

October 21, 2019

Undertaking #24

MPI undertake to indicate the direction and, if possible, the order of magnitude of the impact of the shadow portfolio on Basic MCT ratio.

RESPONSE:

For shadow portfolio 1, the impact on the Minimum Capital Test (MCT) ratio would be slightly unfavourable. Assuming real return bonds and corporate / provincial bonds have similar credit ratings and similar durations, the capital available would decrease slightly due to lower returns, which would ultimately lower the MCT ratio.

For shadow portfolio 2, the impact on the MCT ratio would also be unfavourable. A lower MCT ratio would result from the following:

- transitioning from a portfolio consisting of 100% fixed income assets to a portfolio that includes growth assets consisting of equities, real estate, and infrastructure would increase the risk of the portfolio and therefore the required capital; and
- including infrastructure increases exposure to foreign exchange risk and also has the effect of decreasing the MCT ratio slightly.

For shadow portfolio 3 the impact on the MCT ratio would be slightly unfavourable. Assuming real return bonds and corporate / provincial bonds have similar credit ratings and similar durations, due to lower returns, the available capital would decrease slightly and, in turn, lower the MCT ratio.

For shadow portfolio 4, the impact on the MCT ratio would be favourable. A slightly higher MCT ratio would result from the following:

- a decrease in the investment of growth assets from 60% to 55%, because these assets carry higher risk, this will have a slightly favourable impact to the MCT score;

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- a decrease in infrastructure from 10% allocation to a 5%, because infrastructure carries foreign exchange exposure, the risk related to this will be reduced and subsequently provide a slightly more favourable MCT score;
- the addition of MUSH bonds will increase interest rate risk and decrease the MCT ratio; and
- a greater expected return from this portfolio which will increase the capital available and provide a more favourable MCT score.