



Group of 100 Discount Rate

March 2019

Prepared by:

[Craig McCulloch](#), FIAA FFA
[Jessica Lim](#), CFA, FRM

Level 5
32 Walker Street
North Sydney
NSW 2060

Tel +61 (0)2 8090 9100

au.milliman.com

TABLE OF CONTENTS

1	BACKGROUND	1
	OBJECTIVES AND SCOPE	1
	RELIANCE AND LIMITATIONS	1
2	METHODOLOGY AND ASSUMPTIONS	2
	SUMMARY OF THE ASSET CALIBRATION SET	2
	INTERPOLATION METHODOLOGY	4
	EXTRAPOLATION METHODOLOGY	4
3	FITTED YIELD CURVE	5

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 March 2019 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.

This report was prepared solely to provide assistance to the Group of 100 and the relevant Actuaries Institute of Australia subcommittee. Milliman does not intend to benefit and assumes no duty or liability to other parties who receive this report. Milliman recommends that any recipient of this report be aided by its own actuary or other qualified professional when reviewing the report. Milliman does not certify the information in this report, nor does it guarantee the accuracy, completeness, efficacy, or timeliness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy, completeness, efficacy, and timeliness has been performed. Materials may not be reproduced without the express consent of Milliman.

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	12	5,925	6.2%
AA	123	32,745	34.2%
A	130	34,254	35.8%
BBB	73	22,844	23.9%
BB	0	0	0.0%
Other	0	0	0.0%
Total	338	95,768	100.0%

Source: Milliman analysis based upon Bloomberg data as at 29 March 2019.

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	11	5,650	95.4%
1 AAA rating	1	275	4.6%
Total Combined AAA	12	5,925	100.0%
Combined Credit Rating of AA			
3 AA ratings	41	10,850	33.1%
2 AA ratings	70	19,215	58.7%
1 AA rating	12	2,680	8.2%
Total Combined AA	123	32,745	100.0%

Source: Milliman analysis based upon Bloomberg data as at 29 March 2019.

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 March 2019, 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 MARCH 2019

MLES Parameters		
Long-Run	b0	5.7%
Param1	λ1	138.1%
Param2	λ2	42.2%
Param3	λ3	-127.8%
Param4	λ4	27.7%
Param5	λ5	37.6%
Param6	λ6	28.7%
Param7	λ7	-77.1%
Param8	λ8	9.1%
Param9	λ9	21.5%

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 MARCH 2019

Regression Statistic	
Adjusted R-Squared	96.7%

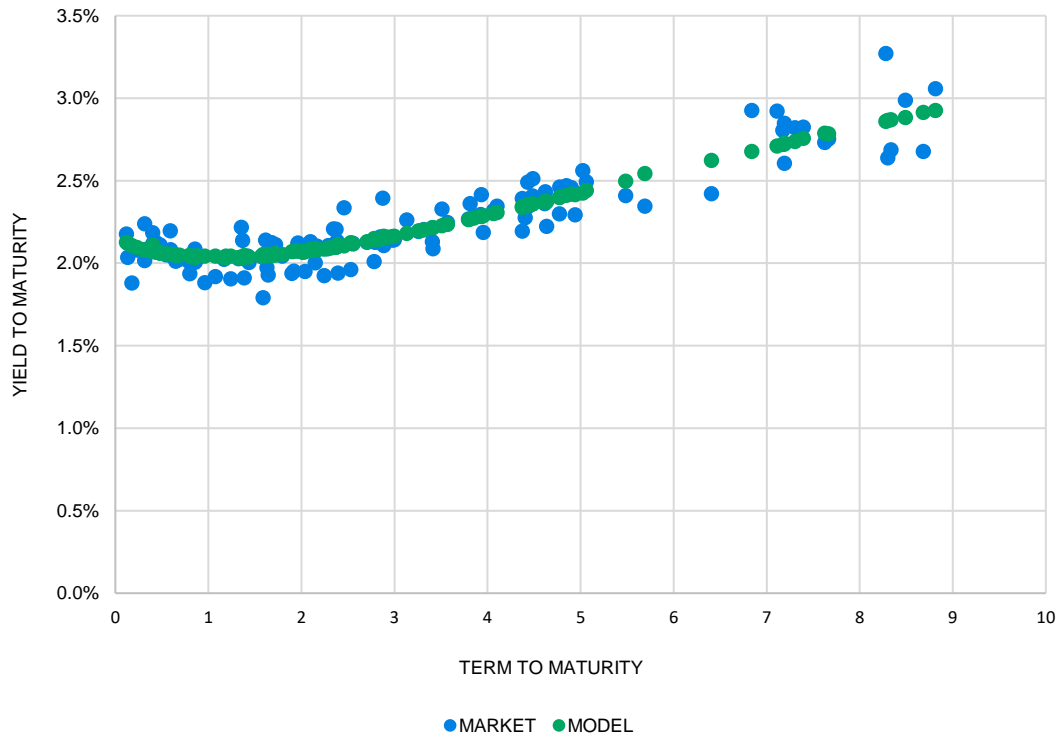
EXTRAPOLATION METHODOLOGY

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

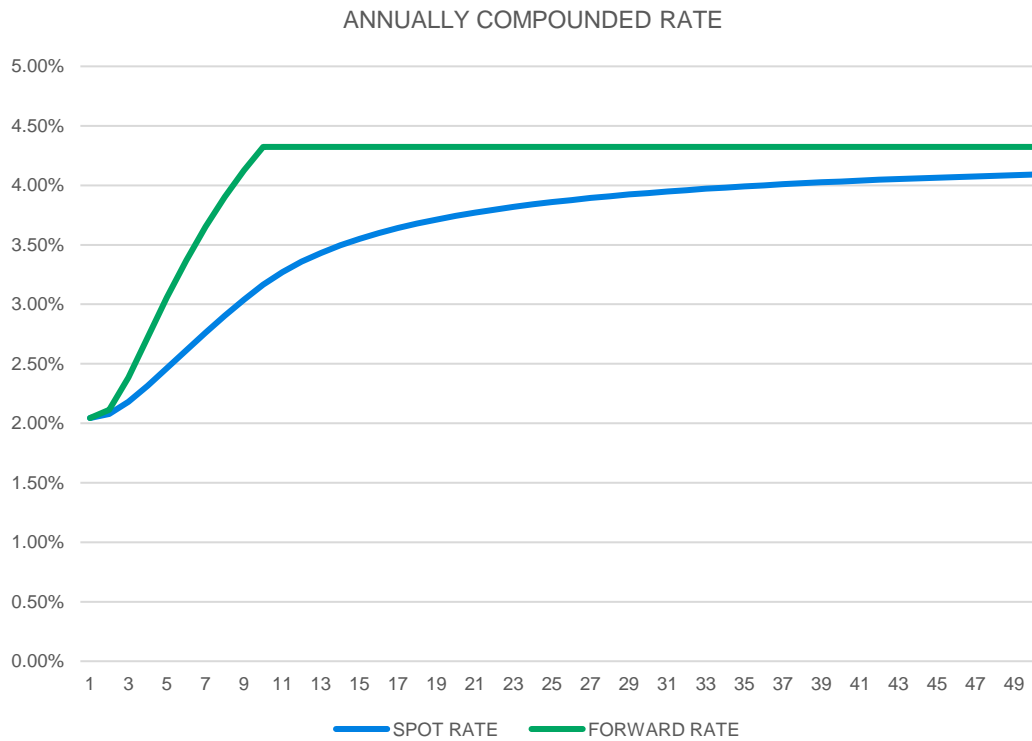
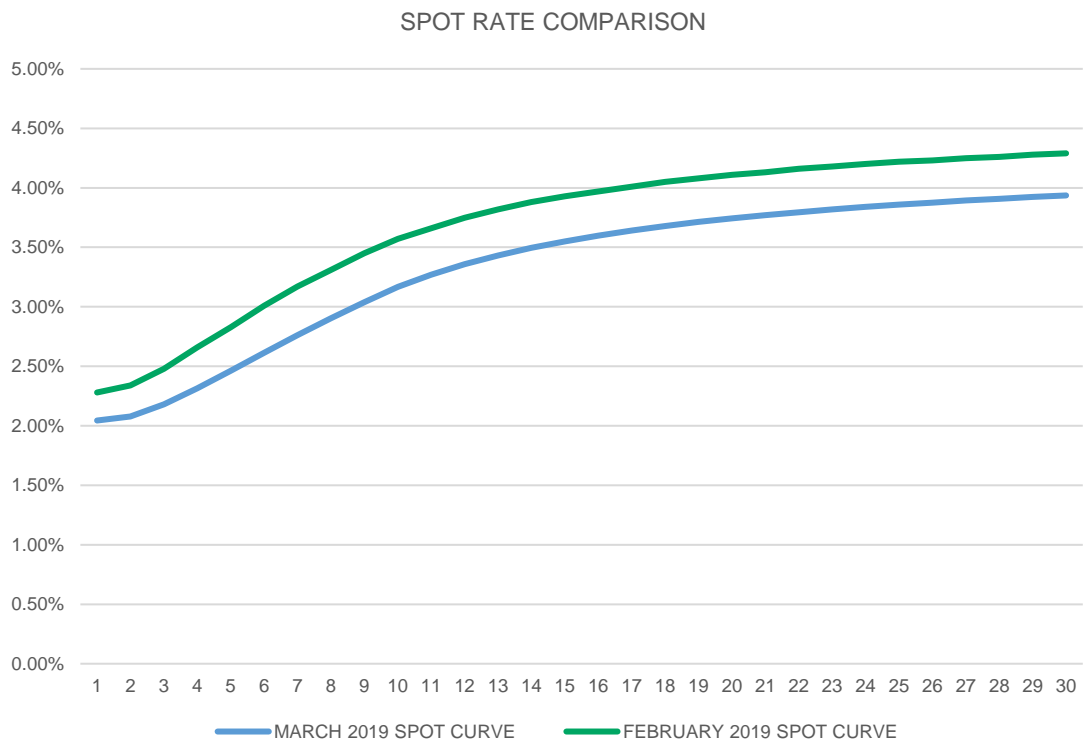


FIGURE 8: SPOT AND FORWARD RATE CURVES FOR ASSET CALIBRATION SET USING AN MLES INTERPOLATION AND CONSTANT FORWARD RATE EXTRAPOLATION METHOD

Term (Years)	Spot Rate	Discount Factor	Term (Years)	Spot Rate	Discount Factor
1	2.04%	0.979967	26	3.88%	0.372002
2	2.08%	0.959688	27	3.89%	0.356587
3	2.18%	0.937328	28	3.91%	0.341811
4	2.32%	0.912500	29	3.92%	0.327648
5	2.46%	0.885428	30	3.94%	0.314071
6	2.61%	0.856558	31	3.95%	0.301057
7	2.76%	0.826377	32	3.96%	0.288582
8	2.90%	0.795337	33	3.97%	0.276624
9	3.04%	0.763828	34	3.98%	0.265161
10	3.17%	0.732177	35	3.99%	0.254174
11	3.27%	0.701838	36	4.00%	0.243641
12	3.36%	0.672756	37	4.01%	0.233546
13	3.43%	0.644879	38	4.02%	0.223868
14	3.50%	0.618157	39	4.03%	0.214592
15	3.55%	0.592542	40	4.03%	0.205700
16	3.60%	0.567989	41	4.04%	0.197176
17	3.64%	0.544453	42	4.05%	0.189006
18	3.68%	0.521892	43	4.05%	0.181174
19	3.71%	0.500267	44	4.06%	0.173666
20	3.74%	0.479537	45	4.06%	0.166470
21	3.77%	0.459666	46	4.07%	0.159572
22	3.80%	0.440619	47	4.08%	0.152960
23	3.82%	0.422361	48	4.08%	0.146622
24	3.84%	0.404859	49	4.09%	0.140546
25	3.86%	0.388083	50	4.09%	0.134722

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





Milliman is among the world's largest providers of actuarial and related products and services. The firm has consulting practices in life insurance and financial services, property & casualty insurance, healthcare, and employee benefits. Founded in 1947, Milliman is an independent firm with offices in major cities around the globe.

[milliman.com](https://www.milliman.com)

CONTACT

Craig McCulloch
craig.mcculloch@milliman.com

Jessica Lim
jessica.lim@milliman.com

© 2019 Milliman, Inc. All Rights Reserved. The materials in this document represent the opinion of the authors and are not representative of the views of Milliman, Inc. Milliman does not certify the information, nor does it guarantee the accuracy and completeness of such information. Use of such information is voluntary and should not be relied upon unless an independent review of its accuracy and completeness has been performed. Materials may not be reproduced without the express consent of Milliman.