MOODY'S
INVESTORS SERVICE

CREDIT OPINION
1 February 2022

Update

Rate this Research

RATINGS

**Public Sector Pension Investment Board**

| | |
|---|---|
| Domicile | Canada |
| Long Term CRR | Not Assigned |
| Long Term Issuer Rating | Aaa |
| Type | LT Issuer Rating - Dom Curr |
| Outlook | Stable |

*Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.*


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# Public Sector Pension Investment Board

Update to credit analysis

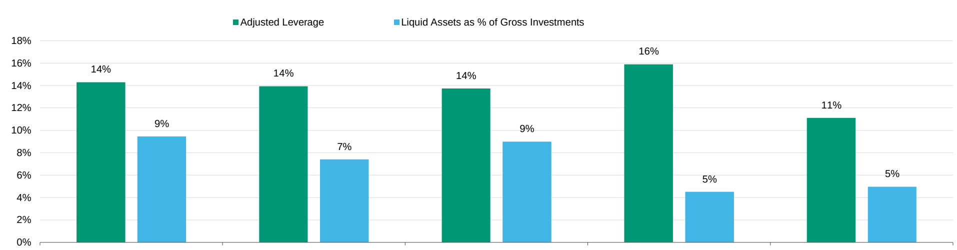

## Summary

Public Sector Pension Investment Board's (PSPIB) Aaa long-term issuer rating is based on its aa2 Baseline Credit Assessment (BCA), a high assumption of extraordinary support from the Government of Canada (Aaa) and our expectation that PSPIB's creditors will have an effective priority of claim over pension obligations in the event of a default, which provides a substantial cushion of assets and increases expected recoveries. The aa2 BCA reflects the pension manager's strong liquidity and predictability of future cash flows as well as its conservative financial policies and low leverage, offset by growth in less-liquid investments and a high proportion of high risk assets under Moody's definition.

The pension manager generated extraordinarily strong returns during its fiscal year ending 31 March 2021. It posted a one-year overall portfolio return of 18.4% versus -0.6% in fiscal 2020. Both public equities (+48.1%) and private equities (+28.4%) were the biggest contributors to the strong performance. Natural resources (+10.6%), credit investments (+10.5%), infrastructure (+4.5%) and real estate (+3.8%) were also positive contributors while fixed income was a small drag at -2.3%.

In the next 3-5 years, we believe the investment characteristics of certain asset classes will change as economies adjust to a post-pandemic recovery. These changes will depend on the length and severity of the economic impact; associated government support measures; and shifting private sector preferences, such as greater employment away from office real estate. That said, PSPIB has weathered the crisis well and has a reputation for strong investment acumen. The fund's long investment horizon is a considerable advantage in this regard as it affords them time to make portfolio shifts, particularly with less-liquid investments.


Exhibit 1
**PSPIB's liquidity levels provide good coverage of its leverage; reducing refinancing risk**




Fiscal year ended March 31. Liquid assets represents cash and money market securities and securities purchased under reverse repurchase agreements.
*Source: Moody's Investors Service, company financials*

PSP Capital Inc., a wholly-owned subsidiary of PSPIB, has a backed senior unsecured rating of Aaa and a backed commercial paper rating of Prime-1, reflecting the unconditional and irrevocable guarantee of its debt obligations by PSPIB. PSPIB Capital Inc. adds a moderate degree of leverage by issuing commercial paper and term debt guaranteed by PSPIB, with the goal of diversifying funding sources and enhancing overall returns of the fund.

## Credit strengths

» Governing legislation that mandates PSPIB as exclusive investment manager for certain Canadian government sponsored pension plans without responsibility for the underlying pension obligations

» Highly predictable cash flows, with positive net contributions projected for at least the next 5 years

» Strong coverage of obligations by high quality liquid assets

» A moderate degree of leverage

» PSPIB Capital Inc.'s issued instruments are unconditionally and irrevocably guaranteed by PSPIB

## Credit challenges

» Execution risk associated with the transition to a higher allocation of private investments

» Comparably high levels of less liquid Level 3 assets than Moody's-rated peers

» Private investments suit PSPIB's long-term investment horizon but weaken portfolio liquidity

» Maintaining effective risk management as PSPIB continues to grow

## Outlook

The stable outlook reflects our expectations that PSPIB's credit fundamentals, specifically its strong and stable liquidity and level of high risk assets, will remain unchanged over the next 12 to 18 months. It also reflects the stable outlook of its government support provider, the Government of Canada (Aaa stable).

The stable outlook on PSPIB Capital Inc.'s ratings reflect the outlook of its parent.

## Factors that could lead to an upgrade

» An upgrade of the Aaa senior unsecured rating is not possible.

» An upgrade of the aa2 BCA could be driven by a sustained decrease in PSPIB's high risk assets.

## Factors that could lead to a downgrade

» The BCA could be downgraded if we were to assess a material reduction in PSPIB's liquid assets. However, a downgrade of the BCA would not necessarily result in a downgrade of the long-term issuer rating because of our expectation of extraordinary support.

» A change in PSPIB's governing legislation or a legal precedent that casts doubt on the status of PSPIB's obligations as having preference over pension obligations; however, given the publicized and political nature of such an act, we view the probability of this happening to be very low

» A material increase in leverage above 25% for a sustained period of time

» A deterioration in the creditworthiness of the Government of Canada

» As well, the supported ratings of PSPIB Capital Inc. could be downgraded if we were to assess a change in the guarantee from PSPIB.

## Key indicators

Exhibit 2

**PSP Investment Board[1][2]**

| Statistics for Public Sector Pension Investment Board | 2021 | 2020 | 2019 | 2018 | 2017 |
|---|---|---|---|---|---|
| Total Assets (C$ millions) | 232,793 | 207,603 | 199,215 | 179,139 | 158,973 |
| Net Assets (C$ millions) | 204,299 | 169,682 | 167,853 | 152,994 | 135,562 |
| Fixed Income % Net Investments | 21% | 19% | 21% | 18% | 18% |
| Public Equities % Net Investments | 29% | 29% | 30% | 34% | 41% |
| Private & Real Assets % Net Investments | 50% | 52% | 49% | 48% | 42% |
| Liabilities C$ millions | 28,494 | 37,921 | 31,362 | 26,145 | 23,411 |
| Liabilites % Gross Assets | 12% | 18% | 16% | 15% | 15% |
| Unsecured Debt (C$ millions) | 16,802 | 15,877 | 14,169 | 12,249 | 10,846 |
| Unsecured Debt % Gross Assets | 7% | 8% | 7% | 7% | 7% |
| Secured Funding (C$ millions) | 9,730 | 20,563 | 15,899 | 12,459 | 11,258 |
| Secured Funding % Gross Assets | 4% | 10% | 8% | 7% | 7% |
| Other Liabilities % Gross Assets | 1% | 1% | 1% | 1% | 1% |
| Derivative Notionals (C$ millions) | 355,320 | 357,047 | 371,355 | 391,213 | 311,339 |
| Annual Reported Return (%) | 18.4% | -0.6% | 7.1% | 9.8% | 12.8% |
| Benchmark Return (%) | 16.5% | -1.6% | 7.2% | 8.7% | 11.9% |

[1] Information based on IFRS financial statements for 2017-2021, [2] Fiscal year end 31 March

*Source: Moody's Investors Service, company financials*

## Profile

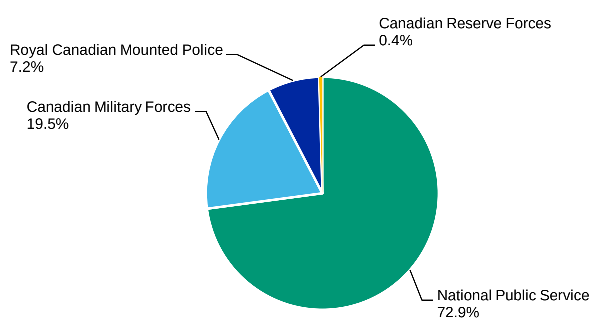
PSPIB was established by the Public Sector Pension Investment Board Act (PSPIB Act) in 1999 to invest the pension contributions (net of benefit payments) of Canada's national public service, its military (Canadian Forces and Reserve Forces), and the national police service, the Royal Canadian Mounted Police (RCMP). The funds for which amounts are currently transferred to PSPIB by the Government of Canada relate to pension obligations under the Plans for service on or after 1 April 2000, and in the case of the Reserve Force Plan, for service on or after March 1, 2007. As such, PSPIB is responsible for managing assets only related to those pension obligations.

At 73%, the majority of PSPIB's net assets is managed for benefits related to the national public service (Exhibit 3).

Exhibit 3

**Most of PSPIB's investments relate to Canada's national public service**

**PSPIB's net assets per pension plan account as of 31 March 2021**




*Source: Moody's Investors Service, company financials*

## Detailed credit considerations

### Funded Status - PSPIB does not have responsibility for the obligation of the underlying pension liability

As a pension reserve fund, PSPIB is not responsible for the administration of benefits, nor in setting actuarial assumptions of the underlying obligations; both which are the responsibility of the sponsoring government. In contrast to a pension fund, the sponsor is the beneficiary of the net assets. As such, we consider PSPIB to be fully funded and assign a aaa-score to its Funding Ratio score.

### Liquidity - Benefits of liquid fixed income portfolio offset by funding sources that encumber assets

PSPIB has strong coverage of liquid assets to cash obligations. The ratio of discounted liquid asset inflows to recognized obligation outflows was 419% as 31 March 2021, supported by high levels of sovereign debt securities and publicly-traded equity. This level is up from 272% last year due to higher levels of publicly-traded equity and lower levels of short-term funding. PSPIB's liquidity position is strong and its asset encumbrance from short-sold securities is modest relative to many of its Canadian pension fund peers.

PSPIB's strong liquidity position is enhanced by the Plan's actuarial profile: net contributions (transfers from the government) to PSPIB are expected to remain positive for at least the next 5 years. PSPIB's net assets increased by 1.8% for the year ended 31 March 2021, before investment returns, as a result of these transfers. With investment returns, total growth in net assets was 20.4% in the same period as PSPIB recorded a net return of 18.4%. PSPIB is also not subject to plan redemptions or loss of mandate, except in the unlikely event of a change in legislation. These characteristics allow PSPIB to adopt a long-term investment horizon.

PSPIB has an initial liquidity score of aaa and we make no adjustments.

### Asset Risk - high levels of less-liquid assets, but with broad geographic and sector diversification

At 75%, PSPIB's high asset risk ratio is broadly in line with peers. These assets are largely invested outside Canada and broadly diversified across several asset classes and sectors. Moody's definition of high risk assets are those assets that are not investment grade debt, which includes equity as well as other less-liquid investments such as infrastructure and real estate.

At March 2021, PSPIB's allocation to private equity and real assets stood at 50% of net investments in line with its long-term target weight of 50%. PSPIB's long-term investment horizon and liquidity profile, from expected positive net transfers, positions it well to execute this type of investment strategy. PSPIB's investment risks are well managed, although this capability will need to continue to keep pace with asset growth and rising complexity as well as shifting economics in a post-pandemic economy.

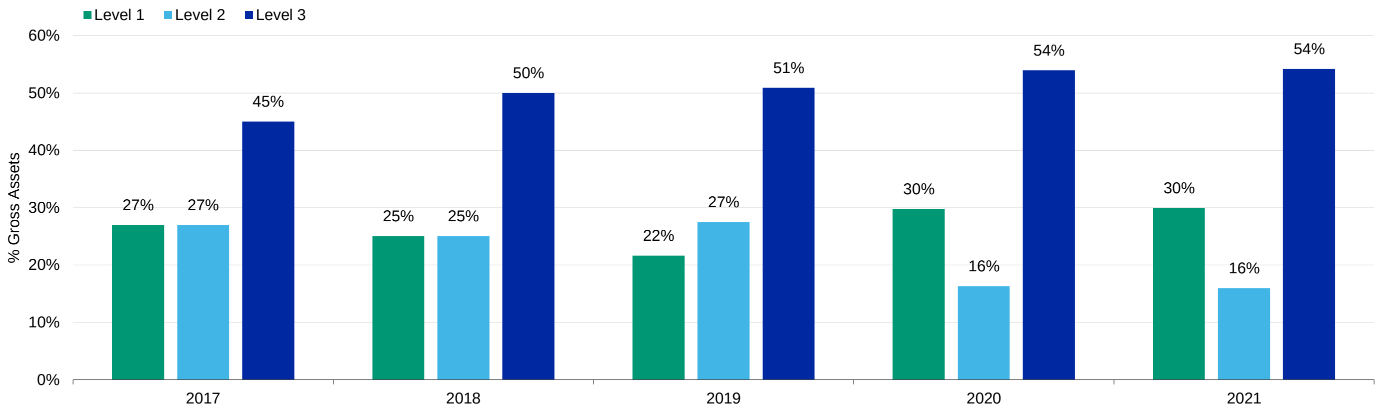
PSPIB's investment approach is designed to achieve a return greater than the Reference Portfolio over a period of 10 years with a lower or equal level of pension funding risk. In addition, PSPIB seeks to generate an additional return through active management within defined risk limits, for example by varying the allocation to a particular sector compared to the Policy Portfolio. In 2016, PSP changed its policy portfolio by reducing target allocations in public equity in favour of more private and real assets; adding a new asset class, Private Debt.

As at 31 March 2021, PSPIB's investment portfolio was comprised of 21% fixed income, 29% public equity, 50% private and real investments. As noted, in recent years, PSPIB's investment portfolio has shifted toward less-liquid Level 3 assets such as real estate, infrastructure and private equity (Exhibit 4). While these asset classes align to the pension manager's mandate to invest with a long-time horizon and offer attractive returns from a liquidity premium, they also add incremental liquidity and operational risks to the fund.

Exhibit 4

**PSPIB's less-liquid Level 3 assets have grown in recent years**

**Real estate, infrastructure and private equity allocation align with PSPIB's long-term horizon**




Fiscal year end 31 March, Level 1 and Level 2 assets have been adjusted for cash and money market securities. Fixed income includes Cash and Cash Equivalents.
*Source: Moody's Investors Service, company financials*

That said, PSPIB's investment portfolio is diversified globally and across many sectors. In our view, the benefits of this diversification strategy offsets higher liquidity and operational risks associated with reliance on Level 3 assets. It also reduces common credit risks with the Canadian economy, providing diversification away from the geographic location of its underlying pension obligation and related contribution cash inflows.

PSPIB has an initial asset risk initial score of ba2 and we make two notches of upward adjustment to account for its geographic and sector diversification.

### Financial Policy - conservative financial policies and investment profile is natural hedge to creditor obligations

PSPIB's financial policies are broadly conservative as expressed in our aa-score for Financial Policy. The pension manager has good liquidity and risk management practices that mitigate a modest level of leverage that creates refinancing and counterparty risks. PSPIB hedges certain currency risks within its portfolios and has natural currency matches between its investments and funding. Almost 60% of PSPIB's investment portfolio is invested in USD or CAD assets which aligns with its creditor obligations, much of which is denominated in USD.

## ESG considerations

PSPIB's exposure to environmental risks is low, consistent with our general assessment for the pension funds sector. See our Environmental heatmap for further information.

PSPIB's exposure to social risks is moderate, consistent with our general assessment for the pension funds sector. Pension funds' social risk exposure is largely driven by: 1) inherent susceptibility to demographic changes such as population ageing, which reduces the number of contributors and increases the number of beneficiaries; 2) employees' specialized investment knowledge which increases risks with talent recruitment and retention; and 3) increasing interconnectedness with the broader financial system which increases interdependency with financial system supply chains. See our Social risks heatmap for further information.

PSPIB has limited exposure to governance risk thanks to an independent board and management that insolates investment and liability decisions from the political process. There remains a possibility that portfolio investments may become a source of reputational risk for the fund and/or the sponsoring government.

## Support and structural considerations

### High expectation of extraordinary support with a mandate as the exclusive investment manager of national public sector employee pensions

Extraordinary support represents the probability that a government owner of a GRI would provide financial support, or other contractual protections, to a GRI to avoid a default on its debt obligations. The expectation of a continuation of ordinary support does not constitute extraordinary support and is instead considered in our assessment of the GRI's BCA.

As noted, PSPIB has special legal status as the exclusive asset manager for investments related to active and retired members of Canada's civil service. We believe the pension manager is a key element of the national government's compensation program and an important contributor to the Canadian economy. In our view, a default of PSPIB would be politically embarrassing to the Government of Canada and would have implications for the country's own ability to access debt markets. As such, we believe the Government of Canada would provide extraordinary support, financial or otherwise, to PSPIB if necessary.

### PSPIB's creditors effectively rank ahead of amounts due to the plans

PSPIB is an exclusive asset manager of the four pension plans, but does not have legal responsibility for their liabilities, which are those of the Government of Canada. We note that the legislative acts constituting PSPIB do not explicitly define the priority of PSPIB's unsecured creditors relative to the amounts due to the Plans. However, it is our view that PSPIB creditors have an effective priority claim on PSPIB's assets because the statutory framework provides that the Government of Canada may only call upon the net assets of PSPIB to pay Plan benefits. In this context, net assets means assets with a fair market value in excess of liabilities, including the unsecured obligations that PSPIB guarantees. As a result, PSPIB's obligations under the PSP Capital Inc. guarantee rank senior to the amounts that become due to the pension Plans and pari passu with PSPIB's other senior unsecured obligations. Similarly the Plans are only entitled to the net returns after PSPIB's operational costs. On a gross asset base of CAD233 billion at 31 March 2021, PSPIB had CAD204 billion in net assets, which we view as a loss absorbing cushion to the benefit of PSPIB's creditors.

As at 31 March 2021, PSPIB's leverage was about 12% after adjusting for nettable repurchase agreements and derivatives that are not offset for accounting purposes.

## Rating methodology and scorecard factors

| | |
|---|---|
| Enter Obligor Name Here ► | PSP Capital Inc. |
| Enter Fiscal Year-End Date Here ► | 3/31/2021 |

| | Historical | | | Assigned | | |
|---|---|---|---|---|---|---|
| | Factor Weights | Historic Ratio | Initial Score | Assigned Score | Key driver #1 | Key driver #2 |
| Funding Ratio* | | | | | | |
| *Net Assets / PBO* | *40%* | 100.0% | aaa | **aaa** | | |
| Liquidity | | | | | | |
| *Liquidity Inflows / Outflows* | *20%* | 419.3% | aaa | **aaa** | | |
| Asset Quality | | | | | | |
| *High Risk Assets / Gross Assets* | *20%* | 75.4% | ba2 | **baa3** | | |
| Financial Policy | | | | | | |
| *Financial Policy* | *20%* | aa | aa | **aa** | | |
| **Financial Profile Outcome** | ***100%*** | | **aa3** | **aa2** | | |
| **Qualitative Notching** | | | | | | |
| *Political Independence* | | | | **0** | | |
| *Corporate Behavior* | | | | **0** | | |
| **Scorecard-Indicated Outcome Before Constraint** | | | | **aa2** | | |
| ***Consideration of:*** | | | | | **Comment** | |
| *Sovereign Constraint (Y/N)* | | | | **Yes** | | |
| *Sovereign Rating* | | | | Aaa | | |
| *Sponsor Constraint (Y/N)* | | | | **Yes** | | |
| *Sponsor Rating* | | | | Aaa | | |
| **Scorecard-Indicated Outcome** | | | | **aa2** | | |

Source: Moody's Financial Metrics

## Ratings

Exhibit 5

| Category | Moody's Rating |
|---|---|
| **PUBLIC SECTOR PENSION INVESTMENT BOARD** | |
| Outlook | Stable |
| Issuer Rating -Dom Curr | Aaa |
| **PSP CAPITAL INC.** | |
| Outlook | Stable |
| Bkd Senior Unsecured | Aaa |
| Bkd Commercial Paper | P-1 |

*Source: Moody's Investors Service*

REPORT NUMBER 1316117

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