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Caisse de depot et placement du Quebec

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Major Rating Factors

Issuer Credit Rating
AAA/Stable/A-1+

Strengths:
- Extremely strong financial position
- Effective governance structure
- Asset manager without responsibility for the funding liabilities

Weaknesses:
- Low interest rate and return environment necessitate an increase in leverage or a move into less liquid, alternative asset classes
- Canadian nonbank sponsored ABCP complicating liquidity management

Rationale

The ratings on Caisse de dépôt et placement du Québec reflect its strong financial position and an effective governance structure. The ratings also take into account the legislative support of the fund's sponsor, the Province of Quebec (A+/Positive/A-1+); the general independence of the Caisse and CDP Financial from their sponsor; the Caisse's excellent track record in asset growth; and its unique position as the asset manager for the majority of public sector pension and insurance plans entrusted to it by law, without regard or responsibility for the funding liabilities.

The Caisse is the legal owner of the assets entrusted to it by its depositor base and is the fund manager responsible for the day-to-day operations and investment activities of the fund.

Although liquidity issues with Canadian nonbank-sponsored ABCP assets are complicating liquidity management, the Caisse has ample liquid assets with which to meet its liquidity needs.

Outlook

The stable outlook reflects the organization's captive depositor base, solid and consistent long-term performance, global operations, strategic partners, strong leadership, and innovative culture.

Business Profile: One Of The Largest Institutional Investors In Canada

The Caisse is the largest institutional investor in Canada, with a mandate to increase and manage the assets of the Caisse depositor base, including Quebec's public pension and insurance plans. At Dec. 31, 2006, the Caisse managed assets of C$237.3 billion, up 9.8% from the previous year. Depositors' assets rose to C$207.9 billion from C$179.7 billion, or 15.7%, while the market value of their net assets rose to C$143.5 billion from C$122.2 billion, or 17.4%, reflecting the strong performance of the Caisse's investment activities (C$17.8 billion) and net deposits of C$3.6 billion in 2006. As a result, the overall portfolio return for 2006 was 14.6%. This is in line with the returns reported by other pension funds. The Caisse has consistently provided long-term quality returns, mainly as a result of its prudent, consistent investment style and philosophy.

As one of the largest Canadian institutional investor in foreign markets, the Caisse is a major financial partner in many investment funds worldwide. These partnerships give the hundreds of businesses in which the Caisse has an interest access to networks that greatly aid their international expansion. These partnerships reinforce the Caisse's power to act and gather information, and let it fulfill two of its fundamental missions: to preserve capital under management, and obtain an optimal risk-adjusted return on its investments. The Caisse is active on five continents, managing its North American operations principally from its offices in Montreal and Quebec City, Que.

Following an internal restructuring, the Caisse is organized around three investment groups: equities, fixed income, and hedge funds make up the investment division; real estate and private equity are each a separate group. The investment division also includes the following teams: research and investment policy advising; tactical asset allocation; currency management; and analytical support.

Pension Fund And Sponsorship

Historical perspective and legal structure

The Caisse was created in 1965 to administer Quebec Pension Plan (the Régie des rentes du Québec) assets. The Caisse and its direct and indirect, wholly owned subsidiaries are agents of the state or Crown. Nevertheless, the Caisse is a distinct legal entity from the Government of Quebec, and is vested with all the rights of a legal person. The Caisse and its direct and indirect wholly owned subsidiaries are agents of the state or Crown. It is also a tax-exempt entity, which gives it and its 90%-owned subsidiaries a tax-exempt status. The Caisse's property belongs to the Crown, but its performance might be pursued against such property. Also, the Caisse could bind itself in any way, such as borrowing, using its property as security, or encumbering it as though it were not the property of the Province of Quebec.

In December 2005, the province amended the Caisse's constituting statute as of Jan. 15, 2006. The new act states the institution's mission: "to receive monies on deposit as provided by law and manage them with a view to achieving optimal return on capital within the framework of depositors' investment policies while at the same time contributing to Quebec's economic development."

The act also introduced governance rules concerning the responsibility and independence of its board of directors:

- Separation of the positions of the chairman and CEO. The chairman has a renewable mandate of up to five years and oversees the implementation of the board of directors' governance rules. The president and CEO is the Caisse's most senior officer and spokesperson, responsible for its direction and management;
- Consultation of the board before the government makes an appointment to the board of directors; and
- The provision that two-thirds of the board, including the chairman, must be independent.

The Caisse manages only the pension funds' assets and not their liabilities, in contrast to a pension plan, which is responsible for both assets and liabilities. Instead, its mandate is to manage funds received on deposits provided for by law. Organizations required by law to deposit funds with the Caisse are the Quebec pension and insurance plans of government bodies. The Caisse administers the securities on behalf of the depositors, in accordance with the terms and conditions set out on an annual basis by the individual depositors' investment policies and procedures.

In other words, by virtue of the act, depositors must deposit their assets at the Caisse. It, in turn, has a mandate to manage these assets to preserve capital and provide superior returns. It is not, however, responsible for actuarial liabilities to the depositors for either the public pension plans or the insurance plans. Commission administrative des régimes de retraite et d'assurances (CARRA--Government and Public Employees Retirement Plan), the largest depositor, is responsible for depositing the pension contributions of Quebec public sector employees.

The funds entrusted by its largest depositor come from government employee contributions. This speaks to the legal independence of the Caisse from the government, which can only be changed if the Quebec National Assembly revises the law. Nevertheless, the government has amended parts of the act periodically.

In summary, the Caisse is held accountable to its board of directors, the Quebec National Assembly, its depositors, and the general public. Its primary focus is on returns. Legally, it is a separate entity with only a reporting obligation. Management will review all investments to ensure that they fit the Caisse's strategic goals and meet internal investment criteria and hurdles.

The board of directors and the Caisse: roles and responsibilities

The board's role is to ensure that the Caisse is managed in accordance with the provisions of its incorporating act and bylaws. It also ensures that the institution takes the measures needed to achieve the stated mission objectives. In pursuing that goal, the Caisse contributes to Quebec's economic development.

The board reviews and approves the Caisse's main policies and strategic orientations, such as the investment program for the year. It also reviews annually sectors of activity, and receives reports from various committees and ad hoc working groups when it must consider specific matters. The board is informed of any transaction, decision, investment, or other matter that requires special attention due to its intrinsic importance or effect on the portfolio or asset allocation.

Depositors

At year-end 2006, the Caisse had 22 depositors (with total net assets of C$143.5 billion), consisting of public pension plans, insurance plans, and other public bodies. The seven largest depositors accounted for 98.3% of depositors' net assets at Dec. 31, 2006.

The largest pension client (with 30.8% of client deposits) is the retirement plan of the Quebec government and public sector employees, Régime de retraite des employés du gouvernement et des organismes publics. Contributions are made by unionized employees, as well as by permanent and casual staff in the public and parapublic sectors. Contributions by management-level staff go into a plan called Pension Plan for Management. CARRA administers both plans. The second-largest pension depositor (22.8%) is the Fonds du régime de rentes du Québec (Quebec Pension Plan). This fund, administered by the Régie des rentes du Québec, provides income security for Quebec residents, including benefits paid to pensioners. This plan is comparable to the Canada Pension Plan, in which residents of all other Canadian provinces participate.

The largest insurance depositor (7.5%) is the Commission de la santé et de la sécurité du travail, which primarily compensates workers who are victims of industrial accidents and facilitates their rehabilitation. All of these are mandatory and unsecured contributions by depositors who must, by law, deposit pension fund assets with the Caisse.

Funding valuation assumptions

In reviewing any pension fund, the determination of funding status begins with an independent selection of actuaries. In this case, each depositor to the Caisse manages this responsibility. They each make the necessary adjustments based on actuarial valuations of the assets and the going concern liabilities. The Caisse has no responsibility to depositors in terms of managing the respective pension surplus or deficit positions. This responsibility remains with the contributing entity that represents the employees of the pension or insurance fund.

Asset Allocation Strategy

Determining the long-term asset mix is the cornerstone of the board's investment policy. The Caisse determines asset portfolio composition by the various depositors' investment policies, needs, time horizon, and risk tolerance together with the Caisse's advice and is revised at least every three years. As at Dec. 31, 2006, the Caisse's overall portfolio benchmark was 34.8% fixed income; 36.3% equity; and 28.9% alternative investments such as real estate, private equity, commodities, or hedge funds.

The Caisse forecasts returns, risks, and correlations on each asset class for the next 10 years. At that point, based on the asset mix goal, it performs a sensitivity analysis for three different reference portfolio scenarios, outlining a prudent, moderate, and aggressive view. These forecasts are just some of the inputs used to establish a target asset allocation for each depositor. Each depositor chooses, with the assistance of the Caisse, its own asset allocation mix from a shelf of different funds--the Caisse manages each of these individual funds separately.

Performance

Similar to other pension funds, the Caisse's portfolios are measured against the comparable benchmarks for the asset class. Generally, the first mandate is to exceed the benchmark. A second mandate reflects value at risk (VAR). As part of the annual budgeting process, each portfolio manager is given a risk budget to manage his or her portfolio's risk. On a consolidated basis, total risk is less than the sum of the individual risk budgets, as diversification reduces overall risk. Although each manager in marketable securities portfolios can track this VAR daily using front-office tools, senior management only receives a consolidated view every month (as a long-term investor, the Caisse feels this to be sufficient). In 2006, the Caisse posted an overall return of 14.6%, above that of the Ontario Teachers' Pension Plan Board (13.2%), but below that of the OMERS Administration Corp. (14.6%). The returns for the major depositors and clients ranged between 12.5%-16.3%, depending on asset mix and risk profile.

In 2006, the Caisse's investment activities generated C$17.8 billion in gains. This performance resulted from C$5.3 billion in net investment income, C$4.6 billion in net gains from the sale of investments, and C$7.9 billion of net unrealized gains.

Also that year, the Caisse's asset managers added 188 basis points (bp) of value above the company's chosen benchmarks. The major sources of the C$2 billion in value added were:

- Equity markets, with C$645 million, or 32.1% of the total. Equity markets posted a return of 20.9% against a benchmark of 19.0%;
- Asset allocation, (including cash allocation) earning C$377 million, or 18.8% of the total;
- Real estate, with C$357 million, or 17.8% of overall returns. Returns in the real estate segment beat the benchmark by 217 bp. The real estate group showed a 20.2% return for 2006; and

- Private equity, contributing C$600 million, or 29.9%, to the C$2 billion, returning 22.0%, which is 583 bp above benchmark.

Human Resources

The Caisse has a wealth of skilled employees. Many of these hold CFA designations, and many hold graduate degrees, including some doctoral degrees. Still, competition for highly-skilled, specialized finance professionals has been increasing. In response, the Caisse has, with the help of outside consultants, initiated adjustments to update its employee incentive structure.

Obligations: Leverage Increasing But Still Moderate

On the benefit side, the Caisse is not responsible for the balance-sheet liabilities of its depositors' pension assets. The vast majority of the Caisse's liabilities are investment-related.

Standard & Poor's Ratings Services notes that the leverage used as a percent of net assets by the Caisse has increased in the past five years, partially as a result of the Caisse's growing real estate portfolio, the use of more repurchase agreements in its bond portfolio, and the use of derivatives. It also reflects the low return environment enticing asset managers to increase leverage in exchange for (possibly) higher returns. Its leverage is still moderate, and not a concern in the rating analysis.

As of Aug. 31, 2007, CDP Financial Inc., the Caisse' funding subsidiary, had two major funding programs outstanding: a C$1.5 billion MTN program, of which C$1.3 billion was outstanding; and a C$7.0 billion CP program, of which C$6.7 billion was outstanding. Both debt programs were added in 2003 and are guaranteed by the Caisse. Fully drawn, the C$8.5 billion MTNs plus CP would have represented 5.9% of depositors' total net assets as at December 2006. CDP's board of directors limits the amount of debt that the Caisse guarantees at 7.5% of depositors' net assets. The debt supports its real estate business, where the company earns a positive spread by borrowing against its 'AAA' counterparty credit rating and investing in higher-risk, higher-margin real estate assets without having to incur market risk as a result of maturity mismatches. The Caisse also uses funds borrowed and secured against its real estate exposures, which amounted to about C$1.6 billion at year-end 2006.

The Caisse is an active user of derivatives. The use of such instruments has increased in recent years, as reflected in large and increasing notional amounts, primarily due to increased commodity exposure. Still, the Caisse had a net negative exposure on its derivatives positions of only C$17 million, or less than 0.01% of depositors' assets at year-end 2006 (C$539 million or 0.3% of depositors' assets in 2005) when assessed by fair value. Nevertheless, the large notional amounts reflect substantial modeling risk. All derivative counterparties must meet minimum criteria with respect to creditworthiness, and the Caisse's management must approve limits.

Liquidity Still Strong Despite Canadian Nonbank-Sponsored ABCP Issue

The Caisse's liquidity management is based on the integrated risk management policy approved periodically by the board. A minimum liquidity requirement is in place to handle any withdrawals by deposit holders or other, unforeseen events. The Caisse comfortably exceeded this minimum liquidity requirement as at Dec. 31, 2006.

In August 2007, the Canadian nonbank sponsored ABCP market, until then highly liquid, suddenly became highly illiquid, in what appears to have been a knock-on effect from concerns about subprime exposures in the U.S. residential mortgage-backed securities market. The Caisse no longer counts ABCP toward its short-term liquid assets, and in August 2007 led a multistakeholder initiative (since referred to as the Montreal Proposal) to address the issue. This initiative is ongoing.

In our opinion, the Caisse has ample liquid assets with which to meet its liquidity needs regardless of liquidity issues with Canadian non-bank sponsored ABCP assets, thanks in particular to the size of its CP and MTN programs compared to:

- Its flexibility with respect to internal liquidity needs (such as deferral of planned discretionary cash outflows);
- The continued net deposit inflow (C$3.6 billion in 2006), and the legal requirement for depositors named in legislation to continue to invest their funds in the Caisse;
- The high likelihood of the availability of competitive financing via either lending of the Caisse's substantial holdings of high-quality fixed-income securities (more than C$45 billion at Dec. 31, 2006), or their use in repurchase agreements; and
- The Caisse's ability to ultimately, if need be, raise cash quickly through sales of its considerable portfolio of publicly traded equities (more than C$60 billion at Dec. 31, 2006).

Ratings Detail (As Of September 28, 2007)*		
Caisse de depot et placement du Quebec		
Issuer Credit Rating		AAA/Stable/A-1+
Issuer Credit Ratings History		
29-Jul-2002	*Foreign Currency*	AAA/Stable/A-1+
17-May-2002		AA+/Stable/A-1+
14-May-2002		--/--/A-1+
14-May-2002	*Local Currency*	AAA/Stable/A-1+

*Unless otherwise noted, all ratings in this report are global scale ratings. Standard & Poor's credit ratings on the global scale are comparable across countries. Standard & Poor's credit ratings on a national scale are relative to obligors or obligations within that specific country.