Milliman

GROUP OF 100 DISCOUNT RATE

July 2017

Prepared by:

Craig McCulloch, FIAA FFA
Danny Wong, CFA, FIAA, FRM

Level 5
32 Walker Street
North Sydney
NSW 2060

Tel +61 (0)2 8090 9100

au.milliman.com

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1 BACKGROUND

Objectives and scope

The Group of 100 has commissioned Milliman to generate a standardised set of discount rates to be made publicly available for the purpose of discounting employee benefit liabilities under Australian Accounting Standard 119 (AASB 119). The scope of the work is limited to Australian employee benefit schemes, and excludes any schemes of foreign subsidiaries of domestic entities which are denominated in foreign currency.

This report provides the Australian corporate bond discount rate curve as at the end of July 2017 produced under the methodology and assumptions described in the 'Discount Rates for Australian Employee Benefit Liability Valuation' report.

Reliance and limitations

In producing this report, we have relied upon the following information:

- Capital market data as sourced from Bloomberg. Should this data be incorrect, it could materially affect the analysis and conclusions drawn from it.

Users of this report should also be aware that it is subject to the following limitations:

- Current debt market conditions. Issuance of corporate bonds is subject to change over time, which may impact upon whether the accounting standard requirements of a deep market are met.
- Current capital market conditions, in particular the liquidity and credit ratings of corporate bond markets, which can change rapidly. The asset calibration set could change very rapidly under stressed market conditions.
- Reassessments of the suitability of the asset calibration set would be needed if the AAA and/or AA corporate bond market thins, which would require a prospective change to the assets selected for AASB 119 calibration purposes.

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2 METHODOLOGY AND ASSUMPTIONS

Summary of the asset calibration set

The set of assets to be used to calibrate the discount rate curve is defined by those securities that meet the following conditions:

1. Individual bonds must have the following characteristics:
    a. Physical bonds, with no embedded derivatives (e.g., callable, putable, convertible, extendible, variable/floating coupon, index-linked)
    b. High-quality corporate bonds issued by both domestic and foreign entities
    c. Payments denominated in Australian dollars (AUD)
    d. Pay fixed (or zero) coupons, non-inflation-linked
    e. Maturity terms of greater than one month and less than 10 years
    f. Minimum amount outstanding on an individual security of $100 million
    g. Securitised bonds are included

2. A deep market for these bonds must exist, as characterised by the ready availability of observable prices and current trades.

What is meant by high quality?

Figure 1 defines the credit ratings by each agency that map to each of these broad categories. This forms the basis for the asset calibration set used in this report.

Figure 1: Definition of AAA and AA Credit Ratings by Agency

Category	AAA	AA
S&P	AAA	AA+, AA, AA-
Fitch	AAA	AA+, AA, AA-
Moody's	Aaa	Aa1, Aa2, Aa3

Where there is disagreement between credit rating agencies on particular securities, we use the following conditions:

- If a security has at least two AAA ratings, then it is classified as a AAA security
- If a security has at least two AA ratings, then it is classified as a AA security
- If a security has only been rated by two agencies with different ratings, then the lower rating is used
- If a security has only been rated by one agency, then that rating becomes the sole reference

Hereafter, all references to credit ratings refer to those that meet the above conditions. For the purposes of this paper, we refer to this as the combined credit rating.

Corporate bond universe

The table in Figure 2 shows the decomposition of the market by the combined credit rating satisfying all but the 'high quality' characteristic.

Figure 2: Australian Corporate Bond Market Outstanding Debt by Combined Credit Rating ($ millions)

Combined Rating	Number of Securities	Outstanding ($ Millions)	% of Total
AAA	11	5,750	5.9%
AA	134	35,785	36.8%
A	142	39,649	40.8%
BBB	66	15,819	16.3%
BB	0	0	0.0%
Other	1	113	0.1%
Total	**354**	**97,116**	**100.0%**

Source: *Milliman analysis based upon Bloomberg data as at 31 July 2017.*

The table in Figure 3 shows the universe of AAA and AA bonds used in the asset calibration set broken down into the composition of their respective S&P, Moody's and Fitch ratings.

Figure 3: Australian AAA/AA Corporate Bond Market Outstanding Debt ($ millions)

Credit Rating Composition	Number of Securities	Outstanding ($ Millions)	% of Total
Combined Credit Rating of AAA			
3 AAA ratings	0	0	0.0%
2 AAA ratings	9	5,175	90.0%
1 AAA rating	2	575	10.0%
Total Combined AAA	**11**	**5,750**	100.0%
Combined Credit Rating of AA			
3 AA ratings	41	11,725	32.8%
2 AA ratings	79	20,855	58.3%
1 AA rating	14	3,205	9.0%
Total Combined AA	**134**	**35,785**	100.0%

Source: *Milliman analysis based upon Bloomberg data as at 31 July 2017.*

Interpolation methodology

For fitting the discount curve to the asset calibration set, the Merrill Lynch Exponential Spline (MLES) method with nine exponential basis functions was used calibrated to yield data as at 31 July 2017, weighting each issue by the inverse duration of the issue. The results of the calibrated MLES parameters are shown in Figure 4.

Figure 4: MLES-Calibrated Parameters as at 31 July 2017

MLES Parameters		
Long-Run	**b0**	5.7%
Param1	**λ1**	127.5%
Param2	**λ2**	10.9%
Param3	**λ3**	-67.6%
Param4	**λ4**	32.5%
Param5	**λ5**	42.5%
Param6	**λ6**	-4.0%
Param7	**λ7**	-66.2%
Param8	**λ8**	-16.9%
Param9	**λ9**	41.3%

For the calibration of the MLES basis functions, an adjusted R-squared statistical goodness-of-fit measure was applied to the difference between modelled and actual bond prices.

An adjusted R-squared statistic value close to 100% indicates a very good fit, whilst lower values (closer to 0%) indicate poor fits. Figure 5 shows the results of the interpolation analysis used.

Figure 5: Adjusted R-Squared Statistic as at 31 July 2017

Regression Statistic	
Adjusted R-Squared	**96.6%**

Extrapolation methodology

For rates beyond 10-year maturities, the fitted yield curve has been extrapolated by assuming that 1-year forward rates remain constant for all subsequent maturities. This is based on the 1-year forward rate between 9- and 10-year maturities, based on the fitted MLES model.

3 FITTED YIELD CURVE

Figure 6 shows the modelled yield-to-maturity for each bond in the asset calibration set, compared with the actual yield-to-maturity, using the MLES method with inverse duration weightings. Note that these are the same bonds as those discussed and analysed in Section 2 above.

Figure 6: Modelled vs. Market Yields to Maturity for Asset Calibration Set Using the MLES Method with Inverse Duration Weightings

Figures 7 and 8 show the resulting spot and forward yield curves of one to 50 years for the calibration set using the MLES method and extrapolated with the constant forward rate extrapolation method. Spot rates shown are quoted as annually compounded rates on zero coupon bonds with maturities of the specified term, forward rates shown are 1-year forward rates ending at the specified term.

Figure 7: Spot and Forward Rate Curves for Asset Calibration Set Using an MLES Interpolation and Constant Forward Rate Extrapolation Method

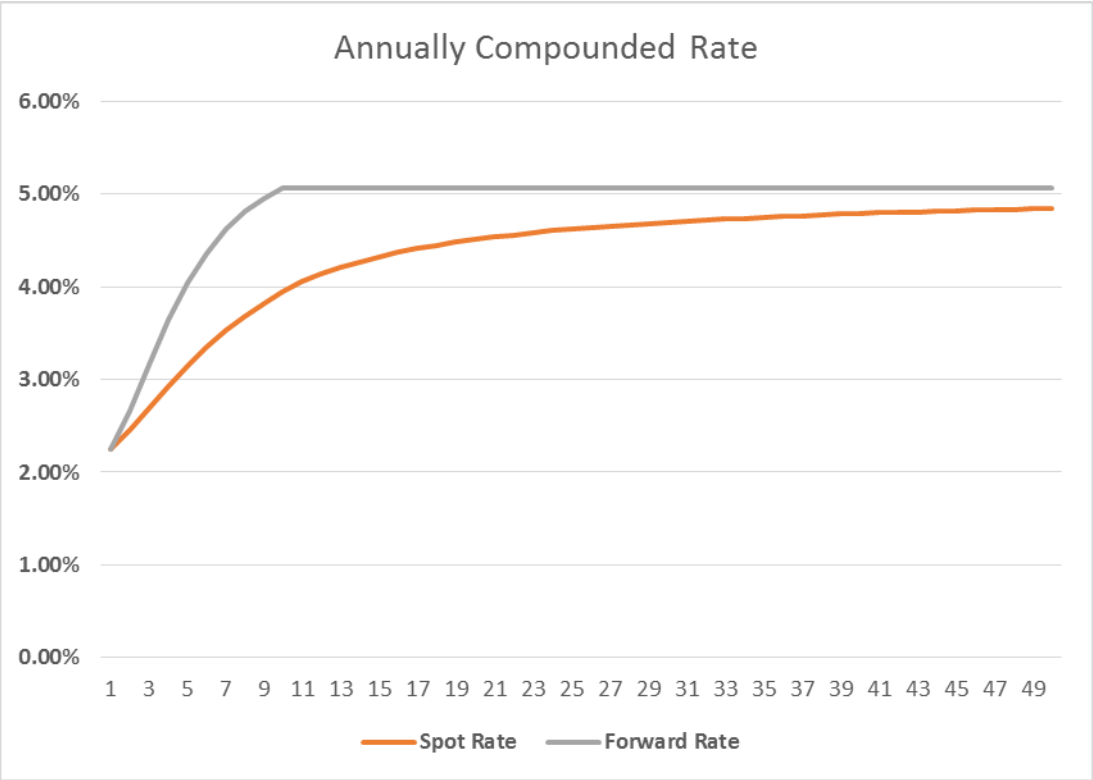


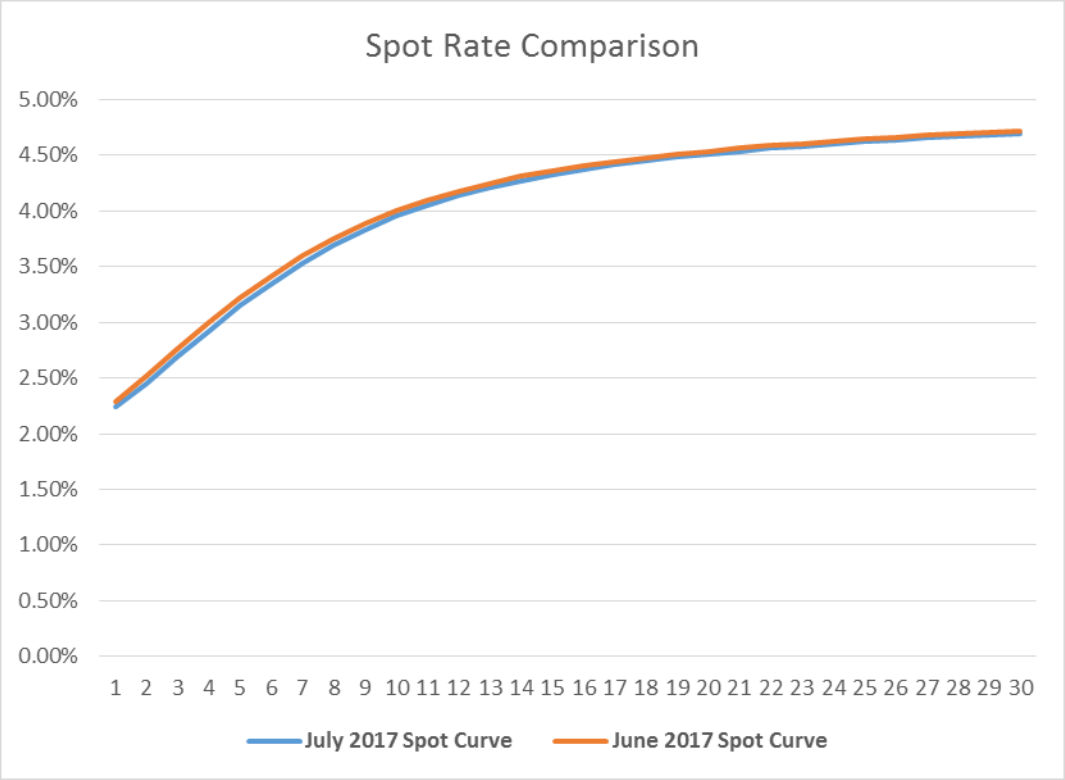
Figure 8: Spot and Forward Rate Curves for Asset Calibration Set Using an MLES Interpolation and Constant Forward Rate Extrapolation Method

Term (Years)	Spot Rate	Discount Factor
1	2.24%	0.978052
2	2.45%	0.952721
3	2.69%	0.923548
4	2.92%	0.891139
5	3.15%	0.856517
6	3.35%	0.820681
7	3.53%	0.784456
8	3.69%	0.748455
9	3.83%	0.713107
10	3.95%	0.678697
11	4.05%	0.645948
12	4.14%	0.614778
13	4.21%	0.585113
14	4.27%	0.556879
15	4.32%	0.530008
16	4.37%	0.504433
17	4.41%	0.480092
18	4.45%	0.456926
19	4.48%	0.434878
20	4.51%	0.413893
21	4.54%	0.393922
22	4.56%	0.374913
23	4.58%	0.356823
24	4.60%	0.339605
25	4.62%	0.323217

Term (Years)	Spot Rate	Discount Factor
26	4.64%	0.307621
27	4.65%	0.292777
28	4.67%	0.278650
29	4.68%	0.265204
30	4.70%	0.252407
31	4.71%	0.240227
32	4.72%	0.228635
33	4.73%	0.217603
34	4.74%	0.207103
35	4.75%	0.197109
36	4.76%	0.187598
37	4.77%	0.178546
38	4.77%	0.169930
39	4.78%	0.161731
40	4.79%	0.153926
41	4.80%	0.146499
42	4.80%	0.139430
43	4.81%	0.132702
44	4.81%	0.126299
45	4.82%	0.120204
46	4.83%	0.114404
47	4.83%	0.108883
48	4.84%	0.103629
49	4.84%	0.098629
50	4.85%	0.093870

Figure 9 shows the resulting spot rate curve of one to 30 years relative to the prior period fitted curve.

Figure 9: Spot Rate Curves Relative to Prior Period Fitted Curve



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