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August 28, 2018

The Public Utilities Board of Manitoba
Attention: Mr. Darren Christle
Executive Director and Board Secretary
400-330 Portage Avenue
Winnipeg, MB R3C 0C4

Dear Mr. Christle:

Re: CAC Manitoba Motion to Compel Responses to
CAC 1-84 f) and 1-85 g)

On Monday, August 20, 2018, Manitoba Public Insurance (MPI) filed a motion brief and affidavit in response to the CAC Manitoba motion to compel responses to information requests CAC 1-84 f) and CAC 1-85 g).

While the material filed by MPI was extremely lengthy, it is not particularly helpful because of its single minded and mistaken focus on capital market assumptions about inflation. However, the concern of CAC Manitoba as exemplified by the information requests is the failure by MPI to appropriately characterize the risks facing its liabilities.

Attached to this letter is a brief memo which attempts to redirect the attentions of MPI to the real issues at stake. As set out in the memo:

*It is the **basis** for describing the risks in the liabilities that the CAC questions, and which has a material impact on the optimal portfolios (and return/risk) – not the capital market assumptions about inflation per se.*

The concern of CAC Manitoba is that the preternatural focus of MPI on the inflation component sidesteps the larger and more volatile issue of capital gain/duration effects. As set out in the memo:

*While MPI provides information about expected inflation and inflation volatility, there is little mention of **real** interest rates and the related **real** risks (which are material). Given the high duration (interest rate sensitivity) of the liabilities, it is important to focus on the long-term duration or "capital gain" effects related to both fixed income assets and the liabilities as well.*

MPI's approach focuses on the inflation component only, not the (larger) capital gain/duration effects. This is like focusing on the dividend yield component of stock returns (low and stable), rather than the capital gain component (larger and more volatile).

To similar effect, the memo states that:

*The standard deviation of the **nominal** interest rate depends on:*

- standard deviation of **inflation**, which the CAC does not question;*
- standard deviation of **real** rates (related to duration), which is not discussed by MPI; and*
- **correlation** between **real** rates and inflation, also not discussed by MPI.*

Moving beyond the characterization of liability risk, to asset allocation selection, CAC Manitoba has a preliminary concern that the process used was circular in that:

*The outputs (portfolios) of its preliminary "real" analyses, which used the **Real** Liability Benchmark, were used to inform the **inputs/model** (capital market assumptions/ characteristics of the Liability Benchmark Portfolio).*

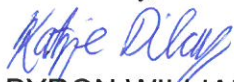
In essence, the preliminary view of CAC Manitoba is that the record currently before the PUB raises the concern that the understanding of the liability risk faced by the MPI is "unsatisfactory" and that the process used in asset allocation is "unreasonable". The information requests posed will clarify the current record before the PUB by enhancing our understanding of the:

1. effectiveness of interest rate risk management practices, clearly distinguishing between the two components of nominal interest rates: i) inflation expectations and ii) real interest rates; and
2. decision-making standard and process for selecting asset allocations to support liabilities.

Allowing for variance in risk tolerance, the information sought will assist in understanding the various asset allocations which would flow from a more analytically sound assessment of the risks associated with the liabilities. This is hardly an academic question given the materiality of the liabilities, the significance of the asset allocation questions and the low frequency of asset/liability studies.

Thank you for your consideration of these comments.

Yours truly,



for: BYRON WILLIAMS
DIRECTOR
BW/ab

cc: Board Counsel
Manitoba Public Insurance
Approved Interveners

