

CLOSING SUBMISSIONS

2019 GENERAL RATE APPLICATION
October 30, 2018



**Manitoba
Public Insurance**

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Part I
Introduction and Summary
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1 Introduction and Summary

1 The 2019 General Rate Application (GRA) reflects the new direction taken by Manitoba Public Insurance's (MPI or the Corporation) new Board of Directors.

2 The 2017 GRA was provided to the Board of Directors for approval two weeks after their appointment. It could not reflect their vision of how the Corporation should operate. The 2018 GRA was a transitional rate application, as the Board of Directors began the process of assessing the affairs of the Corporation and implementing their direction. The 2019 GRA truly reflects the direction in which the Board of Directors intends the Corporation to operate.

3 As a result, this is the most open and transparent GRA in the history of MPI; it should be clear that MPI has made a genuine effort to identify and acknowledge mistakes and is demonstrating how those mistakes will not be repeated.

4 In 2018, the Board of Directors created a new Mission Statement for MPI:

"Exceptional coverage and service, affordable rates and safer roads through public automobile insurance."

5 The Mission Statement is a declaration of the Corporation's core purpose and focus.

6 To attain the objectives of the Mission Statement, management must conduct the affairs of the Corporation in accordance with insurance industry best practice. Best practice is multi-faceted; it includes, but is not limited to:

- i. the use of best estimates;
- ii. the application of value and risk management;
- iii. prudent fiscal management; and

- iv. understanding the needs of both MPI's customers and its Minister Responsible, who is ultimately accountable to the Legislature for the universal compulsory automobile insurance program.

- 7 Recently hired executives bring international experience to MPI and ensure that the Corporation applies insurance industry best practice to its operations. Prior to joining the Corporation, Ben Graham, MPI's President and Chief Executive Officer, held a executive position with QBE Asia-Pacific, one of the largest multinational insurance company in the world. In addition, Curtis Wennberg, MPI's Vice-President, Customer Service & Chief Operating Officer, held senior positions with major corporations such as Boston Consulting Group, GE Capital, and HSBC. Last but not least, Mark Giesbrecht, Vice-President Finance & Chief Financial Officer has held senior financial officer positions with Western Financial Group (including property and casualty insurance).

- 8 Mr. Graham has been tasked by the Board of Directors to implement global best practice across MPI's operations. The rhetorical question is – "Why wouldn't MPI apply insurance industry best practice to its operations?"

- 9 Applying insurance industry best practice to all aspects of MPI's operations will result in stable, affordable rates for ratepayers and reduced volatility for the Consolidated Financial Statements of the Province. The application and use of insurance industry best practice is evident throughout this GRA. Examples include:
 - i. the use of best estimate forecasting;
 - ii. development of risk management capabilities;
 - iii. the application of the Value Management process to significant capital projects;
 - iv. enhancing reserving policies, and accountability;
 - v. adopting MCT as a measure of capital adequacy;

- vi. maintaining capitalization through a Net CMP provision;
- vii. improving Asset Liability Management (ALM), aimed at matching liabilities through appropriate portfolio segmentation; and
- viii. de-risking the Basic claims portfolio, to ensure Basic can meet its existing obligations to claimants.

10 Discussed in prior GRAs, the following issues were again the focus of discussion in this year's GRA:

- Capital;
- Investments;
- Interest Rate Forecasting;
- Reserving;
- Long term liabilities (PIPP); and
- IT Projects.

11 The Corporation is applying insurance industry best practice to address these challenging issues. The results of doing so are self-evident. On June 15, 2018, MPI filed a GRA seeking an overall rate request of 2.2% consisting of:

- i. 0.10% increase to the break-even cost of policies, and
- ii. 2.10% increase for a Net Capital Maintenance Provision (CMP).

12 Although the Corporation will not move to amend its Application, it would endorse having its rate application varied by the PUB, to reflect the actual GoC 10 Yr. bond yields, as of September 28, 2018 (2.43%). MPI notes that, should the PUB decide to vary its GRA as indicated, the new overall rate request would be 1.8%, consisting of:

- i. 0.26% decrease to the break-even cost of policies, and
- ii. 1.80% increase for a Net Capital Maintenance Provision.

- 13 Assuming the PUB approves the 2019 GRA as applied for, MPI is presently forecasting a 0% breakeven rate indication, a 0% CMP and does not presently foresee a requirement for a capital build provision for the next 3 years. The rate stability that MPI is presently projecting is consistent with MPI's objectives, and is a result of the implementation of best practices, and prudent fiscal management.
- 14 Implementation of the direction from the Board of Directors leads to stable, affordable rates and lowers volatility in the Consolidated Financial Statements of the Government.
- 15 MPI has heard the position of interveners, but cautions the PUB against adopting a narrow a view of the insurance environment facing Basic. Intervener recommendations that focus on reducing rates today, drive short term volatility and rate instability.
- 16 MPI is pursuing its mandate by focusing on smaller incremental increases that support long term stability. This balances the needs of ratepayers today and tomorrow, and future proofs the business in a fiscally prudent manner.

Part II
Setting the Direction
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2 Setting the Direction

- 18 The Framework Letter from 2016¹ references a review of the old *The Crown Corporations Public Review and Accountability Act*. This review resulted in the Legislature passing *The Crown Corporations Governance and Accountability Act (CCGA Act)* in June 2017.
- 19 The *CCGA Act* and *The Manitoba Public Insurance Corporation Act (MPIC Act)* are the cornerstones for the provision of Basic compulsory insurance program in Manitoba. Under the *new CCGA Act*, MPI must prepare an Annual Business Plan for approval by the Minister Responsible for MPI.
- 20 The Annual Business Plan is a legislative requirement. It is a key new component of the statutory framework set out in the *CCGA Act* related to the provision of universal compulsory automobile insurance. It is also the roadmap for the Corporation to attain its Mission Statement. The direction of the Board of Directors to focus the management of the Corporation towards industry best practice is apparent throughout the Annual Business Plan.
- 21 Key priorities, as stated in the Annual Business Plan directly impacting this GRA are:
- a) The Basic compulsory insurance program must be operated on a self-sustaining basis with a sufficient capital reserve to absorb unforeseen variations in revenues, claims costs and investment revenues, and with insurance rates that are actuarially supported and established in accordance with Accepted Actuarial Principles.
 - b) The Basic compulsory insurance rates will be kept as stable, predictable and affordable as possible.

¹ CAC Exhibit-18

- c) Products and services will continue to evolve to address the evolving needs of Manitobans, including services to Manitobans in rural, northern and remote communities.
- d) The financial affairs of the Corporation will be managed in a manner that will not impair the consolidated financial statements of the Province.
- e) Capital projects and major technological initiatives will focus on supporting and optimizing core business functions, including ensuring the Corporation's ability to adapt appropriately to changes in the auto insurance and registration environment. As much as possible, solutions will be sourced "off-the-shelf" and will limit customizations.
- f) The Corporation will continue to demonstrate fiscal prudence and sound financial management practices while driving cost-containment, streamlining of operations and elimination of unnecessary operational expenses.

22 The statutory framework in which the PUB conducts its review of MPI's application to change rates for services is set out in the *CCGA Act*, the *MPIC Act* and *The Public Utilities Board Act*. The PUB's jurisdiction to review and approve changes in rates for service is set out in the *CCGA Act*; it is one component of the broader legislative scheme to provide Basic compulsory insurance.

23 This governance scheme has created distinct but complementary roles for the publicly appointed MPI Board of Directors, the Province, and the PUB that together ensure the success of Basic compulsory insurance.

24 Upon careful exercise of their responsibilities as set out in the statutory framework, MPI and its Board of Directors have developed a rate application that balances the interests of ratepayers and the Corporation's requirement to cover the costs of 2019/20 rating year policies. MPI's application has provided ample evidence, supported by detailed analysis, establishing the rate request as just and reasonable.

- 25 While minor points have been contested by interveners, it is fair to conclude that the forecasted costs to be incurred during the rating year are prudent and reasonable. It is well established regulatory law that MPI is allowed to recover these costs.
- 26 The totality of evidence before the PUB supports the conclusion that MPI's rate request is both prudent and consistent with MPI's objectives of rate stability and reduced volatility to bot ratepayes and government.
- 27 MPI supports the PUB's review of MPI's rates for service, and argues that a denial or variance of MPI's requested rate must be accompanied by findings, supported by evidence, that those requested rates are unjust and unreasonable.
- 28 The PUB, as a utility regulator under *The Public Utilities Board Act*, offers a unique set of skills and perspective. Its role is to review this GRA, in the public forum, and assist the Corporation by ensuring that the rates it establishes are just and reasonable.
- 29 MPI's Board of Directors and the Corporation itself each look forward to working constructively and collaboratively with the PUB to improve how the Corporation establishes its rates for service going forward.

Part III
Annual Challenges
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3 Capital Adequacy

30 The issue of capitalization has, in one way or another, been a topic of significant discussion at general rate applications for the past number of years. Whether it is the depletion of the Rate Stabilization Reserve, requiring \$250 million in capital transfers², debate over the methodology of how to calculate the range of the reserve targets or what is the appropriate size of the reserve, the discussion at its core is a discussion about capital.

31 The PUB in Order 130/17 made a significant observation when it stated:

“The Board nonetheless recognizes MPI’s need to protect against the depletion of Basic’s capital position, and finds that a Capital Maintenance Provision could be considered a legitimate necessary Basic expense for rate-setting purposes.”

32 This statement highlights a fundamental philosophical question about Basic rate setting that divides interveners and MPI. Should breakeven rates, based upon Actuarially Accepted Practice, be intentionally designed to reduce the amount of funds in the RSR as the Basic line of business grows, or should rates be designed to maintain the status quo of the reserve amount from the beginning of the rating period to the end?

33 A strategic objective of the Corporation is rate stability. Maintaining the status quo of the reserve levels is a cornerstone of rate stability.

² CAC(MPI) 2-19, and CAC(MPI) 2-11

4 Net Capital Maintenance Provision

34 The Corporation's request for a Net Capital Maintenance Provision (Net CMP) is simple, effective, and it directly supports the principles of a self-sustaining Basic program, rate predictability and stability, and reduced volatility.

35 The Corporation's method for determining the 2.1% Net CMP has been **incorrectly** characterized as:

- a) A move backwards to rate setting based on accounting results
- b) A provision to build capital
- c) A means to hide mismanagement

36 MPI's application for a Net CMP is in the best interests of ratepayers who benefit from the protection afforded by a well-funded RSR, and is consistent with prudent fiscal management of Basic.

4.1 Capital Maintenance Provision is a Just, Reasonable and Necessary Cost

37 The 2018 GRA began to explore the concept of a capital maintenance provision, as an alternative to retaining RSR investment income for purpose of mitigating the depletion of Basic's capital position, as the business grows.

38 Basic's policies are priced without a profit provision, so without the benefit of the RSR investment income, or some reasonable alternative, Basic's capital position would deteriorate, as the risk profile increased.

39 PUB order 130/17 recognized the need to guard against the natural depletion in Basic's capitalization, stating:

The Board appreciates the need to protect Basic's capital position against depletion due to the natural growth in Basic's risk profile, i.e., the expectation for Basic claim liabilities (and investment portfolio) to grow over time since the addition of new claims is expected to outpace the settlement and closing of old claims. The Board believes a properly constituted Capital Maintenance Provision, loosely based on that developed by Saskatchewan Auto Fund, can legitimately be considered as a necessary Basic expense cash flow for rate-setting purposes while remaining consistent with the break-even objective.³

40 The PUB ordered that a technical conference be held, with the objective that:

This Technical Conference shall seek consensus on an approach to estimating a Capital Maintenance Provision⁴

41 MPI participated in the Technical Conference, and found the insights and experience of SGI, as well as moderated discussion to be helpful in informing the design of the Net CMP for Basic, applied for in this GRA.

4.2 MPI's Approach to Net CMP is both Accurate and Fair

42 MPI's method for calculating the Net CMP is accurate, in that it provides for the full amount of capital **actually required** to maintain the capital position of Basic in that particular rating year.

43 It is fair because each policy holder is being asked to contribute only the amount of capital required to maintain Basic's capitalization in that year. That is, policy holders end the year with the same capitalization as when they started the year. Each year, policy holders are asked to pay their way, for that year only, and so it is also fair, intergenerationally.

³ Order 130/17, page 29

⁴ Order 130/17, page 30

44 On this point, the Chief Actuary Luke Johnston elaborates⁵:

Okay, so capital maintenance, again, we've -- we've used the MCT as the basis for determining maintenance. We think that's appropriate.

So, for the capital maintenance we're saying, again, that how -- the capital position that the policyholders come into the year with should be the same when they leave that policy year. And we do that by maintaining the MCT at the same level. ⁶

45 By averaging over multiple years, the SGI model is unchanged from year to year, but it is also more complex, and critically, it does not measure **the actual capital required to maintain capitalization in the rating year**. Accordingly, it is not as fair intergenerationally, and does not fully meet the intent of the MPI's Net CMP. Mr. Johnston explains that SGI's approach to a CMP is more difficult to predict and administer:

"Yeah. So -- so our main -- what we see as the main benefit of -- of the MPI model is that it just focuses on the -- the one (1) year, and what is needed to maintain capital in that one (1) -- in one (1) -- that one (1) fiscal policy year, I guess we can call it. That, in our view, makes sense in terms of what's a fair contribution to capital maintenance for a group of policyholders.

If we start looking at the five (5) year forecast period, there are some questions on, you know, what if your risk profile changes, and -- or if there's things in the forecast that could cause swings up and down. To -- in -- in my view, that would be more difficult to normalize over a five (5) year outlook period than it would be to understand the most recent year that you're going in, and at least providing evidence here that the Cap -- Capital Maintenance Provision for that particular fiscal year is approp -- is appropriate."⁷

⁵ T: 693, lines 14-24

⁶ T: 694-695, lines 6-25 and 1-4

⁷ T: 712-713, lines 12-25 and 1-5

The observation that MPI's Net CMP is a return to rate setting based on accounting results has merit, but only in the superficial sense. A careful examination of MPI's Net CMP proposal reveals it is nuanced, and based on more reliable near term estimates of capital required in the coming year to maintain Basic's projected financial position. Mr. Johnston explains:

So now we're -- based on what we've just gone through, like, in -- in -- through these examples, what we're really trying to goal seek our match to our MCT ratio. That -- and -- and so that is an accounting view. But again, if -- if we -- even under AAP, the big -- the big issue with our break-even rate-making methodology was largely related to interest rates. We were forecasting changes into the future, positive or negative, and then we were either giving people rate decreases or rate increases based on what was really prior years' experience. AAP fixed that issue.

In terms of capital, though, we have -- it's pretty clear through the MCT and the DCAT what our capital targets are, and I -- I think it's also pretty clear what we would need to maintain them. And so from that perspective, I -- I don't really know what other option we would use other than something like the MCT ratio. So if -- yeah, I -- I can't think of a better option.

46 Mr. Giesbrecht elaborates on the various components that comprise the CMP:

While the total equity would be based on, you know, accounting results, the required capital calculation under MCT is based on a number of actuarial, you know, computations based on the -- the risk charges that apply to different assets and different components. So it's not purely based on accounting. There are other factors.⁸

⁸ T: 516-518

4.3 Net CMP Accounts for the Investment income on the RSR

- 47 MPI's Net CMP explicitly considers forecast investment income on the RSR, and deducts those amounts from the total required to maintain the Basic's MCT as at March 1, 2019.
- 48 This is a direct benefit to ratepayers, ensuring that the Net CMP charged to ratepayers is no larger, or smaller than is needed. MPI's breakeven rates continue to be based only on the costs and revenues associated with issuing new policies, which is what ensures they are priced on a breakeven basis.
- 49 The investment income earned on the RSR balance is in no way associated with the costs or revenues of new policies, but is properly considered with Basic's capital. By factoring RSR investment returns into the Net CMP calculation, ratepayers benefit from the income, through a reduction in the capital maintenance provision, while the break-even cost of policies remains based on the costs and revenues associated with those policies.
- 50 In response to a question from PUB counsel about the need for a Net CMP in the context of RSR investment income accounted for in the rate calculation, Mr. Johnston explains that Basic's total equity must grow with the business:

So at least under current forecasts when we set rates based on accepted actuarial practice, we see expo -- well, especially if we return the investment income from the RSR as part of the rate calculation, we would see total equity stay approximately flat, which is what's shown in the second last row of this table.

And to most people they would say, okay, well, what's the problem? You -- you know, the RSR is staying at the same level. The issue right now is that the business continues to grow, so -- again, use the example, if your assets are growing you would have, all else equal, say more equities, which means if there is a stock market crash, you could lose

more. So the MCT and the DCAT and other measures would say you have more risk, you should have more capital.”⁹

4.4 CMP Maintains Basic’s Capital Position as a Percent of MCT

51 The purpose of the Capital Maintenance Provision is simply to maintain the Corporation’s capital at the end of the rating year, to be the same as at the beginning of the rating year. This requires a ‘measuring stick’, and MPI’s proposes the MCT ratio.

52 The proposed Net CMP for Basic is described as follows:

“The purpose of the Capital Maintenance Provision is to ensure that the RSR Balance, total equity as measured by the Minimum Capital Test (MCT) ratio, which compares capital available to capital required, at fiscal year-end 2019/20 is unchanged from fiscal year-end 2018/19.”¹⁰

53 Capital Maintenance Provision is **not** a capital build provision. Mr. Johnston explains that the reason why Basic’s risk profile continues to grow is the that PIPP program has not yet fully matured:

“And the main reason right now is that assets and liabilities continue to grow, and based on that, they demand a -- a higher capital amount. As I mentioned yesterday, our liabilities are continuing to grow. We -- we expect that will plateau in the next five (5) to ten (10) years. But right now we're still seeing growth in the balance sheet. And again, if capital stays the same absolute value relative to a growing balance sheet, it -- it would show these declining capitalization rates.”¹¹

54 Because the CMP is calculated on a forecast basis, any evolution in the risk profile reflected in the MCT calculation is set and accounted for at the time the Net CMP requirement is calculated. The Net CMP’s reference point is only the rating year’s starting MCT percentage, and the year-end balance sheet as forecast at that time.

⁹ T: 494-495, lines 16-25 and 1-17

¹⁰ CAC (MPI)2-18

¹¹ T: 496, lines 15-24

4.5 Net CMP does not 'Paper-Over' Mismanagement

55 The Net CMP should not be seen as a means for Basic to maintain its capital in the face of management errors¹². While it is true that management errors may ultimately impact the total equity balance of the corporation, at least in timing if not overall magnitude, MPI's management is applying a higher standard of care with respect to value management and risk management to reduce the potential for error. Mr. Giesbrecht elaborates:

*"It -- you know, it could absorb other things, a cost overrun potentially. We are working very diligently on our expenses, and -- and we have shown and you walked us through it earlier, how our costs have been coming down and we continue to work on ensuring that we are having efficient operations."*¹³

*"And we have seen examples in the past where we've had strategies or plans that maybe didn't work out as well as we would have hoped. However, the -- the intent of a CMP is by no means to take away the accountability or the responsibility of management. It is to manage appropriately as an insurance fund using best practice and ensure that we have the ability to manage capital to deliver on our mandate to Manitobans."*¹⁴

56 The additional capital amounts are not cushion for 'management largesse', but reflect the forecast growth in Basic's risk profile. This growth in risk, needs to be matched with capital in order to prevent Basic's capital position from deteriorating.

¹² T: 591, lines 8-21

¹³ T: 590-591, lines 5-25 and 1

¹⁴ T: 592, lines 7-15

4.6 CMP is the Reasonable First Step to a Capital Management Plan

- 57 MPI's proposal for a net CMP stands on its own merits, but it is also a reasonable component of a Capital Management Plan, which MPI intends to bring forth in a coming application.
- 58 The proposal to maintain capital in the face of a growing risk profile is just and reasonable, and does not require the detail of the Capital Management Plan to assess its reasonableness. To the contrary, the forthcoming Capital Management Plan can be properly assessed in the context of the Net CMP, and any other capital provisions will be designed with the Net CMP in mind.

5 Rate Stabilization Reserve

5.1 MPI is Expressing DCAT Based Capital Targets as an MCT Ratio

- 59 To say that MPI is applying to change the methodology used to calculate the upper and lower RSR Targets is false and misleading.
- 60 MPI has applied for capital targets that are based on best estimates, and are consistent with the approach developed through the collaborative process to create DCAT based Upper and Lower RSR Targets. MPI's application is seeking a Lower RSR Target of 34% MCT (\$143 Million), and an Upper RSR Target of 85% MCT (\$305 Million) to start the rating year on March 1, 2019.
- 61 MPI calculated the Upper and Lower RSR Targets based upon the DCAT analysis. The calculation produces a dollar amount. MPI then chose to **express** the dollar amount as an MCT ratio. The advantages of this approach are:

"The Dynamic Capital Adequacy Test (DCAT) provides a lower and upper target for a specific point in time, that being the beginning of the rating year (March 1, 2019). By converting the DCAT target numbers into a Minimum Capital Test (MCT) ratio, the Corporation can forecast lower and upper targets. The Corporation can also estimate what the lower and upper DCAT targets would be if circumstances (i.e. risk levels) change in the future.

RSR Fig. 11 shows how the MCT ratio can be used to forecast future RSR targets. Specifically, this table shows how planned changes to the Corporation's investment portfolio affect the RSR targets. For both the lower and upper DCAT-calculated RSR targets, the equivalent MCT ratio remained essentially unchanged before and after the assumed transition to the lower risk investment portfolio."¹⁵

¹⁵ CAC(MPI) 2-12

62 To ensure clarity around the approach, MPI has stressed that the DCAT approach, developed through the collaborative process, is still the foundation of the applied-for RSR targets:

*"The Corporation uses the MCT ratio as a means to forecast future DCAT-based RSR target calculations. The Corporation does not take the position that the MCT ratio can replace the DCAT exercise in 2020 and beyond. **The 34% MCT ratio is derived from the 1-in-40 DCAT scenario.**"¹⁶ [Emphasis added]*

63 MPI explained that the MCT and DCAT approaches complement each other, as stated by Mr. Giesbrecht:

"...the MCT and the DCAT are not mutually exclusive. In -- in terms of target setting, the -- the DCAT is really what underpins the MCT, and they work hand-in-hand. And so they -- they are not two (2) different things, but they really work together to set your -- your target."¹⁷

5.2 MCT Remains MPI's preferred expression of Capital Adequacy

64 MPI's preferred approach to **expressing** capital adequacy remains the MCT ratio. MPI has reflected this preference in past applications for an MCT based upper RSR target.

65 Management has also chosen to express its desired capital range in the quarterly financial statements as being between 75% and 100% MCT. Mr. Giesbrecht explains:

So this target range, which is published in the quarterly report is our -- our desired end state. It is not aligned to our current framework. It is a longer-term view towards what management and Board is looking for in terms of our -- our desired end state.¹⁸

¹⁶ CAC (MPI) 1-15

¹⁷ T: p 678 line 11-17

¹⁸ T: 523 line 6-11

- 66 MPI has routinely expressed the benefits of using MCT as a measure for capital adequacy, which include¹⁹:
- ease of estimation, at various periods of time, that incorporates changes in risk profile;
 - ability to update based on the actual and forecast balance sheets;
 - standardized test allows for comparability to peer insurers; and
 - Assesses key risks such as insurance, market, credit and operational risks.

- 67 MPI continues to view MCT as the appropriate risk based measure of capital adequacy, and the management and operation of Basic continue to be informed by capital adequacy measured by MCT. The benefits to MPI were explained by Mr. Giesbrecht as:

"Firstly, the -- the MCT allows us to measure our capitalization level at any given month or quarter end; that it produces a dynamic number whereas a static number based on total equity or based on a DCAT modelling does not factor in market changes, growth in the business, if we've made changes to our lesson portfolio. And so, if we have a number to start any given year, that number may not be a fair representation of what we need to carry for adequate capital, six (6), nine (9) or twelve (12) months or eighteen (18) months down the road, given changes in the business or in the marketplace."²⁰

5.3 MPI's RSR Targets Reflect the Results of the Collaborative Process

- 68 MPI has applied for and upper and lower RSR Targets that reflect the results of the collaborative process, Technical Conferences and the Regulatory Hearing process to date, including:
- i. utilizing a 1-in-40 risk tolerance;
 - ii. adjusting the assumptions of adverse scenarios (e.g. inflation, equity returns);

¹⁹ 2019 GRA Part VI RSR.4.5.2

²⁰ T: 501-502, lines 1-4, 17-25, and 1-10

- iii. using the PUB's iterative methodology;
- iv. building, modifying, and sharing the Corporation's stochastic and financial models; and
- v. adopting the 2 year time horizon for modelling response to adverse events in determining the upper RSR Target.

69 However, MPI is unable to adopt the assumption of capital transfers in the modelling of capital targets, as explained in the sections that follow.

5.4 Satisfactory Financial Condition Must be Based on Best Estimates

70 To date, MPI's DCAT modelling to determine satisfactory financial condition, and the establishment of the Lower RSR Target have been the same exercise. That is, the Lower RSR Target has reflected the threshold for satisfactory financial condition.

71 The capital target methodology adopted by the PUB in Order 130/17, decouples the lower RSR target from the threshold for satisfactory financial condition, by assuming capital transfers that adjust the Total Equity balance such that the resulting modified forecasted MCT ratio is forecasted to remain unchanged throughout the forecast period.

72 These 'adjustments' assume transfers from Extension totaling \$48 million²¹ over the 4 year modelling period. The assumption of these transfers is problematic because:

- it represents amounts that the Board of Directors may be unable, or unwilling to transfer, and so is not a best estimate assumption;
- it assumes a subsidization of Basic that is inconsistent with principle that Basic should stand on its own; and

²¹ PUB (MPI) 1-16 (a) Appendix 1b

- it blurs the risk assessment of Basic, decoupling the determination of satisfactory financial condition from the lower RSR Target.

73 In Order 162/16 the PUB was explicit in its expectation that (i) the capital targets reflect the risk facing basic, and (ii) that they be based on best estimates, stating:

*“The Board continues to favour the use of scenario testing adapted from the annual Basic DCAT investigation for purposes of setting Basic target capital levels, expressed in terms of Basic total equity. **This approach is consistent with the objective of setting Basic target capital levels to be specific to the risk profile of the Corporation’s Basic insurance operations.***

...

It is the Board’s expectation, and for that matter a requirement of accepted actuarial practice in Canada, that the Corporation’s Basic Application, including the rate indications, the Basic DCAT investigation and the target capital analysis, be prepared on a best estimate basis. Doing otherwise complicates the regulatory review process.”²² [Emphasis added]

74 However, in Order 130/17, the PUB reversed its position, conceding that the modelling approach did not reflect best estimate expectations, stating:

“The Board agrees that such transfers are not best estimate expectations, but rather sees these transfers as a theoretical means to an end, that “end” being the testing of Basic’s resilience to adverse circumstances when operating at about the proposed threshold level.²³

75 Two critical failings arise as a result of Order 130/17:

76 First, Basic’s capital targets no longer reflect the risk profile of Basic. The true risks facing Basic are no longer measured in the DCAT based capital target analysis. Mr.

²² Order 162/16 p. 60

²³ Order 130/17 p. 78

Johnston explains that the actual risk assessment of Basic becomes blurred by the assumption of capital transfers:

"We don't -- when we talk about the modified DCAT, assuming transfers from other lines of business, we don't want to show or -- or blur the assessment of Basic by capital transfers. We wanted to -- the -- the PUB and others to see this is the risk of Basic, you know, on its own. That's not to say that we -- we know we've transferred capital, but we -- we just want to have that independent measure."²⁴

77 Second, Basic's capital targets are no longer set on a best-estimate basis, an uncontested fact given MPI's objection to the assumption of transfers in the 2017 GRA, and the PUB's concession in Order 130/17.

78 A key reference point for the determination of satisfactory financial condition of Basic is the current RSR balance, not a hypothetical RSR balance. In response to PUB (MPI) 2-10, MPI explained in response to its assertion that "it is inappropriate to view the establishment and maintenance of Basic's satisfactory financial condition as a theoretical exercise"²⁵, as follows:

There is a difference between theoretical 'best estimate' scenario testing and arbitrary theoretical scenarios. With respect, the determination of the threshold for satisfactory financial condition of Basic by MPI's Chief Actuary is based on best estimates, not imagined base case scenarios. The PUB methodology for the determination of the lower RSR target is not based on best estimates and produces a minimum RSR target that is below the amount required for satisfactory financial condition of Basic. MPI does not support the PUB approach theoretically or in actuality.²⁶

79 Which Mr. Johnston elaborated on in his oral testimony:

So the second one is that we don't think the target capital methodology should include anything other than a best estimate assumption. So, the

²⁴ T: 278 and 279, lines 24 and 1-7

²⁵ PUB (MPI) 1-16(c)

²⁶ PUB (MPI) 2-10 (b)

-- the whole issue with capital transfers in the methodology, whether that -- that's seen as a modeling item or not, we're struggling with including that in there. So that -- that's the second one.

On a similar topic, last year's RSR target methodology was based on a 50-50 interest rate forecast and using the same logic, we -- we want the -- the targets to be set on what we feel are best estimates."²⁷

80 The management actions of the Corporation (e.g. the need for rebuilding fees) and the behavior of the financial model (e.g. the amount invested in equities) will be different depending on the current RSR balance. Such impacts are not properly recognized when modeling imagined base case scenarios.

81 The PUB methodology for the determination of the lower RSR target is not based on best estimates and produces a minimum RSR target that is below the amount required for satisfactory financial condition of Basic. here is no evidence to justify not using a best estimate, and MPI does not support the PUB approach theoretically or in actuality.²⁸

5.5 The lower RSR Target Cannot be Set Below the Level for Satisfactory Financial Condition

82 The Corporation cannot support a lower RSR target that is below the minimum amount required to maintain the satisfactory financial condition of Basic, as calculated using Accepted Actuarial Practice in Canada.

83 A lower RSR target that is below the minimum level required for satisfactory financial condition could compromise the financial standing of Basic.

84 For the fiscal year 2018/19, the Board of Directors transferred \$37.3 million from the competitive lines of business to bring the Basic RSR Total Equity Balance to \$210.8

²⁷ T: 548-550, lines 13-21, 17-25, and 1-4

²⁸ PUB (MPI) 2-10 (b) and (d)

million. This transfer exceeded the amount required for satisfactory financial condition of Basic (\$201 million) by \$9.8 million.

- 85 In Order 130/17, the PUB approved \$180 million as the lower RSR target for 2018/19. Basic would have an unsatisfactory financial condition had MPI's Board of Directors been unwilling or unable to transfer those funds from Extension. Further, under the present RSR framework, the Corporation could not have sought the full amount of RSR rebuilding fees to achieve satisfactory financial condition, as the lower RSR target was less than the minimum capital required for satisfactory financial condition of Basic. The timing for a request for regulatory approval of an RSR rebuilding fee would have also been deeply problematic had the MPI Board not intervened in February of 2018.

5.5.1 Basic Remains the Most Thinly Capitalized Insurer in Canada

- 86 The state of Basic's capitalization, while materially improved over prior years still lags that of peer crown insurers. The Basic line of business remains thinly capitalized, and the RSR range remains below the minimum and/or target capital levels of peer insurance providers.
- 87 MPI is applying for a lower RSR target of 34% MCT, and an upper target of 85% MCT, while other crown insurers have capital targets (SGI, SAAQ), or lower thresholds (ICBC) of 100% MCT²⁹. While MPI's capital level is projected to be 70% MCT to start the 2019/10 rating year, Mr. Graham put some context around that figure as follows:

"...we have the lowest capital of any operational insurance company in Canada; if not North America. If we were a private insurance company we would be technically insolvent. We would not be allowed to take on any further liabilities. We would be on a very strict regulatory management plan."³⁰

²⁹ T: 276, lines 4-7

³⁰ T: 123, lines 1-6

88 MPI is not applying for a 100% MCT capital target, nor is MPI arguing that a private sector capital target of 150% MCT is appropriate for a monopoly insurance provider like Basic.³¹ However, the Board of Directors is intent on moving towards insurance industry best practice around risk-based solvency thresholds as measured by MCT. In its current state, the Board of Directors considers that Basic is insolvent given that the MCT measure of Capital Available is less than Capital Required.

5.6 Prudent Fiscal Management Demands Adequate Capital

89 Adequate capital in the RSR is crucial to allow MPI to deliver on our objective to provide stable and predictable rates. It allows MPI to effectively protect rate payers from rate increases that would otherwise be necessary due to unexpected variances from forecasted results and due to events and losses arising from non-recurring events and factors. It is fiscally prudent to plan for the future and prepare for adverse events that will occur, as they inevitably will, from time to time.

90 Being undercapitalized leaves MPI and its rate payers in a vulnerable position. The possibility of bad weather, adverse market movements, or a combination of adverse events, exposes Basic's ratepayers rebuilding fees, or in extreme circumstances government bail-outs.

91 Proverbially 'living paycheque to paycheque' is not consistent with prudent fiscal management. Unfortunately, Basic has found itself in this circumstance in the recent past, and if not for transfers of capital from other lines of business, rate payers would have been subject to significant rebuilding fees.

92 Without adequate funds in the RSR, Basic is dependent on luck; luck in weather, luck in claims experience, luck in financial markets. Luck is not a strategy, and relying on luck is not prudent fiscal management.

³¹ T: 277, lines 8-14

6 Interest Rate Forecasting

- 93 In this application, MPI is seeking to set rates for service on the basis of the most current actual Government of Canada 10 Year (GoC 10 Yr.) bond yield (the naïve forecast).
- 94 For the past number of years, it has been challenging to forecast the future interest rates for setting Basic insurance rates at the GRAs. Incorrectly doing so has had material impacts on Basic's financial results.
- 95 While the move to AAP-based ratemaking through Order 162/16 served to reduce the impact of incorrect interest rate forecasts, it did not fully alleviate the pricing risk that occurs when inaccurate interest rate forecasts are used in rate setting.
- 96 Interest rate forecasting has been particularly challenging over the past decade. Rates moved lower than most could have predicted and consistently defied expectations 'that they could go no lower, and would have to rise'.
- 97 The Standard Interest Rate Forecast (SIRF), based on the major banks' interest rate forecast, were not up to the challenge as they persisted in modelling a simple mean revision. If there were any other economic considerations factored into the forecasts, they did not improve forecast accuracy.
- 98 Attempts to moderate the SIRF forecast, by judgmentally weighting the results against the naïve forecast, created the 50/50 forecast. The results of this forecast have also been inadequate.

- 99 The falling interest rate environment also exposed the negative impact of incorrect interest rate forecasts and lead to MPI under collecting a total of \$163 million in premiums.³²
- 100 The problem facing MPI, the PUB, and ratepayers is this – what interest rate forecast is going to most accurately price policies. MPI submits that the best estimate interest rate forecast for rate setting purposes is the current actual interest rate (i.e. the naïve interest rate forecast).
- 101 There are numerous opinions and endless speculation on what future interest rates will be, but the only certainty is what is known today, and no one knows what those rates will be.
- 102 History over the last two decades has shown that the methodology with the least error for predicting future interest rates is to use the current known actual interest rate throughout the rating period. This is the naïve forecast methodology.
- 103 Dr. Simpson correctly stated: “Those who cannot remember the past are condemned to repeat it.”³³
- 104 History has taught that errors have been made forecasting interest rates in General Rate Applications. MPI has taken the opportunity to learn from these errors.
- 105 Using the most current actual interest rate as the forecast (naïve forecast) further reduces pricing risk if it is updated as close to the time of the issuing policies (as is practical). Perhaps interest rates will change from the levels set by the most recent naïve interest rate forecast. While that pricing risk will remain, it will at least anchored in the information we know to be true today: an actual observed interest rate.

³² MPI Exhibit 21, page 17

³³ T: 1181

- 106 The most current actual interest rate (naïve forecast) is also the conservative and prudent forecast. Given the significant premium shortfalls that have resulted from past interest rate forecasts, and the fact that but for capital transfers from competitive lines of business, Basic's RSR would be depleted, it is preferable to err to the conservative, than to return to ratepayers for significant rebuilding fees when optimistic forecasts do not materialize. This approach is prudent fiscal management, and is consistent with the intention of the Board of Directors of MPI to reduce volatility, and deliver predictable, stable rates to customers.
- 107 In essence, it is better to have a good problem than a bad problem.
- 108 In what follows, MPI demonstrates that the naïve forecast is qualitatively a best estimate, as well as being a prudent estimate.³⁴

6.1 The Naïve Forecast is Relevant for Rate Setting

- 109 MPI has applied for rates based on the naïve forecast because it is the best estimate of the GoC 10 Yr. Bond yield over the relevant time horizon of 11 to 18 months (until September 1, 2019).
- 110 The naïve forecast may not be the best estimate of interest rates over the full 5 year outlook period, but it does not have to be. The PUB is being asked to approve rates for service for the 2019/20 policy year, which are based on an interest rate forecast as at September 1, 2019.
- 111 Rates for service are no longer set on the basis of Proforma net income, and as such the Proforma net income, in 2019/20 through 2022/23 is not determinative of the rate request in this Application.
- 112 Insofar as the Naïve interest rate forecast factors into the DCAT analysis, MPI and its appointed actuary agree that the naïve interest rate forecast is an appropriate

³⁴ T: 700-701, lines 24-25 and 1-20

assumption in the Base Forecast, for DCAT modelling, and the purposes of determining target capital thresholds.

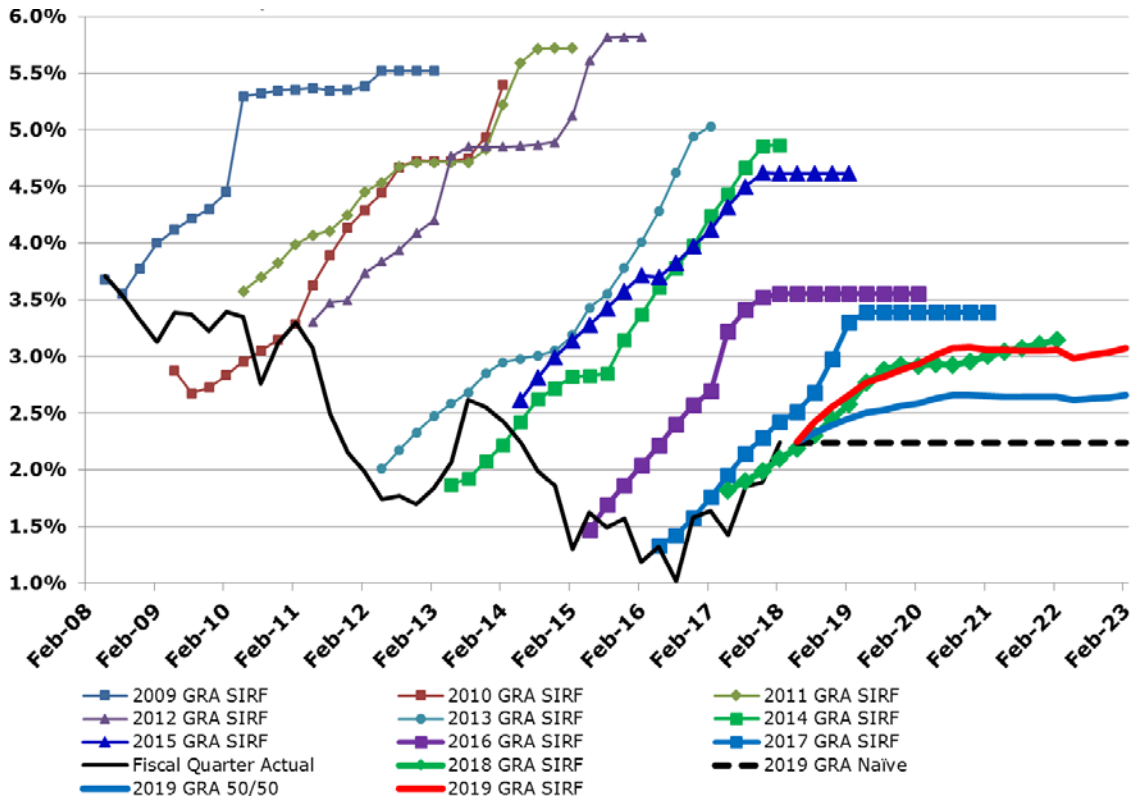
6.2 Sound Methodology and a Dependable Inputs Produce Just and Reasonable Rates

- 113 Similar to the 2018 GRA, MPI is asking the PUB to approve rates on the basis of a sound methodology, and dependable inputs.
- 114 Applying the naïve interest rate forecast to rate setting is a sound methodology, and a best estimate. The actual market yield for the GoC 10 Yr. Bond is a known and dependable input, outside of MPI, or any one single party's control. The GoC 10 Yr. Bond yield is determined in financial markets based on the independent actions of countless market participants, reflecting the full set of information available to the market at that point in time.
- 115 The entirety of MPI's application for rates for service is based on applying a sound methodology to dependable inputs. Updates to the rate indication, whether based on September actuals, or through a compliance filing using actual interest rates at a later date, is consistent with the approach used throughout MPI's application, and will result in just and reasonable rates for service.

6.3 The Naïve Interest Rate Forecast is the Best Estimate

- 116 MPI has produced evidence in the 2019 GRA that builds upon the evidence provided in the past, namely, that the Naïve forecast is a best estimate. The new evidence supporting the naïve forecast is provided below, but certain relevant facts in prior applications bear repeating.
- 117 First, the Banks forecasts, as reflected in the SIRF, have proven to be materially wrong, year after year. This is evidenced by the Figure 1 below.

Figure 1 – History of Interest Rate Forecasts



118 While a simple visual inspection confirms this fact, Mr. Johnston elaborates on the performance of the SIRF and Naïve forecasts over the past decade:

“The fact that the naive forecast perform better in that environment is the most extreme example I could give that the naive forecast is better, because everyone in the world, like apparently knew interest rates were going up and they didn't for the whole entire time.

That should have been the -- the most likely scenario where your upward interest rate forecast was going to be correct and it wasn't and it still didn't do as good as the naive over that period. That tells you that, man, if we were in a regular period of time where the -- everyone

*wasn't saying 100 percent chance rates are going up, it would do even better would be my expectation.*³⁵

119 Mr. Johnston then explains further:

*"I think there is overwhelming evidence here that banks aren't very good at predicting it. If this chart doesn't tell you that, I don't know what does. So again, naive is the current rate, we're suggesting we update it as late as possible. Whether these are up, down or straight I don't think it changes our opinion on that. We're not interested in making a bet based on performance that looks like this."*³⁶

120 Also, in the 2017 GRA, Dr. Sean Cleary's analysis demonstrated that using the naïve forecast "would have improved forecasting accuracy significantly, reducing the percentage forecast error by close to 60%."³⁷

121 MPI's Investments Manager, Glen Bunston, summarizes the key points supporting the Naïve forecast as a best estimate:

"So in terms of interest rate forecasting, our -- our best estimate on interest rates relies on a naive interest rate forecast, and that's because it provides a neutral and unbiased forecast. So going forward the yield on the Government of Canada 10 year bond could increase, it could decrease, it could remain flat and the naive forecast, essentially, uses current rates as the forecast going forward.

And we've presented evidence to show that -- that it is a better predictor and less biased than the 50-50 forecast or the standard interest rate forecast. Over the short term, which is -- we define as 1 to 1 1/2 years, which is the period that we forecast interest rates for for rate setting purposes. The Bank of Canada overnight rate is -- is not a reliable predictor of the direction and magnitude of movements in the 10 year bond rates, and we've presented a significant amount of historical evidence to -- to support that and to show that over the long term there is a relationship, but over the short term the relationship is

³⁵ T: 351, lines 7-20

³⁶ T: 346, lines 13-16

³⁷ CAC Exhibit 15

certainly not direct and, in fact, the two (2) rates have -- have often moved in opposite directions.

So our goal here is -- is to reduce pricing risk and to provide the most accurate forecast of interest rates possible."³⁸

122 Mr. Bunston's points are elaborated on in the following sections.

6.3.1 The Naïve Forecast is Unbiased and Efficient

123 MPI has provided significant quantitative evidence that the Naïve Forecast is unbiased, efficient, and superior to the 50/50 forecast on both counts.

124 An efficient estimate is one with a low standard error, a measure of how variable a forecast is relative to actual. MPI has demonstrated that the standard error of the naïve forecast is lower than the 50/50 forecast in Figure INV-11.

125 Actuarial standards define a Best Estimate as 'an unbiased forecast'³⁹.

126 MPI then demonstrated, based on 14 years of interest rate forecasts, that the naïve forecast produces an estimate that is statistically the same as the actual forecast. That is, the average difference of the naïve to the actual forecast is between 0.48% and -0.17%, with 95% confidence.⁴⁰

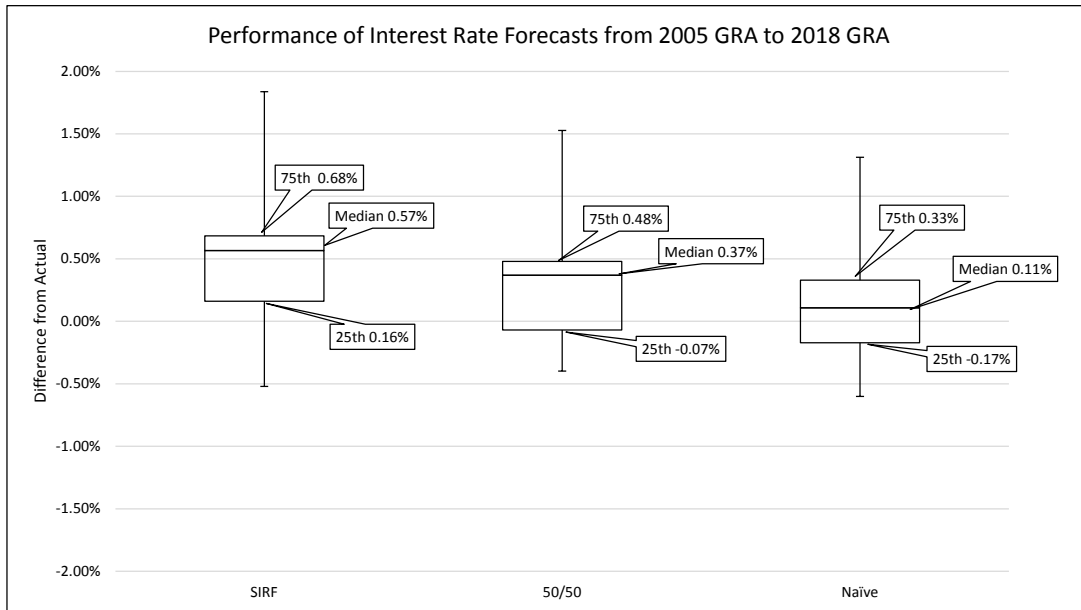
127 To support this analysis MPI presented a schematic highlighting how each of the interest rate forecasts differ from actuals.

³⁸ T: 264-265, lines 8-25 and 1-9

³⁹ PUB (MPI) 1-11

⁴⁰ CAC (MPI) 1-6

Figure 2 – Statistical Performance of Interest Rate Forecasts



The figure below shows how each of the three interest rate forecasts differ from the actual. As indicated, there is marginal difference in the variance between the 50/50 and naïve forecast (as seen by the overall length of the 'whisker' in the box and whisker plot below). However, the naïve forecast is less biased than the 50/50 forecast (given the range of differences of the naïve forecast plots closer to the 'zero difference' line – that is, the 'box' in the box and whisker plot is more centered around the zero difference line) and, as seen in the Corporation's response to PUB (MPI) 1-11 (a), the naïve forecast is statistically less biased than the 50/50 forecast.

Further, the middle line of the 'box', the median, is closest to 0.00% in the naïve forecast, while the 50/50 forecast produced forecasts that are at least 37 basis points higher than actual, 50% of the time. ⁴¹

⁴¹ CAC (MPI) 1-4

6.3.2 MPI's Appointed Actuary Supports Naïve Forecast

128 MPI's appointed actuary, Joe Cheng, has also endorsed the Naïve forecast in the base scenario stating:

*"In my opinion, a naïve interest rate assumption is appropriate for the base scenario. Notwithstanding the two recent rate hikes by the Bank of Canada, I do not see any material risk in assuming a naïve interest rate as a base case"*⁴²

129 He further notes that any forecast other than the Naïve would require more work, but would not necessarily provide any benefit, and thereafter provides examples of 5 largest insurers he reviewed, indicating that three of the five assumed a naïve interest rate forecast in their recent DCATs.⁴³

6.4 The Bank of Canada Overnight Rate is not a reliable proxy of the GoC 10 Yr. Bond Yield

130 MPI relies on the forecast of the GoC 10 Yr. bond yield, for forecasting and rate setting purposes. The GoC 10 Yr. Bond yield is a long term bond traded in financial markets, whose rate (yield) is determined by the actions of market participants.

131 The Bank of Canada's Overnight rate is a very different interest rate. It is a policy rate set by the Bank of Canada, and movements in one should not be confused for movements in the other.

132 MPI has produced evidence that the Bank of Canada's overnight rate is simply not a relevant consideration for selecting a best estimate interest rate forecast for rate setting purposes⁴⁴, by demonstrating that changes in the Bank of Canada overnight

⁴² PUB (MPI) 1-11 Attachment A

⁴³ PUB (MPI) 1-11 Attachment A

⁴⁴ CAC (MPI) 1-6, CAC(MPI) 2-1

rate is not a reliable predictor of changes in the GoC 10 Yr. bond yield over the short term⁴⁵.

133 While it is true that there is a term structure to interest rates, and that long term bond yields eventually respond directionally to overnight interest rate movements, this relationship is not strong enough over 12 to 18 month timeframe to consider the overnight rate a reliable proxy or leading indicator for the GoC 10 Yr. bond yield.

134 Mr. Bunston summarized the historical data and patterns of movements in interest rates as follows:

“Well, there were other IRs asked on this topic, CAC-2-1 was one (1) of those where we provided data going back further than this. This is about a two-year period. And so we pointed out that there were many periods of time, as recently as 2010, when the overnight rate increased and the yield on the Government of Canada bond fell and the difference between the two (2) can be as large as 400 basis points.

So there is -- there is no guarantee that a rising overnight rate will translate over the outlook period, the rate setting period of 1 to 1 1/2 years into an increase in the yield on the Canada 10-year bond.”⁴⁶

135 MPI notes six different annual periods since 1994 where the overnight rate and the GoC 10 Yr. bond yield **diverged** materially, between 1.36 and 2.92 percent⁴⁷. MPI has also demonstrated that there have been periods of time where the overnight rate is unchanged, while the GoC 10 Yr. bond yield varies considerably.

136 This history of the GoC 10 Yr. Bond yield and the Bank of Canada Overnight rate is presented below.⁴⁸ MPI does not dispute that over the span of more than two

⁴⁵ CAC (MPI) 2-1

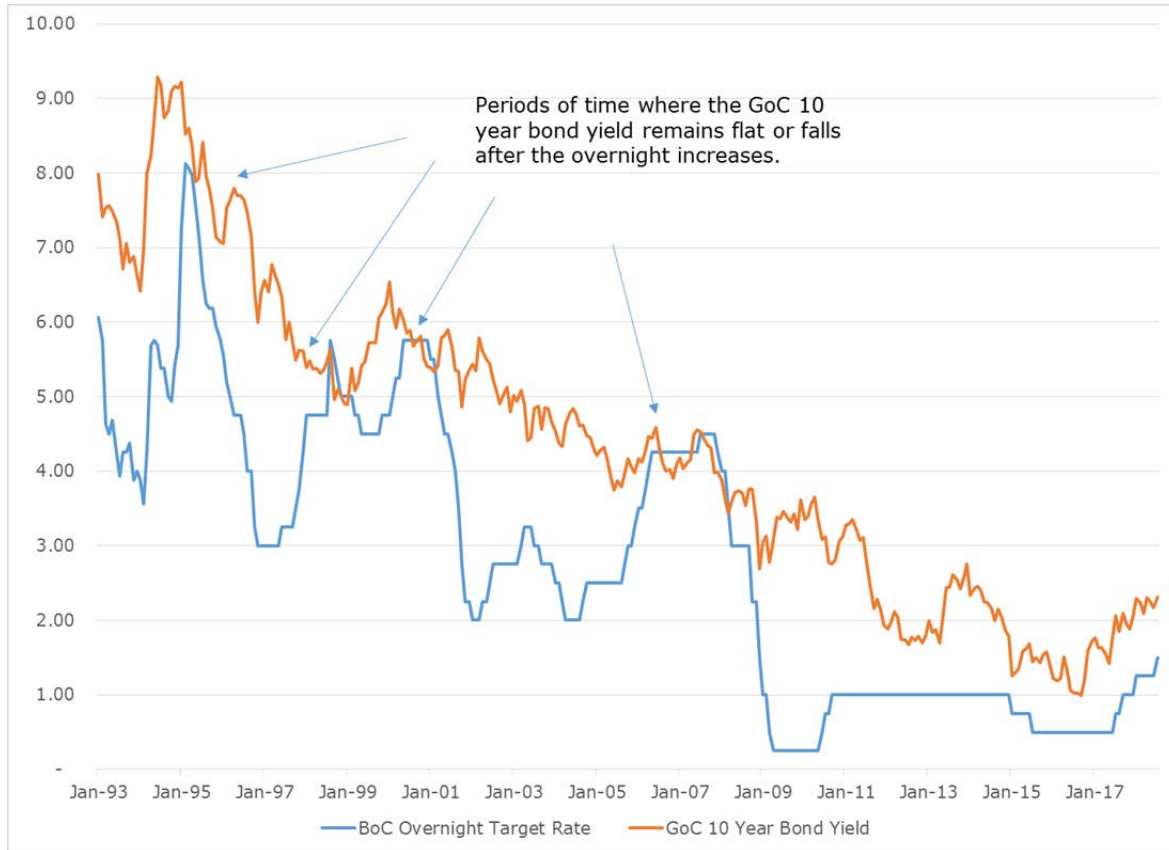
⁴⁶ T: 374-375, lines 13-25 and 1-8

⁴⁷ CAC (MPI) 2-11 Figure 2

⁴⁸ CAC(MPI) 2-1 Figure 1

decades, dating back to 1993, that both interest rates have trended in the same direction.

Figure 3



137 MPI also concedes that there are times, when the overnight rate and GoC 10 Yr. bond yield do move together in the near term. However, there are also periods in time where the two rates diverge, or otherwise move independently of one another. MPI’s evidence demonstrates that this relationship is simply not dependable enough to inform the selection of a best estimate forecast.

138 Therefore, movements in the Overnight rate cannot reliably be used as a proxy, or leading indicator, of movements in the GoC 10 Yr. Bond yield over the relevant time horizon of 12 to 18 months. Accordingly, the PUB can place no weight on the evidence of ‘expected’ increases in the Bank of Canada’s overnight rate.

6.5 50/50 Forecast Introduces Avoidable Pricing Risk

139 In the 2018 GRA, MPI characterized the risk around forecasting interest rates as “forecasting risk”, and, in this GRA, it is further refining the description as “pricing risk”. This is to say, that if rates are set based on a forecast, that proves to be wrong, then the policies have been mispriced, there is no protection or hedge for this risk.

140 Mr. Johnston characterized the risk of mispricing as follows:

“So my example I used yesterday, if naive was a \$1000 rate and we want to be really optimistic and say, you know, rate should only be \$950 because interest rates are going to go up, then it just stays the same, well we've lost \$50 – we mispriced by \$50 a policy and there's no getting that back. It's -- it's -- we just priced wrong.”⁴⁹

141 MPI's goal in forecasting interest rates is to minimize the risk of mispricing policies. Using the most current actual interest rate information, i.e. the most recent naïve interest rate forecast, is the best approach to meet that goal. This pricing risk is different from the interest rate risk that has been fully neutralized by the ALM study, as Mr. Johnston explains:

For the most part, neutralizing interest rate risk to the claim liabilities themselves has been something that MPI's had in place for some time now, at least since 2014. That strategy does not shield us from the pricing risk of -- of optimistic interest rate forecasts. So as I talked about yesterday, we can match assets and liabilities as much as we want. We can go right to the cash flow basis, but if we use a poor assumption for pricing, there is no escaping that price that you -- you set here. If it's based on a really high interest rate and priced too low, we will get the consequences of that, and of course, vice versa.”⁵⁰

⁴⁹ T: 371, lines 1-18

⁵⁰ T: 666-667, lines 8-17 and 12-25

- 142 This is consistent with the approach taken in other forecasts supporting the GRA. MPI proposes to set rates based on that which is known and observable today, which Mr. Johnston explained as follows:

"I would continue to suggest that we should update our rate indication based on the latest actuals, but I would not recommend making another bet on rising interest rates. A lot can change, just as fast as this change is an upper direction, it can go in the other direction.

You know, we've talked -- if you put parallels to other forecasts we makes, so say we have a road safety initiative and we're expecting it's going to reduce claims or whatever, do we make the bet on that before it happens, or do we wait until we actually see it in evidence and then book that into the rates."⁵¹

- 143 MPI supports updating the rate indication based on the most recent actual data, and continues to support the approach of further updating GoC 10 Yr. bond yield and the rate indication through a compliance filing to the PUB's order in the 2019 GRA. In the alternative, MPI would support updating the rate indication based on the actual GoC 10 Yr. bond yield as at September 28th, 2018, through PUB Pre-Ask 1.

⁵¹ T: 376, lines 10-22

7 Investments

144 Section 18 of the *MPIC Act* contains the following direction to MPI:

*“The corporation shall **establish and maintain reserves** in such amounts that, at all times, it has sufficient funds to meet all the payments as may become payable under this Act and regulations.”*
[Emphasis added]

145 Throughout the insurance industry, both private and public, capital reserves are held to protect companies from insolvency and ratepayers from rate shock.

146 Continuing within this statutory framework, section 12 of the *MPIC Act* requires MPI to pay these reserves to the Minister of Finance who is to then invest them for the benefit of the Corporation:

“The corporation shall pay to the minister charged with the administration of The Financial Administration Act, for investment for the corporation, moneys in any reserve established under section 18 and such additional moneys as are not immediately required for the purposes of the corporation and are available for investment.”

147 Following up on the recommendations included in the Asset Liability Management (ALM) Study undertaken by Mercer Canada (Mercer), the Corporation and its Board of Directors, in consultation with the Government, dramatically changed the Corporation’s investment fund. The result of these changes has been to significantly reduce the risk profile of Basic, and establish portfolios suitable to the purpose of each reserve fund.

148 The Board of Directors, pursuant to section 18 of the *MPIC Act*, established five reserves, three of which are relevant to this Application:

- i. the Basic Reserve;
- ii. the RSR; and
- iii. the Employee Future Benefits (Pension) Reserve.

149 As described by Mr. Bunston, the Corporation moved from a commingled investment portfolio to one that segregates the assets of MPI's lines of business into "buckets" -- namely, the Basic Claims Liability portfolio, the RSR portfolio, the Post-Retirement Benefits portfolio (along with the extension line of business and Special Risk Extension portfolios). Dave Makarchuk of Mercer, testified that this segregation is perhaps the biggest change to the Corporation's investment fund.⁵²

150 The purpose of each Reserve is as follows:

- i. The Basic Claims Liability Reserve:

This portfolio is to pay for insurance claims associated with accidents. Very little investing risk will be taken to jeopardize having the funds necessary to pay for future claims expenses.

- ii. Rate Stabilization Reserve

The RSR is Basic's capital reserve. It is there to protect motorists from rate increases that would otherwise have been necessary due to unexpected variances from forecasted results and losses arising from non-recurring events. The RSR is in place to pay for these losses so that next year's ratepayers do not. Given the purpose of the RSR, the investment risk tolerance can vary. There will be minimal investment risk tolerance when the RSR balance is below the DCAT minimum; however, there will be

⁵² T: 336, line 22-25.

moderate investment risk tolerance when the RSR is within the approved range.

iii. Employee Future Benefits (Pension) Reserve

This reserve is to ensure that pension and other obligations are paid as they become due, while earning investment returns that keep contribution rates at reasonable levels. This fund represents combined pension liabilities for all lines of business (approximately 85% allocated to Basic and 15% to the other lines of business). Because of this, the investment risk tolerance is moderate.

- 151 The Board of Directors, including the three members that comprise the Investment Committee, determined the risk tolerance specific to each reserve. They are overseen by the Department of Finance and have developed an Investment Policy Statement for investing these reserves. These investment decisions for these reserves were informed by the results of the Mercer ALM Study.
- 152 The Mercer ALM study, the Board of Directors' Investment Policy Statement and the implementation plan were all thoroughly discussed and reviewed before embarking on the new investment strategy. As it concerns the PUB's review of the new investment strategy in the 2019 General Rate Application, 440 pages of documents were submitted in the application, 82 investment questions were answered through IRs, and an MPI panel consisting of the Vice-President of Finance, the Chief Actuary, and the Manager of Investments, and an expert from Mercer (qualified as an expert in the areas of institutional investment planning and asset & liability matching) were presented to answer numerous questions under oath over the course of three days.
- 153 The new investment strategy, to be implemented fiscal year 2018/19 (ongoing), has shown immediate positive results. The total equity requirements for the Rate Stabilization Reserve have been reduced by approximately 30%, with MPI calculating the lower and upper targets for the upcoming fiscal year to be \$143 million and \$305

million. During last year's GRA, under the commingled investment fund, MPI calculated the lower and upper targets at \$201 million and \$438 million respectively.

- 154 The amount in the Rate Stabilization Reserve for the 2018/19 fiscal year was \$211 million (as of February 28, 2019). In the absence of the new investment strategy, that would have been below the lower target this year, necessitating a rebuilding fee. However, as a direct result of the new investment strategy, there was no capital rebuild provision sought by the corporation in this year's GRA.
- 155 Another immediate and positive impact, is that the new investment strategy provides 100% protection against 'interest rate risk' (the risk associated with changing interest rates)-- that is, the Basic Claims Liability portfolio contains an interest rate hedge ratio of 100%. The assets backing the Basic liabilities have been significantly de-risked under the new investment strategy, primarily as a result of the need to meet Basic's existing obligations to claimants, and Basic's low level of capitalization. Although the investment fund shows a lower expected annual return, the risk of loss is now significantly lower.
- 156 Throughout their testimony, the witnesses on the Investments panel repeatedly indicated that the chance of incurring losses due to 'interest rate risk' has been mitigated under the new investment strategy. Indeed, under cross-examination, the expert witnesses that testified as part of the case advanced by the Consumers Association of Canada (CAC), made admissions as follows:

"THE CHAIRPERSON: So, does the interest rate factor play as big a role as it did before when you had equities and the liabilities all co-mingled?"

DR. WAYNE SIMPSON: My general sense, and I profess no great expertise on the financial model, but as you run these scenarios through the financial model, these adverse scenarios, it will make a difference. Yes. They won't be as -- as severe as they would have been before, that's -- that's my sense of of the -- of the -- of some of the declining risk that's associated with the lower RSR thresholds.

MS. ANDREA SHERRY: If that -- if the asset liability management is within the model that is used to perform the DCAT, then yes, it would lower the risk and therefore have an impact."

- 157 The MPI Board of Directors includes an Investment Committee comprised of three individuals that have spent their entire careers in the investment industry. Appendix 1 to the MPI Rebuttal Evidence⁵³ contains a summary of the credentials of Domenic Grestoni, Daniel Bubis and Valerie Wowryk. These individuals not only bring a wealth of investment experience to MPI, but are aware of the Corporation's recent financial history and the concerns and guidance expressed by the Department of Finance. Recommendations to the Minister of Finance concerning the Corporation's investment fund are made by the Board of Directors with a full understanding of all the information needed to make prudent decisions.
- 158 In compliance with section 12 of the *MPIC Act*, the Investment Committee Terms of Reference⁵⁴ include a Mandate that has the strategies and policies of the corporation's investment fund addressing the needs and objectives of both MPI and the Government.
- 159 Accordingly, the Investment Committee must recommend investment policies and strategies to the Board of Directors for subsequent consideration by the Minister of Finance. Once these investment policies and strategies are approved by the Board of Directors and the Minister of Finance, the Investment Committee must ensure their implementation.
- 160 A thorough and comprehensive review of MPI's new investment strategy was undertaken. Given net income losses of \$250 million in recent years, it should come as no surprise to the outside observer that there is currently little appetite for risk as it concerns the corporation's investment fund. In all the circumstances, under the expertise of the Investment Committee, and with approval from the Minister of

⁵³ MPI Exhibit 19

⁵⁴ INV Appendix 8

Finance, the MPI Board of Directors has made reasonable investment decisions with full consideration to the recommendations in the ALM Study.

- 161 The evidence before the PUB is that there were many investment options available to investors. The absence or presence of any one investment cannot render the strategy unreasonable, particularly because the performance of any one investment is, by nature, speculative. On its whole, the objectives, risk tolerance and accompanying investments selected by the MPI Board of Directors are patently reasonable. More importantly, the investment decisions of the MPI Board of Directors were made within their legislative authority, meaning any assumptions or forecasts flowing from those decisions must be applied by the PUB.

8 IT Strategy and Projects

- 162 MPI's Information Technology (IT) Expenses and IT Projects exemplify the new direction given by the Board of Directors to conduct the affairs of the Corporation in accordance with insurance industry best practice.
- 163 To that end, MPI continues to increase its transparency by detailing the current state of IT Projects and IT expenses, responding to over 75 IT-related information requests and through its presentation of the Information Technology/Physical Damage Re-Engineering/Value Management Panel, a witness panel comprised of Mr. Graham, the President and CEO, Brad Bunko, Vice President of IT, Business Transformation & CIO, Mr. Wennberg, Vice President Customer Service & COO, Lawrence Lazarko, Director, Information Technology, John Remillard, Corporate Business Architect and Charles (Chuck) Henry, Vice President, Solutions and Pricing of Gartner Inc., for two full days of testimony before the PUB.

8.1 The IT Strategy is a Shift to Mainstream Proven Technologies

- 164 Aligning with industry best practice required a shift in the Corporation's approach to IT. MPI made this shift through its new IT Strategy, a plan that focuses less on specific IT projects and more on ensuring that the business needs of the Corporation are met by its IT and Business capabilities.
- 165 No longer does MPI view itself as a leader in developing new and innovative technology. MPI is, above all else, an insurance company focused on its core insurance business. MPI included a copy of its new IT Strategy in this year's GRA⁵⁵. While its focus is on the 2018/19 fiscal year, the IT Strategy will continue to guide MPI in future years and will be updated annually.

⁵⁵ Part IV IT Appendix 2

8.2 Value Management Drives New Initiatives

- 166 Industry best practice also requires that decisions regarding new IT projects be informed and properly costed. Accordingly, MPI introduced the Value Management process into its decision making regarding IT capital projects and used this process to conduct cost benefit analyses of the completed Customer Claims Reporting System (CCRS) and Physical Damage Re-Engineering (PDR) capital projects. While Value Management required a shift in MPI's culture, the evidence establishes that it is now engrained in its practices.
- 167 Business cases are required for all projects costing \$500,000 or more and business acumen must be established for even daily operational decisions. A newly formed Value Management Office (VMO) is now involved at every stage of the lifecycle of a project to evaluate, measure and validate the business value of corporate initiatives. Further, a new Operational Business Champion ensures accountability for key decisions made on these initiatives.
- 168 Unfortunately, MPI has made mistakes when it comes to deciding whether to undertake certain corporate initiatives. An extensive cost/benefit analysis of CCRS resulted in the cancellation of the project in April 2018 while a further review of PDR resulted in a decrease in the reported Net Present Value (NPV), from \$13m to -\$53m. MPI acknowledges and accepts these errors. It has learned lessons and has taken corrective action, which includes fundamentally changing its project governance structure. MPI does not ask ratepayers in this rate application year to bear the costs of these mistakes.
- 169 Mr. Wennberg explains that change at MPI starts from the top:

"On lessons learned for PDR and CCRS there's a few of them. One (1) is that corporate culture and the tone from the top is absolutely essential and -- and we need this, not just for the project budgeting upfront, but we need it for post- implementation reviews as it goes forward so that we really learn from what was rolled out and then you correct any mistakes.

Part of the business case on PDR, for example, is recognizing what we did with eighty-one dollars (\$81) and the value it's giving us or not giving us in our current negotiations and public stuff that we've put out to our trade. They know that we -- we can't afford the eighty-one dollars (\$81) and it's not industry standard practice. So we're working our way out of that as an example.

2. It's gotta stay open to revisiting weak assumptions. So if the assumption, for example, was that we could get direct repair out in shops and do it for nothing but then we had to the eighty-one dollars (\$81), you -- you just have to put it in your business case.”⁵⁶

170 While MPI's new approach to value management strives to ensure that the cost of corporate initiatives does not exceed their value, it would be misguided to view projects like PDR and CCRS as complete failures.

171 Mr. Wennberg elaborates on the nuance to this point in an exchange with PUB counsel:

“MS. KATHLEEN MCCANDLESS: Thank you. And Mr. Wennberg, this morning in your presentation, you made a comment to the effect that sometimes, the -- a -- a given project may not have a positive net

present value, but you still would recommend that the Corporation undertake the project. Do you recall saying that?

MR. CURTIS WENNBERG: Yes, that's right.

MS. KATHLEEN MCCANDLESS: And with respect to the PDR project, what's MPI's perspective on it?

MR. CURTIS WENNBERG: Well, we also covered that a little bit this morning, too, when the-- the question came up of -- of is this worthwhile doing? And the magnitude of the loss, would you do it as an armchair quarterback today? Would you do the exact same thing? No, I think the this executive team and -- and Board wouldn't do that, without putting words in their mouth. But -- but the nuggets -- we have

⁵⁶ T: 914-915, lines 25 and 1-21

to understand that the nuggets of getting into a – a Mitchell-based or an estimating-based system that's software instead of faxes and paper, that made sense to do. And -- and what we need to do is streamline and really double check on some of the other components of PDR, and - - and make sure before we -- we -- particularly as you heard Brad say, before we innovate in-house, given our size, do we -- do we know where industry best practice is that we can lift and shift back in here for all Manitobans?"⁵⁷

- 172 Although there are elements of the PDR project that, with the benefit of value management, would not have included or would have done differently by MPI, other elements retained their value. When asked about how he would describe the PDR Program, Mr. Henry provided the following response, under oath:

"I can't comment on the -- on the whole program, but I can say that MPI had no choice but to get to some technology like Mitchell and standardize how estimating was being done across the project. Without that, things like fraud analysis is impossible because the -- the data wouldn't be reliable enough. So there is a huge amount of value in getting to, you know, a platform like Mitchell and having this common standard in place with the repair industry. And from there, lots of things are possible going forward.

So by having the standard in place, having good data, you know, there's lots of possibilities of what MPI and the industry together can do with this that -- that was not possible in the past. So to me, that was essential. I can't comment on all the other components."⁵⁸

- 173 For CCRS, when asked whether MPI has completely abandoned the project by cancelling it, Mr. Wennberg testified:

"No, it hasn't. So there's some very good work done around the intellectual property of how we picture these accidents and -- and can visualize them to

⁵⁷ T: 1058-1059, lines 11-25 and 1-16

⁵⁸ T: 944-945, lines 16-25 and 1-9

customers. So as we watch this develop in the marketplace, we still have that body of work that we can rely on.”⁵⁹

- 174 Moving forward, MPI’s approach to its Legacy Systems Modernization (LSM) future capital project will incorporate the Value Management process. This includes conducting independent assessments of the legacy systems risks, establishing a strategy to mitigate those risks, developing business cases, conducting financial analysis and preparing a roadmap and plan for project implementation. MPI expects to include detailed business cases supporting the plan for LSM in the 2020 GRA.

8.3 IT Operations Lead Peers in Many Measures

- 175 Last year, the Board recognized the progress made by MPI in controlling IT spending, reducing its reliance on external IT consultants and implementing the new Value Management Process. This year, MPI expands on that progress. MPI’s IT Scorecard, the results of an independent evaluation by Gartner of how effective MPI’s business needs are met by its IT organization, show that MPI continues to improve its performance to either better align with or exceed the capabilities of its peers.⁶⁰ For example, MPI has reduced its IT spend as a percentage of Operating Expenses by 7.1% over 5 years while increasing its IT maturity by 3.9% over the same period of time. IT maturity, which reflects a higher level of service delivery capability, typically costs more to achieve.⁶¹
- 176 Finally, MPI continues to make progress towards its goal of transitioning 27 external IT contractors to employees by the fiscal year 2019/20. To date, MPI has achieved 20 transitions, has approximately 2-3 additional transitions in progress and remains committed to completing all 27 transitions within the stated timeframe. MPI has also increased the projected savings of this initiative from \$2.4m to \$3m. MPI will also

⁵⁹ T: 921-922, lines 21-25 and 1

⁶⁰ MPI Exhibit 1, Pg. 261 (BMK Attachment A)

⁶¹ T: 908, lines 3-10

explore the possibility of reducing its IT staff further through the adoption of newer technology as part of its LSM assessment.⁶²

⁶² T: 1070-1071, lines 20-25 and 1-8

9 Breakeven Ratemaking: Expenses and Revenues

177 The rate increase to the cost of breakeven policies is 0.1 percent (as filed); calculated in accordance to the Accepted Actuarial Practices (AAP), where “the process for determining breakeven rates is separate from the process of determining the level of capital required to maintain the current capital position.”⁶³

178 MPI ratemaking methodology is proven and stable over time, drawing accolades from Mr. Sherry in testimony:

“We've done a lot of work moving towards rate making on accepted actuarial practice. It's only been one (1) or two (2) years where we've actually had that.

I think that that move was very important to help bring stability in terms of the projection period that you had to do to get to an indication.”⁶⁴

179 There are no significant changes to the ratemaking methodology applied for this year other than the technical line and group changes specified in the RM.2 section of the Ratemaking chapter.⁶⁵

9.1 Revenues

180 The 0.1% breakeven rate request (as filed) is based on four components:

- i. a forecasted 1.5 percent increase in volume of vehicles;

⁶³ CAC (MPI) 2-23

⁶⁴ T: 1276, lines 4-11

⁶⁵ RM.2 Rate model, Ratemaking p.5 of 58

- ii. an upgrade factor forecasted in this application at 2.39 percent, which includes changes to makes and models of vehicles, insurance uses, and different territories;
- iii. anti-theft discounts; and
- iv. fleet rebates.

181 Mr. Giesbrecht explained fleet rebates in his direct evidence, as is a surcharge or a rebate that owners of ten or more vehicles may qualify for. Moreover, he explains that:

"...historically, rebates have hovered around \$16 million, surcharge is at \$2 million for a net rebate of roughly \$14 million"⁶⁶.

182 Mr. Giesbrecht further explained that the anti-theft program is in runoff and that will gradually diminish its impact on the revenues over the future years going forward. Nonetheless, it represents about a \$2.4 million rebate to customers for this application year.

9.2 Expenses

183 Ms. Cynthia Campbell, the Corporate Controller, explained that "Expenses continue to be actively managed and they do not factor into any rate increase"⁶⁷. This is prudent fiscal management, that is evident throughout this application.

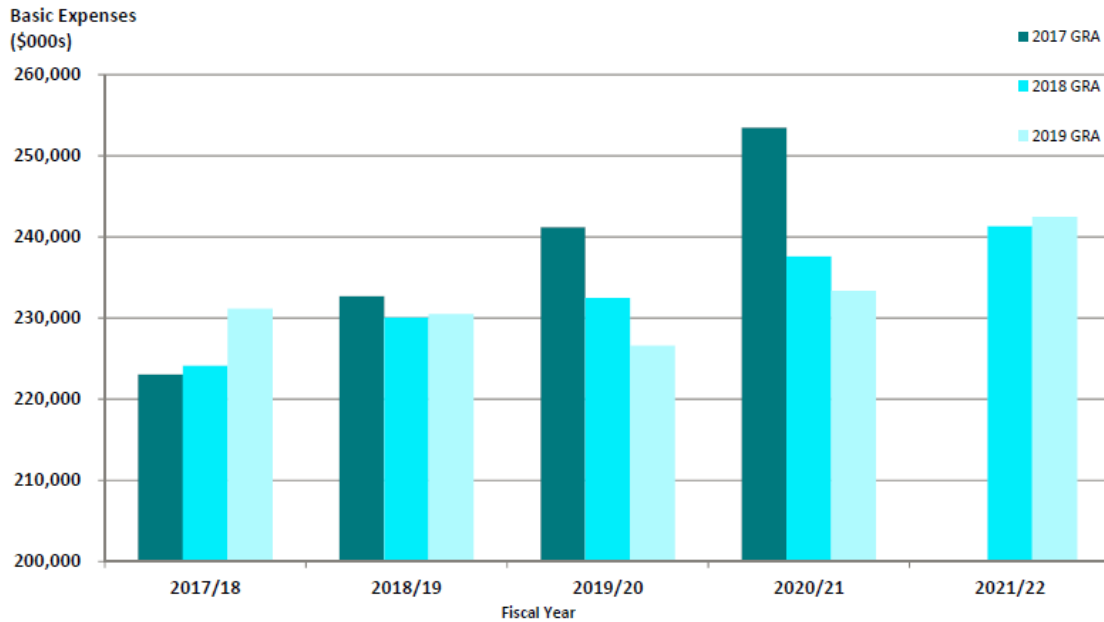
184 Dependable control over expenses is essential to deliver predictable and stable rates. The following chart⁶⁸ illustrates this trend of improving outlooks on expenses over successive GRA applications:

⁶⁶ T: 731, lines 21-23

⁶⁷ T: 737, lines 2-3

⁶⁸ MPI Exhibit 25, slide 18

Figure 4 – Expense Projections from Current and Past GRAs



185 There is over a 2 percent reduction in operating expenses for the rating years compared to the prior year’s rate application and, as a result, the operating expenses do not factor into the increase in this application.⁶⁹

186 Regarding FTEs, MPI has demonstrated the cost savings realized between eliminating the management full-time equivalent count by 15 percent, and creating the 24 new positions is \$4,496,843.⁷⁰

187 MPI also continues to improve the management of long terms claims through a two-pronged approach that relies on the hire of 13 FTE to actively case manage claimants, and address issues around reserving and fraud management. This is expected to dampen the growth in long term BI claims experienced in recent years.

⁶⁹ T: 736, lines 21-25.

⁷⁰ MPI Exhibit 41, Undertaking 14

- 188 The Corporation will continue to demonstrate fiscal prudence and sound financial management practices while driving cost-containment, streamlining of operations and elimination of unnecessary operational expenses.

10 Conclusion

- 189 MPI has brought a rate request that is just and reasonable, and fully supported by the evidence before the PUB. MPI respectfully submits that the application should be approved based on the methodology requested, and based on the updated GoC 10 Yr. bond yield as at September 28, 2018.
- 190 MPI also submits that 2018/19 Vehicle For Hire (VFH) rates should be approved, and the final approval of 2016/17 and 2017/18 VFH rates should receive final approval.
- 191 MPI has presented a clear and compelling case, supported by increased transparency and access to corporate executives, that appropriately balances the needs of MPI and those of ratepayers.
- 192 ALL OF WHICH IS RESPECTFULLY SUBMITTED.