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Undertaking #34

For MPI to advise directionally, of the impact on the discount rate of adding equities instead of Real Return Bonds to the basic portfolio "on a cash basis" with no repos or reverse repos and, in addition, MPI provide an explanation of the basis for why the impact on the discount rate is the same or different from the impact of Real Return Bonds on a cash basis.

RESPONSE:

Adding equities or real return bonds to the portfolio would have a similar impact on the discount curve as both would be viewed as federal bonds; adding them on a cash basis would cause the discount curve to fall as it would require the sale of higher yielding Provincial bonds.

If MPI were to add either equities or real return bonds to the Basic Claims portfolio on a cash basis existing investments would need to be liquidated in order to fund the purchase. MUSH bonds are illiquid and cannot be sold; of the remaining marketable bonds Provincial bonds are the most liquid and generally have lower yields than corporate bonds.

The 34% allocation to equity after adjusting for the equity risk premium would be like having a 34% allocation to federal bonds. If provincial bonds, corporate bonds, or even a blend of the two were reduced, it would imply a lower yielding discount curve and an increase in liabilities.

With regards to the question of reflecting the use of equities in the discount curve, IFRS 17 does not specify restrictions on the reference portfolio of assets. However, the intention is for the discount curve to reflect the characteristics of the liabilities rather than those of the assets and as such factors that are not relevant to the characteristics of the liabilities need to be removed. Hence the necessity to remove the credit/default component of spreads in order to leave the liquidity premium remaining. The same would be true for the use of equity, and the CIA educational notes indicate that you would be required to remove the systematic or "market" risk

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from the equity return as the liabilities do not have equity risk. Since equities are exchange traded and viewed as liquid there would be little left in the way of illiquidity, effectively leaving the risk free rate:

From Section 4.2.3 on page 30

<https://www.cia-ica.ca/docs/default-source/2022/222097e.pdf>

A reference portfolio could contain non-fixed income assets such as public equity and real estate. Public equities are considered to be highly liquid since they can usually be sold at any time at the prevailing market price. Therefore, the risk premium over risk-free rate represents a premium for market risk and would not be considered relevant to the insurance contract and would be removed from the discount rate.

There are several other impacts to consider:

Our current target weight for Provincial bonds is 37%; liquidating 34% of our Provincial bonds would make management of the asset-liability management strategy more challenging and expensive as the strategy depends on having liquid bonds to trade in order to adjust the duration to match the duration of the claims liabilities. The remaining marketable bonds would primarily be corporate bonds, which have wider bid-ask spreads than Provincial bonds (meaning they are more expensive to trade) and they tend to be relatively short in duration (making it challenging to replace the Provincial bonds on a duration neutral basis).

Also, if the dollar value of the fixed income assets does not equal the present value of the liabilities required capital would increase.

Finally, if equities were purchased required capital would increase by about \$205 million as equities have a capital charge of 30% ($\$2,000 \text{ M} \times 34\% \times 30\%$) while real return bonds have no capital charge.