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Public Sector Pension Investment Board

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Public Sector Pension Investment Board

Rationale

Issuer Credit Rating
AAA/Stable/A-1+

The ratings on Public Sector Pension Investment Board (PSPIB or the fund) and subsidiary PSP Capital Inc. reflect the PSPIB's stand-alone credit profile (SACP), which S&P Global Ratings assesses at 'aaa'. The ratings also reflect our opinion of a moderately high likelihood that the Canadian government would provide extraordinary support in the event of financial distress.

The fund is a global institutional investor nearing its 20th year since inception. In its almost 20 years of operations, the fund's assets have grown rapidly (to C$153.1 billion in fiscal 2018 from C$2.5 billion in fiscal 2001). In the beginning, PSPIB's asset growth was fueled by annual contributions from the fund's government sponsor while more recently PSPIB's growth has come from investment returns. The fund's investment returns now account for about 80% of the PSPIB's annual increase in net assets. Despite strong investment returns, PSPIB's rapid growth in net assets is now slowing as anticipated and the fund's focus has shifted to rebalancing its portfolio from rapid deployment of funds. This transition marks PSPIB's next phase as a mature investor, in our view.

The PSPIB is a pension investment manager with a large net asset position and strong fundamentals. The SACP reflects our view of the fund's operational independence from the Government of Canada, well-diversified portfolio, and low-to-moderate leverage, as well as strong institutional and financial position, corporate governance, management, and liquidity. We believe the fiercely competitive investment environment will continue to challenge PSPIB, along with peers, as the fund strives to fulfil its mandate.

We believe that the PSPIB enjoys a strong institutional position because of its statutory role as the pension investment manager for four of the Government of Canada's pension funds. While it invests the funds of four pension plans, the PSPIB is a pension investment manager with no legal responsibility for the plans' underlying funding liabilities. PSPIB has grown rapidly since its inception and now manages net assets of C$153.1 billion at fiscal year-end 2018 (March 31), making it one of Canada's largest pension managers. We expect the fund to maintain its strong financial position for the foreseeable future.

We consider the PSPIB operationally independent from the Government of Canada. The government has established a governance framework that supports the fund's independent functioning, while establishing a clear framework for transparency and accountability. The PSPIB operates at arm's length from the Government of Canada, and we expect this to continue. Moreover, we believe the fund would be financially resilient to political intervention, given its legal ownership of the investment assets. We consider the board of directors to be independent and highly qualified. Furthermore, we expect no changes to the governance framework over the next few years.

In our opinion, the PSPIB benefits from strong management and a comprehensive risk management framework. We believe the management maintains a clear and comprehensive set of operating principles, objectives, and strategies, and that it performs well against its targets. The fund's 10-year annualized nominal net return is 7.1%, compared to real return objectives of 3.3% for the same period as of March 31, 2018. Audit and control systems are extensive and improving. Moreover, the board has a clearly articulated risk threshold and formal enterprise risk management policies in place.

The PSPIB also benefits from adequate diversification. Its assets are diversified geographically, by asset class, credit quality, and sector. Its top 10 investments account for about 26% of total investments up from about 21% the year before and they remain concentrated in high-quality government bonds that support the fund's liquidity. The PSPIB also has low-to-moderate leverage, in our opinion. The board of directors has established a limit for capital market debt, equal to 10% of adjusted net assets. Total leverage was 14.6% of total assets as of March 31, 2018, consistent with the year before, a level we consider low-to-moderate.

Previously we considered PSPIB's rapid growth in net assets requiring scalable operations and investment strategy to be our primary credit concern; the fund has increased to its current size from C$2.5 billion in less than 20 years. PSPIB appears to be managing its growth well and is now entering into a period of slightly slower forecasted growth (the fund is forecasting net assets of C$255.7 billion by 2028). We now believe the challenging investment environment is the chief risk PSPIB faces as it strives to meet its long-term return objective without undue risk of loss as required under its mandate.

In accordance with our government-related entities (GRE) criteria, we view the likelihood of the PSPIB receiving extraordinary government support as moderately high, based on our assessment of the fund's important role. The PSPIB operates as a not-for-profit entity that plays an important public policy role by investing the pension assets of four federally sponsored pension plans. We believe the federal government has a strong link with the fund as evidenced by its direct relationship as sponsor. The PSPIB is guided by a clear corporate governance set-up with independent management and makes its own business decisions.

We have used our "Principles Of Credit Ratings" in conjunction with "U.S. Public Finance: Public Pension Funds," "Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds," "Rating Government-Related Entities: Methodology And Assumptions," and "Rating Private Equity Companies' Debt And Counterparty Obligations" as our criteria foundation for our analysis of the PSPIB's creditworthiness. We also use our "Methodology For Linking Long-Term And Short-Term Ratings" criteria as a basis to provide short-term ratings. In our view, the fund's qualitative credit factors, such as management and independence, are similar to those of rated pension funds and pension fund investment boards, such as Caisse de depot et placement du Quebec and the Canada Pension Plan Investment Board. We also believe the PSPIB's quantitative credit factors, including liquidity, leverage, and portfolio diversification, are more akin to those of alternative asset managers, such as closed-ended U.K. investment trusts.

Liquidity

We believe the fund has strong liquidity owing to its positive contribution cash flows, lack of redemption risk, large pool of liquid assets, and low-to-moderate level of debt. The PSPIB's funding profile is very predictable, in our opinion. It receives monthly net plan contributions, which we expect to remain positive until approximately 2030. The fund maintains a sizable pool of liquid assets with which to meet its funding requirements. It had C$11.4 billion of cash and money market securities as well as corporate, government, and inflation-linked fixed-income securities of C$35.0

billion as of fiscal year-end 2018. It also has the ability to raise cash quickly through sales of its publicly traded equities (C$32.9 billion). These well exceed the PSPIB's CP and medium-term note programs, which totaled C$12.2 billion. The PSPIB maintains a revolving C$2 billion credit facility and a C$1 billion demand line of credit, both of which remained undrawn at March 31, 2018.

Outlook

The stable outlook reflects our expectation that the fund will retain its strong institutional and financial position in the next two years and that it will continue to build out investment capabilities and risk management systems in line with its expected growth. In addition, we expect the PSPIB to maintain its strong management, liquidity management, and risk management systems. We further expect the fund's leverage to remain relatively low, well below 40% of total assets. We do not expect any significant changes to the PSPIB's mandate and legislative framework. In addition, we do not anticipate any change to our assessment of a moderately high likelihood that the Canadian government would provide extraordinary support to the fund in the event of financial distress.

We could lower the ratings if we saw evidence of a material increase in risk appetite or erosion in the performance of risk management systems. This could include an increase in PSPIB's total liabilities above 40% of total assets, a relatively large investment loss, or a marked decline in liquid unencumbered assets relative to liabilities. We could also lower the ratings if Canada's creditworthiness deteriorated and the federal government became more involved in the fund's operations or strategy. We consider these scenarios unlikely over our two-year outlook horizon.

Rating Methodology: Government-Related Entities

In accordance with our GRE criteria, we view the likelihood of the PSPIB receiving extraordinary government support as moderately high, based on our assessment of the strong link with the federal government and the important role the fund plays for the government. We believe that in the event of distress, there is a moderately high likelihood that the federal government would provide support to the PSPIB. Moreover, we believe that the government is unlikely to be a source of negative intervention for the fund.

Demonstrating the strong link between the two is the government's appointment of PSPIB board members and other provisions of its federal enabling act. According to the Public Sector Pension Investment Board Act (PSPIB Act), the fund is required to submit quarterly and annual financial statements to the President of the Treasury Board, the Minister of National Defence, and the Minister of Public Safety and Emergency Preparedness for its respective plans, and participate in special examinations by external auditors, which include the auditor-general. Moreover, the government retains regulation-making powers under the act. The government determines the PSPIB's mandate and legislation, and appoints its board members (from a nominee list selected by an independent panel). The government has historically maintained an arm's-length relationship with the fund and is not involved with its day-to-day operations. The government does not provide a guarantee in respect of the PSPIB's liabilities. We do not anticipate any changes to the link between the government and the fund.

We believe that the PSPIB's role is important to the government because it invests the assets of four federally sponsored pension plans. Of those four plans, the employees of three (federal civil service, the Royal Canadian Mounted Police, and the Armed Forces) fulfill very important and visible roles for the government. Furthermore, although the fund does not carry those plans' pension liabilities on its balance sheet, sustained underperformance (investment returns) would likely have a budgetary impact on the government through contribution rate increases.

We do not expect the government to be a source of negative intervention in the PSPIB. In recent years, when one of the four plans was in surplus, the government did not withdraw the surplus; rather, it took a contribution holiday. During the global financial crisis, the government did not turn to the fund as a source of funds, or direct it to invest in any specific assets important to the government.

Independence And Corporate Governance

In our view, the PSPIB has a strong corporate governance and internal control structure, which soundly supports the independence of the fund's board and management from the federal government as a plan sponsor. The government is not involved with the PSPIB's day-to-day operations. The board of directors supervises the fund's business and affairs. It also has established an independent audit committee that regularly reviews, evaluates, and approves the adequacy and effectiveness of the fund's internal control systems. Its investment and risk committee reviews all investments and borrowings above certain thresholds. The governance committee monitors and assesses the relationship between the board and management. Finally, the human resources and compensation committee makes recommendations to the board in respect of the PSPIB's human resources and compensation as well as board members' remuneration.

The PSPIB Act outlines the board's responsibilities, which include approving a written Statement of Investment Policies, Standards and Procedures (SIP&P). The board also approves strategies and benchmarks for investment performance objectives; ensures an appropriate code of conduct, conflict of interest procedure, and risk-management policies; approves human resources and compensation policies; and approves quarterly and annual financial statements for each underlying pension plan and the fund. The president and CEO is appointed by and reports to the board of directors, which reports to Parliament through the Treasury Board president.

The governor-in-council appoints the fund's directors following the Treasury Board president's recommendation. A nominating committee of independent members, which the Treasury Board president establishes, suggests a list of qualified candidates. We believe that, in the long term, eligibility criteria for the PSPIB's board should contribute to professional and independent management, and therefore to the strength of the fund's corporate governance framework. For example, legislation excludes elected federal or provincial officials, federal government employees, and any other people entitled to benefits from the participating plans from board membership.

Although the federal government is the sponsor and administrator of the four pension plans, the fund has been set up to operate at arm's length. It does not benefit from any form of sponsor guarantee.

Management

We believe that the PSPIB benefits from strong management practices, a stable organizational structure, strong operational effectiveness, and good risk management.

Organizational background

The PSPIB was established to invest the net pension contributions of the Public Service, Canadian Forces, and Royal Canadian Mounted Police pension plans related to the post-2000 liabilities of these plans. In 2007, this mandate expanded to include the investment of net contributions of the Reserve Force pension plan. The fund is a statutory Crown corporation established in 1999 and governed by the PSPIB Act, the Public Sector Pension Investment Board Regulations, and parts of the Financial Administration Act.

The PSPIB invests the plans' money without direct responsibility for their liabilities; those remain with the plan sponsor. The PSPIB Act specifies the fund's mandate is "to manage amounts that are transferred to it ... in the best interests of the contributors and beneficiaries ... and to invest its assets with a view to achieving a maximum rate of return, without undue risk of loss," although this primary focus is qualified by "having regard to the funding, policies and requirements of the pension plans ... and the ability of those plans to meet their financial obligations." Therefore, although the fund cannot ignore the actuarial funding status of the underlying pension plans, it is free to focus on its investment activities.

The PSPIB is one of Canada's largest pension investment managers, with $153.1 billion of net assets under management as of March 31, 2018. It has a head office in Ottawa and a main business office in Montreal. By fiscal year-end, the fund had more than 800 employees based primarily in Montreal.

Operational effectiveness

We believe the PSPIB has been successful in meeting its investment return objectives. Based on its legislated mandate, and as required under regulations, the PSPIB's board develops a SIP&P that outlines the policy portfolio. When developing the SIP&P and its policy portfolio, the board considers its expectations for various asset classes based on the results of long-term asset liability studies, market conditions, and the fund's return objectives as communicated by the Treasury Board secretariat. The policy portfolio is designed to deliver the required rate of return, as determined by the chief actuary, with the least amount of risk. Owing to a number of common features in the plans (such as being contributory; final average-earnings defined-benefit pension plans are fully indexed to the CPI with high net contributions), the SIP&P is currently applied to all four plans. We believe the SIP&P contains clear guidelines on the policy portfolio, allowable investments, return expectations, risk appetite, permitted borrowings, use of derivatives, liquidity requirements, and use of external managers contributing to its strong operational effectiveness, in our view.

The policy portfolio is designed to capitalize on structural advantages the fund has, specifically its consistent positive net inflows resulting in higher liquidity, large size allowing for economies of scale, and the plan's long-term investment horizon. These attributes allow the fund to invest in long-term and illiquid assets. In addition to the policy portfolio, the PSPIB has developed an active portfolio that implements active management strategies, through which it seeks to generate additional returns by investing in assets outside of its policy portfolio.

The PSPIB evaluates the success of its investment strategies based on fund performance versus benchmarks and its short and long-term real return objective. The PSPIB's short-term real return objective (over the next 10 years) is 3.3% and its long-term real return objective is 4.0%. By those metrics, the PSPIB succeeded in fiscal 2018; its net return of 9.8% was above its benchmark return of 8.7%. Moreover, its annualized 10-year net return was 7.1% compared to its return objective of 5.8%.

Table 1

Public Sector Pension Investment Board (PSPIB)--Portfolio Returns Versus Benchmark Returns					
(%)	**2018**	**2017**	**2016**	**2015**	**2014**
Benchmark	8.7	11.9	0.3	13.1	13.9
PSPIB returns	9.8	12.8	1.0	14.5	16.3
Excess returns	1.1	0.9	0.7	1.4	2.4

Risk management

The PSPIB continues to benefit from what we consider a strong risk management framework. The fund derives risk appetite from its legislated mandate, which instructs it to avoid "undue risk of loss." Beginning in fiscal 2014, the board committed to the annual development and formal approval of a risk appetite statement that articulates the PSPIB's appetite, attitude, and tolerance toward risk as it pursues its return objectives. The risk appetite statement helps inform the development of the policy portfolio, including active risk. The fund also has an enterprise risk management framework in place that sets out the guiding principles that govern its overall approach, philosophy, culture, and values with respect to its risk management. The board of directors approves the framework.

The PSPIB's largest risk is its investment risk, which it manages pursuant to its investment risk management policy. To mitigate investment risk, the fund puts limits on recourse leverage (including capital markets debt) and monitors sector and geographic concentrations and counterparty credit ratings. The fund has decided to cease routinely hedging its foreign exchange exposures, but will do so where considered strategically appropriate. The investment functions' risk management process includes back-testing the risk models' robustness and stress testing. The fund emphasizes continuous improvement of its risk management capabilities. Management has access to periodic reports detailing value-at-risk by manager, type of investment, risk factor, and individual positions.

The PSPIB's board is also involved in the fund's risk management. The board actively monitors the fund's investment risk via its investment and risk committee and enterprise risks via its audit committee. The board receives a detailed risk report quarterly and has in camera sessions with the chief risk officer.

Diversification

We consider the PSPIB portfolio to be well-diversified by asset class and geographically as well as by credit and sector exposure. The fund's 10 largest single-name investments account for about 26% of the PSPIB's total investments; these holdings are mixed between exposures to governments and private investments. The fund's high level of government bond holdings supports liquidity. The PSPIB exposures are also diversified by credit quality, with 74.6% of assets considered investment-grade. The fund's assets are also subject to concentration limits. Based on the PSPIB's policy portfolio, and the board's commitment to diversification, we expect the fund portfolio to remain well-diversified over the next few years.

Table 2

Public Sector Pension Investment Board--Long-Term Target Asset Allocation (%)			
World equity	43		
		Public market equities	30
		Private equity	13
Real assets	30		
		Real estate	15
		Infrastructure	10
		Natural resources	5
Government fixed income	20		
		Fixed income	
		Cash and cash equivalents	
Credit	7		
		Private debt	

PSPIB's investment strategy is serving it well as the fund continues to exceed its long-term return objectives. PSPIB realized strong returns in fiscal 2018, driven by a strong performance in public equities and real assets. While all asset classes delivered positive returns, private equity and fixed income fell short of their benchmarks. While most assets are managed internally, which allows greater control over risks and costs, PSPIB does use external managers to employ some strategies for which it does not have the requisite in-house expertise. We expect this practice to continue. Furthermore, with the exception of fine-tuning, we do not anticipate major shifts to PSPIB's investment strategy or asset allocation over the next two years.

Table 3

Public Sector Pension Investment Board--Investment Returns

	--Fiscal 2018--			
Asset Class	**Fair value (mil. $)**	**Fair value (%)**	**Portfolio returns (%)**	**Benchmark returns (%)**
Equity				
Public market equities	51,813	33.8	11.3	10.3
Private equity	19,382	12.7	12.9	17.6
Government fixed income				
Fixed income	24,856	16.2	1.6	1.7
Cash and cash equivalents	2,927	1.9	1.5	0.8
Credit				
Private debt	8,857	5.8	8.2	2.3
Real assets				
Real estate	23,245	15.2	13.6	12.3
Infrastructure	14,972	9.8	19.3	12.1
Natural resources	4,833	3.2	11.2	3.1
Complementary portfolio	2,201	1.4	33.0	8.7
Total	153,086	100	9.8	8.7

Liquidity

Compared with that of hedge funds and other alternative investment managers, the PSPIB's funding profile is very predictable, in our opinion. We believe the PSPIB has an advantage over other funds owing to the long-term and predictable nature of its contribution cash flows. Net contributions are remitted to the fund monthly and we expect them to be positive until approximately 2030, which we view as positive for the PSPIB's liquidity. In fiscal 2018, the fund received C$3.9 billion in net contributions.

The fund's withdrawal profile is forecast to begin sometime after 2030. Funds can only be withdrawn from the PSPIB if they are required to pay benefits, or if a surplus exists. While the government may withdraw funds above the amount of a surplus, it may also use a surplus to lower its current service payments. Currently, none of the plans has a surplus. We view the fund assets as effectively locked-in owing to the legislated restrictions on their withdrawal. Consequently, we do not expect the government to withdraw funds from the fund because there is no requirement to pay benefits for many years (because net contributions are positive) and there are no surpluses in any of the four plans.

Moreover, in our opinion, the PSPIB continues to have sizable liquid assets with which to meet its liquidity needs compared with the relatively small size of its commercial paper (CP) and medium-term note (MTN) programs, which totaled C$12.2 billion as of March 31, 2018. The fund had C$11.4 billion of cash and money market securities as at fiscal year-end. Furthermore, the PSPIB has access to other channels of liquidity including through the sale or loan of its significant holdings of fixed-income securities (C$35.0 billion), as well as its ability to raise cash quickly through sales of its publicly traded equities (C$32.9 billion). Although the fund does have sizable portfolios of marketable assets, liquidating portfolios of this size quickly without depressing their market value could be a challenge. The PSPIB maintains a C$2 billion revolving credit facility and a C$1 billion demand line of credit, both of which remained undrawn as of March 31, 2018.

We believe the PSPIB maintains good oversight of its liquidity needs and prudent debt management policies. The fund's treasury and risk management department oversees the PSPIB's treasury funds with the requirement that is has sufficient liquidity for operational needs including debt repayment and collateral calls as well as funds available for commitments and investment opportunities. The PSPIB's treasury and risk departments closely monitor the fund's liquidity. The treasury department prepares 10-day, one-month, three-month liquidity, and forecast reports. The investment and risk committee of the board receives quarterly reports on the fund's liquidity. The PSPIB's capital markets debt does not contain any call provisions that would accelerate repayments.

Leverage

The PSPIB has low-to-moderate leverage, in our view. Total leverage (which includes capital market debt and investment-related liabilities) remained consistent at 14.6% of total assets as of March 31, 2018, compared to 14.7% the year before. The fund's board-imposed limit for capital markets borrowing (not including other liabilities) is 10% of adjusted net assets. We do not expect this limit to change. The PSPIB also allows for nonrecourse borrowing on some asset classes (for example, real estate and infrastructure). However, it sets specific targets for its borrowings as a share of assets under management, and limits the acceptable range of fluctuation. The fund's use of leverage is guided by its corporate leverage policy, which is reviewed by the board every two years. Furthermore, no corporate borrowings are allocated to public equity investments. The PSPIB issues debt through PSP Capital Inc., its wholly owned, fully guaranteed subsidiary. PSP Capital was set up to issue debt in response to the fund's increasing borrowing needs and desire to leverage its private markets portfolio. The guarantee conforms to our guarantee criteria and PSP Capital debt issues take the same ratings of those on the PSPIB accordingly.

PSP Capital manages a Canadian CP program and a U.S. CP program with a global limit of C$12 billion, as well as an MTN program. As of March 31, 2018, the fund had Canadian CP of C$944 million and U.S. CP of C$5.4 billion outstanding, as well as C$5.9 billion of MTNs outstanding. The PSPIB's capital market debt leverage ratio was 8% of net assets.

All obligations under the short-term promissory note and MTNs rank pari passu to the PSPIB's unsecured and unsubordinated obligations and liabilities, but senior to potential distributions to the plans. We believe this provides additional support for the ratings.

Related Criteria

- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- General Criteria: Rating Government-Related Entities: Methodology And Assumptions, March 25, 2015
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009
- Criteria - Financial Institutions - Other: Rating Private Equity Companies' Debt And Counterparty Obligations, March 11, 2008
- Criteria - Governments - U.S. Public Finance: Public Pension Funds, June 27, 2007
- Criteria - Financial Institutions - Fixed-Income Funds: Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds, Sept. 12, 2006

Ratings Detail (As Of October 17, 2018)	
Public Sector Pension Investment Board	
Issuer Credit Rating	AAA/Stable/A-1+
Issuer Credit Ratings History	
10-Nov-2006	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings’ credit ratings on the global scale are comparable across countries. S&P Global Ratings’ credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.