



Group of 100 Discount Rate

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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 September 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, puttable, 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	5.5%
AA	135	35,910	34.4%
A	151	42,129	40.3%
BBB	73	19,169	18.4%
BB	2	548	0.5%
Other	5	934	0.9%
Total	377	104,439	100.0%

Source: Milliman analysis based upon Bloomberg data as at 29 September 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	10	5,475	95.2%
1 AAA rating	1	275	4.8%
Total Combined AAA	11	5,750	100.0%
Combined Credit Rating of AA			
3 AA ratings	41	11,450	31.9%
2 AA ratings	80	21,105	58.8%
1 AA rating	14	3,355	9.3%
Total Combined AA	135	35,910	100.0%

Source: Milliman analysis based upon Bloomberg data as at 29 September 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 29 September 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 29 SEPTEMBER 2017

MLES Parameters		
Long-Run	b0	5.7%
Param1	λ1	127.1%
Param2	λ2	8.3%
Param3	λ3	-69.0%
Param4	λ4	39.3%
Param5	λ5	40.7%
Param6	λ6	-5.4%
Param7	λ7	-62.7%
Param8	λ8	-17.0%
Param9	λ9	38.6%

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 29 SEPTEMBER 2017

Regression Statistic	
Adjusted R-Squared	96.5%

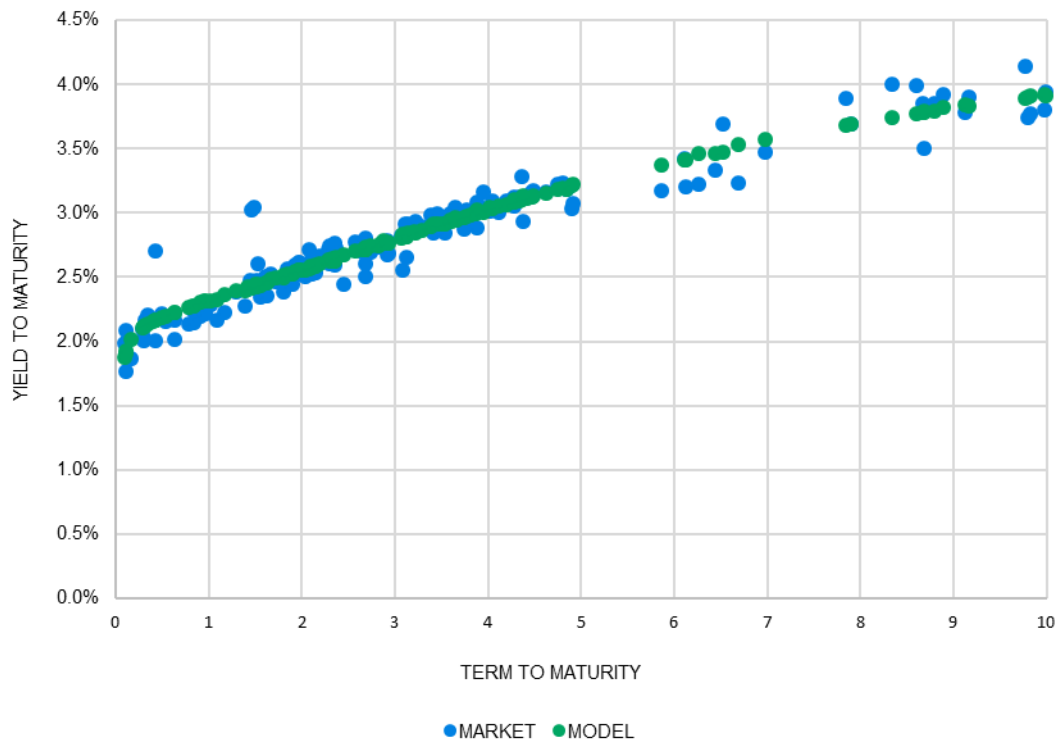
EXTRAPOLATION METHODOLOGY

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

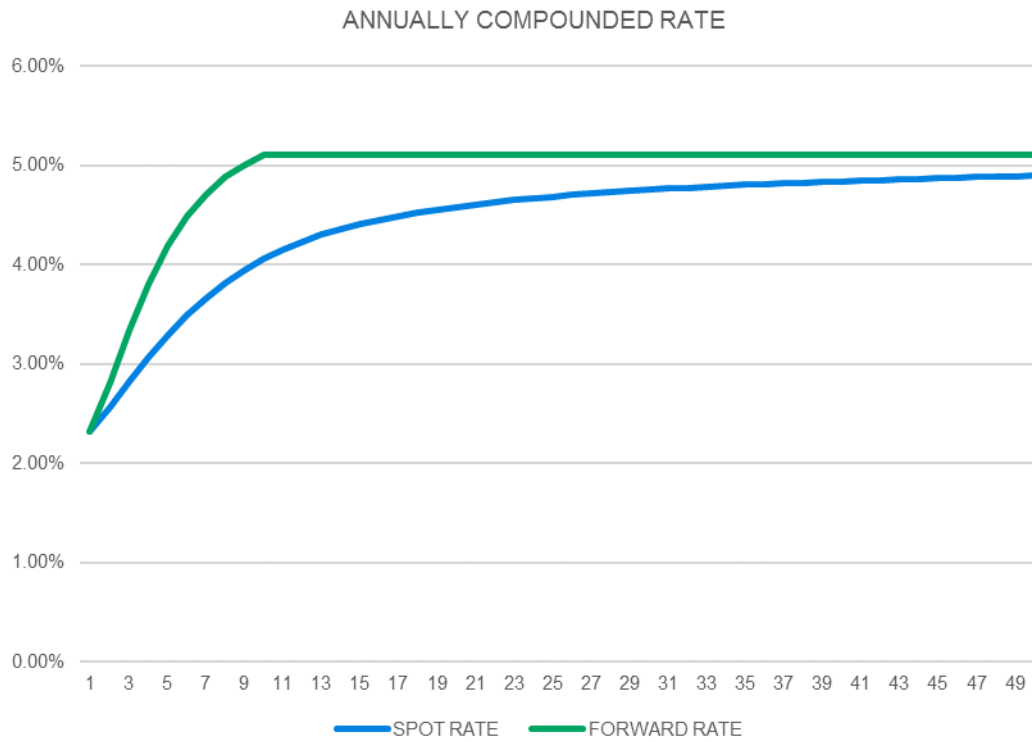
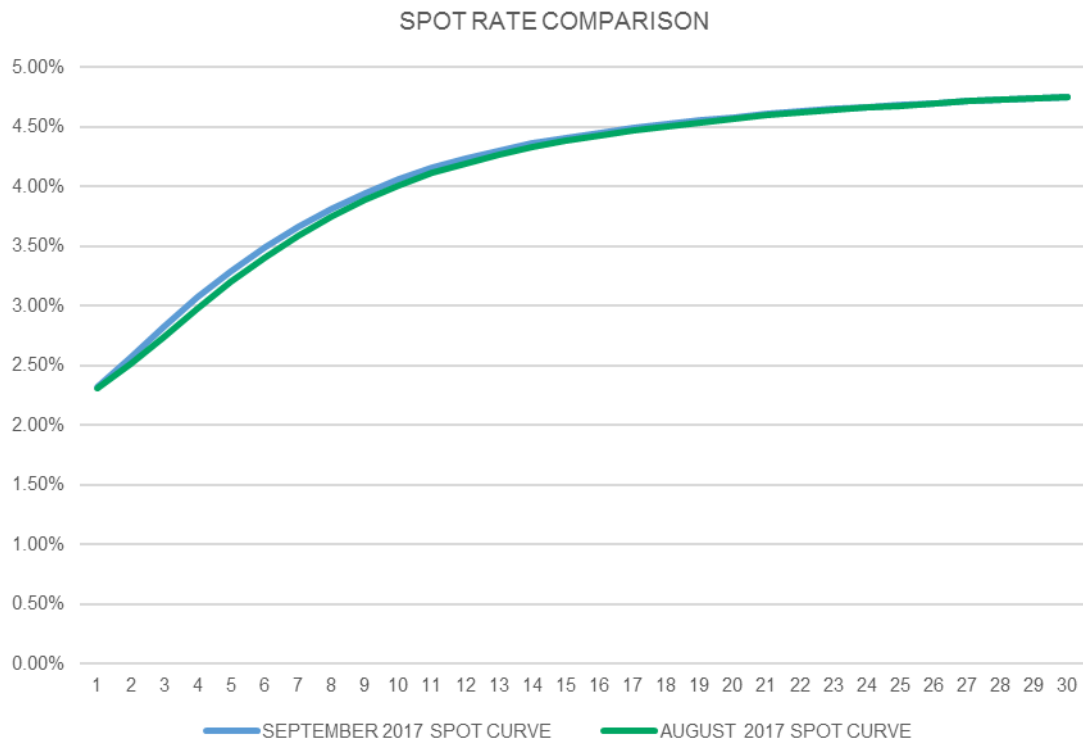


FIGURE 8: SPOT AND FORWARD RATE CURVES FOR ASSET CALIBRATION SET USING AN MLES INTERPOLATION AND CONSTANT FORWARD RATE EXTRAPOLATION METHOD

Term (Years)	Spot Rate	Discount Factor	Term (Years)	Spot Rate	Discount Factor
1	2.32%	0.977299	26	4.70%	0.302922
2	2.57%	0.950548	27	4.72%	0.288216
3	2.82%	0.919879	28	4.73%	0.274223
4	3.07%	0.886182	29	4.74%	0.260910
5	3.29%	0.850575	30	4.75%	0.248243
6	3.49%	0.814065	31	4.77%	0.236192
7	3.66%	0.777441	32	4.78%	0.224725
8	3.81%	0.741267	33	4.79%	0.213815
9	3.95%	0.705925	34	4.79%	0.203434
10	4.06%	0.671654	35	4.80%	0.193558
11	4.15%	0.639046	36	4.81%	0.184161
12	4.23%	0.608021	37	4.82%	0.175220
13	4.30%	0.578503	38	4.83%	0.166714
14	4.36%	0.550417	39	4.83%	0.158620
15	4.41%	0.523695	40	4.84%	0.150919
16	4.45%	0.498270	41	4.85%	0.143592
17	4.49%	0.474080	42	4.85%	0.136621
18	4.52%	0.451064	43	4.86%	0.129988
19	4.55%	0.429166	44	4.86%	0.123677
20	4.58%	0.408330	45	4.87%	0.117673
21	4.61%	0.388506	46	4.88%	0.111960
22	4.63%	0.369645	47	4.88%	0.106525
23	4.65%	0.351699	48	4.88%	0.101353
24	4.67%	0.334625	49	4.89%	0.096433
25	4.68%	0.318379	50	4.89%	0.091751

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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