

Research Update:

Canada Pension Plan Investment Board 'AAA' Rating Affirmed; Outlook Is Stable

January 15, 2021

Overview

Canada Pension Plan Investment Board's (CPP Investments or the fund) medium-term investment returns continued to exceed its required rate of return despite the negative economic effects of the COVID-19 pandemic, its liquidity is robust, and its leverage remains low-to-moderate.

We are affirming our 'AAA' long-term and 'A-1+' short-term issuer credit ratings on CPP Investments, as well as our 'AAA' senior unsecured debt rating, and 'A-1+' global scale and 'A-1(High)' Canada scale commercial paper ratings on subsidiary CPPIB Capital Inc.

The stable outlook reflects our expectation that CPP Investments will continue to realize good medium-term investment returns, liquidity will be more than adequate, and leverage will remain well below 40% of total assets in the next two years.

Rating Action

On Jan. 15, 2020, S&P Global Ratings affirmed its 'AAA' long-term and 'A-1+' short-term issuer credit ratings on the Canada Pension Plan Investment Board (CPP Investments or the fund). The outlook is stable. At the same time, S&P Global Ratings affirmed its 'AAA' senior unsecured debt rating, and 'A-1+' global scale and 'A-1(High)' Canada scale commercial paper (CP) ratings on subsidiary CPPIB Capital Inc. (CPPIB Capital).

Rationale

The ratings on CPP Investments reflect the fund'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 SACP on CPP Investments reflects our assessment of the fund's low-to-moderate leverage; strong liquidity; history of strong investment returns; independence in day-to-day operations; and strong corporate governance, management, and risk management. The fund's need to appropriately scale up investment strategies and operations as assets continue to increase rapidly somewhat mitigates these strengths. We believe the negative economic effects of the COVID-19 pandemic will have an impact on the fund's fiscal 2021

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investment returns. Nevertheless, we believe the fund's medium-term investment returns will continue to exceed the required rate of return and that it has sufficient liquidity to meet near-term debt obligations.

We consider CPP Investments's low-to-moderate leverage to be a credit strength. Total liabilities were C\$133.6 billion at the end of fiscal 2020 (year ended March 31), consisting of C\$127 billion of investment liabilities and C\$6.5 billion of payables, pending trades, and accrued liabilities. Total liabilities represented 24.6% of total assets, which was up from 21.6% a year earlier.

CPP Investments issues CP and term debt through its wholly owned subsidiary CPPIB Capital. The fund has provided a timely, unconditional, and irrevocable guarantee covering all debt it might issue through CPPIB Capital. The guarantee conforms to our guarantee criteria and the debt issues of CPPIB Capital take the same ratings as those on CPP Investments accordingly. As of fiscal year-end 2020, CPPIB Capital's debt, which is recourse to CPP Investments because of the guarantee, totaled C\$38.4 billion (9.4% of net assets), up from C\$30.9 billion (7.9% of net assets) a year earlier.

Canada Pension Plan Investment Board -- Leverage

(%)	Fiscal 2020	Fiscal 2019	Fiscal 2018	Fiscal 2017	Fiscal 2016
Total liabilities/total assets	24.6	21.7	17.6	16.9	19.9
Secured funding*/total assets	15.6	14.4	11.1	10.6	14.3
Unsecured debt/net assets	9.4	7.9	6.8	6.3	5.6

*Secured funding includes repos, short selling of securities, amounts related to derivatives positions, and short-term secured debt.

The COVID-19 pandemic had a negative effect on the fund's fiscal 2020 return. The total fund generated a net nominal return of 3.1%, lower than the 8.9% return recorded a year earlier. The timing of the fund's year-end on March 31, means that capital market turmoil at the onset of the pandemic was reflected in CPP Investments' 2020 results. Despite lower 2020 results, the fund's five- and 10-year annualized net real rates of return were 7.7% and 9.9%, respectively, both of which easily exceeded the 3.95% required real rate of return. Net investment income was C\$13.4 billion, which was lower than the C\$33.2 billion in the previous fiscal year. The fund has posted a stronger performance in fiscal 2021. Its net 2021 return in the first and second quarters were 5.6% and 5.0%, respectively.

In 2019, the Canada Pension Plan (CPP) began a process of gradual enhancement of benefits in exchange for higher contributions. In fiscal 2020, CPP completed its first full year receiving the additional funds. The additional CPP funds are being managed in tandem with CPP investments, but are held in a separate account with C\$2.3 billion in assets at the end of the fiscal year.

We consider CPP Investments independent, both operationally and financially, from the Government of Canada and participating provinces. These governments have established a governance framework that supports the fund's independent functioning while implementing a clear framework for transparency and accountability, and have maintained a hands-off approach to CPP Investments' day-to-day operations. We expect no changes to the current governance framework for the foreseeable future.

We view CPP Investments' corporate governance and management as strong. We consider the board of directors independent and highly qualified. The fund has a clearly articulated risk budgeting process and formal enterprise risk management policies in place. We believe management maintains a clear and comprehensive set of operating principles, objectives, and strategies, and that it performs well against its targets. Audit and control systems are extensive.

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CPP Investments has what we consider a strong risk management framework. The board of directors approves the reference portfolio, which expresses the investment portfolio's long-term total risk appetite. In turn, the investment planning committee determines each investment unit's active risk budget based on current and planned investments. The fund also adheres to what we view as a straightforward, prescriptive investment decision-making process that requires management to evaluate investment opportunities according to each investment's individual risks and how these fit within the portfolio's risk profile. A centralized risk management function complements CPP Investments' strong investment decision-making procedures. The fund manages its risks under its risk management framework, which looks at five principal categories of risk: market and credit; liquidity and leverage; operational; regulatory and legal; and strategic. In addition, CPP Investments has established an investment risk department to monitor and measure all facets of investment risk across the organization. We believe the fund's risk management framework, although thorough and well organized, should continue evolving as the portfolio increases and incorporates new and potentially more sophisticated investments.

In keeping with its investment risk management practices, the fund diversifies its investment portfolio broadly by geography, asset class, credit risk, and single-name exposure. Liquidity risk management practices have a strong influence on diversification levels, because CPP Investments maintains large holdings of highly rated and highly liquid government securities. CPP Investments invests in public and private equities; government bonds; credit investments; and real assets, such as real estate, infrastructure, energy and resources, as well as power and renewables.

CPP Investments is the largest investment pool in Canada, with net assets of C\$409.6 billion as of fiscal year-end 2020. Thanks to continuing good investment returns and positive net contributions, the fund's assets have increased rapidly in the past 10 years. We believe that rapid growth can introduce investment and operational challenges as investment operations scale up while maintaining returns on investments above the fund's required real rate of return of 3.95% for base CPP and 3.38% for the additional CPP. In our view, it is crucial that risk management policies and practices expand at the same pace as investment activities to ensure that all risks are understood, managed, and monitored. This is especially important as the fund's total assets are expected to increase to approximately C\$1 trillion in the next 15 years and to C\$3 trillion by 2050.

In accordance with our criteria for rating government-related entities, we view the likelihood of CPP Investments receiving extraordinary government support as moderately high. We base this on our assessment of CPP Investments' critical role and limited link with the federal government. CPP Investments has a critical role in investing the assets of the CPP. The plan is an essential component of Canada's social safety net because of the pension, disability, and other programs it delivers. The plan has about 20 million participants for whom benefit payments will represent a significant proportion of their retirement income. The fund has a limited link with the federal government, as evidenced by the federal government's hands-off approach to the fund. Linkages are minor: CPP Investments reports its financial results to Parliament. The provinces are also important stakeholders in the CPP; the federal government has a duty to consult with the provinces in certain circumstances, such as the appointment of a director. Accordingly, the federal government must be careful to limit any unilateral influence on the fund if it is to maintain harmonious relations with provincial stakeholders. For this reason, we do not expect the federal government will negatively intervene in the fund.

We have used our "Principles Of Credit Ratings" in conjunction with "U.S. Public Finance: Public Pension Funds" and "Rating Government-Related Entities: Methodology And Assumptions" as our criteria foundation for our analysis of the CPP Investments' creditworthiness. We also use our "Methodology For Linking Long-Term And Short-Term Ratings" criteria as a basis to assign short-term ratings as well as our "Guarantee Criteria" as the basis for the rating on the debt of the fund's issuing trust. In our view, the fund's qualitative credit factors, such as management

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(including operational effectiveness and financial risk management) and independence, are similar to those of rated pension funds and pension fund investment boards. As of Jan. 13, 2020, we no longer use "Counterparty And Debt Rating Methodology For Alternative Investment Organizations: Hedge Funds" and "Rating Private Equity Companies' Debt and Counterparty Obligations" as our basis for analyzing CPP Investments' liquidity and leverage, as we retired these criteria articles. However, our analysis of the fund's liquidity and leverage remains largely unchanged. As part of our liquidity analysis, we assess the fund's expected cash flows as well as its ability to sell assets to meet payment obligations when cash shortfalls exist. Our leverage analysis considers various metrics, including the ratio of liabilities to assets.

Liquidity

We believe that CPP Investments has more than adequate liquidity, owing to its net cash inflows from net contributions and investment income and the strength of its considerable and largely liquid balance sheet. For fiscal 2020, net contributions amounted to C\$5.5 billion and operating expenses were C\$1.3 billion. We expect that the fund will remain cash-flow positive for fiscal 2021, as it has for many years.

CPP Investments held C\$76.6 billion in marketable government bonds in addition to C\$77.6 billion in developed market equities as of fiscal year-end 2020. These well exceed CPP Investments' CP and medium-term note programs, which totaled about C\$38.4 billion. Total liabilities (including debt) maturing within one year were C\$86 billion. The fund also maintains segregated securities in its short-term cash management program to meet CPP benefit payment obligations as they arise.

In general, we consider withdrawal risk remote because of the impediments that a withdrawing province would face in establishing an organization that could invest its share of CPP assets. However, Alberta has signaled its intention to explore the establishment of a provincial pension plan and withdraw from CPP. If that happens, we believe that in addition to its share of the assets, Alberta would assume a portion the fund's liabilities, and that the transition would be orderly. Furthermore, we believe that CPP Investments without Alberta would remain largely unchanged. Beneficiaries cannot withdraw from the CPP.

Outlook

The stable outlook reflects our expectation that CPP Investments will continue to realize good medium-term investment returns, liquidity will be more than adequate, and leverage will remain low-to-moderate in the next two years. We expect that the fund will continue to be independent of federal and provincial governments. As well, we expect the fund will expand and refine its risk management systems, to ensure that its investments remain diversified, and maintain strong management and governance practices. 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 there were a substantial increase in liabilities, such that total liabilities exceeded 40% of total assets in the next two years. We could also lower the ratings if there were a dramatic drop in liquidity levels or we believed the quality of management (including risk management) deteriorated significantly and was therefore unable to evolve in tandem with the growing size and sophistication of CPP Investments' investment portfolio. We consider these scenarios unlikely over our two-year outlook horizon.

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
- Criteria | Governments | U.S. Public Finance: Public Pension Funds, June 27, 2007

Related Research

- Canada Ratings Affirmed At 'AAA/A-1+'; Outlook Remains Stable, July 22, 2020
- S&P Global Ratings Definitions, Jan. 5, 2021

Ratings List

Ratings Affirmed

Canada Pension Plan Investment Board

Issuer Credit Rating AAA/Stable/A-1+

CPPIB Capital Inc.

Senior Unsecured AAA

Commercial Paper A-1(HIGH)

Commercial Paper A-1+

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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