.9-per-cent increase in terminal portfolio wealth over 20 years. The FPR limit subsequently was raised to 30 per cent, and in a 2003 paper, “The Foreign Property Rule: A cost-benefit analysis”, David Burgess and Joel Fried estimated that this increase had boosted the annual revenue from pension savings by \$1 billion per year. They also calculated that the 30 per cent limit continues to depress pension earnings by \$1.5 to \$3.0 billion per year.

These findings apply to all Canadian registered investments, but they are particularly pertinent to the Canada Pension Plan – a critically important savings vehicle for working Canadians. In a speech last fall, CPP Investment Board President and Chief Executive Officer John MacNaughton characterized the FPR as a source of “long-term portfolio risk” for the fund, citing the reasons enumerated above – *i.e.*, the small size and sectoral concentration of Canadian equity markets. But, that’s not the only reason Canadians should be concerned about the FPR’s impact on the CPP. According to the 21<sup>st</sup> Actuarial Report on the Canada Pension Plan (as at December 31, 2003), the CPP will have amassed \$332 billion (in 2004 dollars) of assets by 2020. By requiring that 70 per cent of those funds stay in Canada, the FPR ensures that the CPP will become an increasingly dominant player in Canadian equity and debt markets. Having that much market influence concentrated in one player is not healthy.

Furthermore, investing so much of the CPP in Canada creates a form of “double jeopardy” for Canadian pensioners. As it stands now, the FPR means that nearly three-quarters of the CPP’s investment income comes from the Canadian economy, which is also the source of 100 per cent of the fund’s premium revenue. As a result, if there were an economic downturn in Canada – or worse, a prolonged period during which Canada underperformed other economies – the CPP would be doubly hit.

In fact, a credible argument can be made that all of the CPP’s assets should be invested outside Canada. Norway’s Government Petroleum Fund provides an instructive case in this regard. The Fund was established in 1990 as a fiscal tool for managing the revenues from Norway’s offshore oil sector. It is administered by the central bank on behalf of the Ministry of Finance, and all of its assets are invested in foreign securities. Part of the rationale for this investment strategy is to shield Norway’s economy from fluctuations in crude oil prices and extraction rates in the petroleum sector. But, an equally important reason is to ensure that the government has adequate savings to meet the challenges of an aging population. As Norges Bank Governor Svein Gjedrum explained in a recent speech, “these two purposes imply that the Petroleum Fund must be invested outside the Norwegian economy.”

### Conclusion

Eliminating (or at least substantially raising) the foreign asset restriction on registered investments would be a win for all segments of the Canadian economy. By being able to achieve higher returns on their pension savings, Canadians could prepare better for retirement. The positive wealth effect to the Canadian economy would benefit the corporate sector and raise government revenues. The federal government should use the occasion of the 2005 Budget to take action on delivering this positive result.

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