



Illiquidity premium for public sector entities

Objectives of this agenda paper

1. Consider emerging practices in the public sector with respect to determining illiquidity premiums when entities adopt a bottom-up approach to discount rates under AASB 17/PBE IFRS 17 *Insurance Contracts*.¹
2. In this context, the Group is asked to discuss three questions:
 - (a) are public sector entities considering both the top-down and bottom-up approaches to estimating discount rates?
 - (b) are there unique public sector considerations that mean discount rates adopted could differ materially from Australian private sector insurers?
 - (c) are the approaches taken by similar schemes in other jurisdictions (such as Canada) relevant to consider when adopting an approach in Australia?

Disclaimer and assumptions

3. This paper has been prepared for discussion purposes only.²
4. It is evident that most (and possibly all) public sector entities will be applying the Premium Allocation Approach to measure their liabilities for remaining coverage (LRC) and any assets for reinsurance coverage held (ARC). Accordingly, the discussion on illiquidity premium in this paper is primarily relevant in the context of recognising and measuring liabilities for incurred claims (LIC) and any assets for incurred claims recoveries (AIC) and for any onerous contract testing (which, when relevant, public sector entities are expected to do at the portfolio level).

Requirements relating to liquidity premiums in discount rates

5. Entities are permitted to adopt a 'bottom up' or 'top down' approach to determining the discount rate(s) [AASB 17.B80 and B81]. Illiquidity premiums are only relevant when the bottom up approach is adopted [AASB 17.B81].
6. AASB 2022-9 *Amendments to Australian Accounting Standards – Insurance Contracts in the Public Sector* does not make any public sector modifications to AASB 17 for determining discount rates.
7. AASB 17.36 requires that (emphasis added):

36 An entity shall adjust the estimates of future cash flows to reflect the time value of money and the financial risks related to those cash flows, to the extent that the

1 This paper references AASB 17 *Insurance Contracts* and AASB 2022-9 *Amendments to Australian Accounting Standards – Insurance Contracts in the Public Sector*, but is intended to apply equally in the context of the New Zealand XRB's PBE IFRS 17 *Insurance Contracts* and XRB's *Insurance Contracts in the Public Sector (Amendments to PBE IFRS 17)*.

2 The AASB and the authors of this paper do not guarantee, and accept no legal liability whatsoever arising from or connected to, the accuracy, reliability, currency or completeness of any material contained in this paper. This paper is not a substitute for independent professional advice and users should obtain any appropriate professional advice relevant to their particular circumstances. The views in this paper do not necessarily reflect the views of the AASB, or indicate its commitment to a particular course of action.



financial risks are not included in the estimates of cash flows. **The discount rates applied to the estimates of the future cash flows** described in paragraph 33 shall:

- (a) **reflect** the time value of money, the characteristics of the cash flows and **the liquidity characteristics of the insurance contracts**;
- (b) **be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts**, in terms of, for example, timing, currency and **liquidity**; and
- (c) exclude the effect of factors that influence such observable market prices but do not affect the future cash flows of the insurance contracts.

8. AASB 17.B79, B80 and B84 note that (emphasis added):

- B79 For cash flows of insurance contracts that do not vary based on the returns on underlying items, the discount rate reflects the yield curve in the appropriate currency for instruments that expose the holder to no or negligible credit risk, **adjusted to reflect the liquidity characteristics of the group of insurance contracts**. That adjustment shall reflect the difference between the liquidity characteristics of the group of insurance contracts and the liquidity characteristics of the assets used to determine the yield curve. Yield curves reflect assets traded in active markets that the holder can typically sell readily at any time without incurring significant costs. In contrast, under some insurance contracts the entity cannot be forced to make payments earlier than the occurrence of insured events, or dates specified in the contracts.
- B80 Hence, for cash flows of insurance contracts that do not vary based on the returns on underlying items, **an entity may determine discount rates by adjusting a liquid risk-free yield curve to reflect the differences between the liquidity characteristics of the financial instruments that underlie the rates observed in the market and the liquidity characteristics of the insurance contracts (a bottom-up approach)**.
- B84 In principle, for cash flows of insurance contracts that do not vary based on the returns of the assets in the reference portfolio, **there should be a single illiquid risk-free yield curve that eliminates all uncertainty about the amount and timing of cash flows**. However, in practice the top-down approach and the bottom-up approach may result in different yield curves, even in the same currency. This is because of the inherent limitations in estimating the adjustments made under each approach, and the possible lack of an adjustment for different liquidity characteristics in the top-down approach. An entity is not required to reconcile the discount rate determined under its chosen approach with the discount rate that would have been determined under the other approach.

Commercial private sector insurer estimates of illiquidity

9. For their first annual financial statements under AASB 17, the large locally-listed general insurers (IAG, Suncorp, and QBE) calculated discount rates by taking the risk free discount rate estimated based on a portfolio of Commonwealth Government bonds, and added an illiquidity premium. These insurers adopted an illiquidity premium of between 0.25% and 0.30%.
10. Relevant information from their annual reports is noted below.

IAG 2024 annual report, page 121: In determining discount rates for each group of contracts under AASB 17, the Group applies a bottom-up approach. Under this approach, the Group estimates discount rates as points on a liquid, risk-free rate curve for the same currency and duration as the cash flows of the relevant insurance contracts. The Group



adjusts the risk-free rate for an illiquidity premium, 25 basis points, as yield curves derived from observable market prices reflect liquid assets rather than insurance contracts, which are relatively less liquid. The Group applies judgement in determining the liquidity characteristics of the group of insurance contracts

IAG 2024 annual report, page 153: the impact on adopting AASB 17 of including an illiquidity premium is \$20m.

Suncorp 2024 annual report, page 92: The adjustment is driven by the introduction of 30 basis points of illiquidity premium as per AASB 17 to the discount rates used for discounting the insurance contract liabilities and reinsurance contract assets.

Suncorp 2024 annual report, page 107: To calculate the discount rate, a bottom-up approach is applied, whereby the risk-free yield curve is adjusted to reflect the liquidity characteristics of the insurance cash flows through the addition of an illiquidity premium (ILP) which will increase the discount rate. The derivation of ILP comprises a market ILP and an illiquidity ratio which adjusts the market ILP to reflect the liquidity characteristics of the Group's insurance and reinsurance contracts.

QBE 2023 annual report, page 90: A bottom-up approach is applied to determine the discount rates used to discount insurance and reinsurance contract cash flows, which uses risk-free rates adjusted to reflect the liquidity characteristics of the insurance contracts.

The illiquidity premium within discount rates is derived based on the long-term weighted average credit spread of a reference portfolio of assets with a similar currency mix and weighted average duration as the related insurance liabilities over the longer term. The effect of credit risk and other factors that are not relevant to the liquidity characteristics of insurance contracts is eliminated to estimate the portion of the spread that reflects the illiquidity premium.

QBE 2023 annual report, page 133: The opening net asset impact mainly reflects increases from the application of the AASB 17 risk adjustment (\$130 million) and higher discount rates due to the inclusion of the illiquidity premium (\$168 million), ...

11. Large general insurers operating in Australia and New Zealand, but not listed locally, include Allianz and Hollard and relevant information from their annual reports is noted below.

Allianz (worldwide) 2023 annual report, page 159: The Allianz Group applies a bottom-up approach in which the basic risk-free liquid yield curves are usually derived from swap rates or government yields for the specific currency and adjusted for remaining credit risk. These risk-free liquid yield curves are then adjusted to reflect illiquidity of the underlying insurance liabilities based on reference portfolios.

Hollard (Australia and New Zealand) 2024 annual report, page 30: The liability for incurred claims and loss components are discounted at a rate equivalent to that inherent in a portfolio of risk-free fixed interest securities with coupon and redemption cash flows exactly matching the projected inflation claim cash flows plus an illiquidity premium. Due to the short term nature of the business, an allowance for illiquidity premium is deemed to not be material and has not been recognised. The discount rates disclosed above are expressed as weighted averages.

12. Consistent with Hollard, the large private health insurers do not employ discounting.

Medibank 2024 annual report: makes no mention of discounting (but there is no 'insurance finance income or expense' presented – hence, it is evident there is no discounting).

NIB 2024 annual report, page 37: Insurance contract liabilities are not discounted as the effect of accounting for the time value of money on amounts expected to be paid or received one year or more from the date of claims being incurred is immaterial



13. [The Australian Actuaries Institute Information Note on AASB 17](#) notes there are typically three approaches to estimating an illiquidity premium [Section 4.2.4]:
- (a) The Credit Default Swap (CDS) basis. This approach assumes the difference in yield between a portfolio of market traded corporate bonds that are highly rated, and a portfolio of Australian Government bonds, comprises risk premiums for credit risk and illiquidity. The credit risk component can be removed, based on the price of Credit Default Swaps for similar issuing entities and maturities, with the remainder being the illiquidity premium.
 - (b) Structural model approach. This uses the Merton model to estimate the credit risk of market traded bonds. The approach then compares the yield on an illiquid corporate bond portfolio with the yield on a liquid position with otherwise equivalent credit risk characteristics.
 - (c) Covered bond spreads. If (illiquid) covered bonds are viewed as being essentially free of credit risk, the spread over the risk-free reference rate can be considered as an estimate for the illiquidity premium.
14. The Information Note observes that the CDS basis is likely to be the most familiar to Australian insurers. The authors of this paper understand that:
- (a) the CDS basis has been widely used by Australian insurers to estimate illiquidity; and
 - (b) adopting a CDS approach over the past 10 years would have produced average illiquidity premiums of 0.5%, with a low and high of 0.2% and 0.8%.

Australian public sector context

15. Most private sector general insurance business is arguably quite 'liquid'. For most classes of business, once a claim has occurred and been lodged, there is nothing in the policy terms or in the *Insurance Contracts Act 1984* that would delay the claimant or policyholder's entitlement to settle the claim. There is, however, an *average* delay to settling claims that is measured and is used to calculate the duration of the liabilities. In the private sector the authors of this paper understand that estimates of the illiquidity premium take this average duration into account.
16. Some of the same types of general insurance business is issued in both the private and public sectors. However, some classes of business with a long claims tail are more often issued in the public sector and the relevant public sector insurers are also more likely than their private sector counterparts to be concentrated in only one line of business.
- (a) Most workers' compensation insurance business in Australia and New Zealand is issued by public sector entities and are typically statutory benefits. Income replacement payments are generally made periodically (such as fortnightly or monthly), and cannot be 'sped up'. Medical and treatment payments are made when required, after a course of treatment has occurred.
 - (b) Transport accident and other types of catastrophic injury schemes are mostly operated by public sector entities in Australia and New Zealand. Benefit payments are made to carers of injured participants. These payments are made when care is provided and will (in general) continue for the remainder of the injured participant's life. That is, they cannot be 'sped up'.
17. For these types of insurance businesses, the average delay to payment is much longer than for the business that private sector insurers tend to issue and the benefits are able to be scheduled with some accuracy. Accordingly, insurance liabilities associated with these types of



business are regarded as relatively 'illiquid', which would be expected to be captured in higher illiquidity premiums than those typically seen in the private sector.

International public sector comparisons

18. In Canada, the provinces have workers' compensation Boards that provide statutory benefits to injured workers. These are broadly similar to Australian workers' compensation schemes. Canada adopted IFRS 17 from 1 January 2023, and the Canadian workers' compensation Boards applied IFRS 17 in their annual 2023 financial statements.
19. The four largest Boards (for the provinces of Alberta, British Columbia, Ontario, and Quebec) adopted discount rates of around 4.8% as at December 2023. The mean term of the liabilities is around 10-15 years. The yield on Canadian government 10-year bonds at that time was around 3.1%. This suggests the Canadian Boards adopted an illiquidity premium of approximately 1.7%, which is substantially higher than Australian private sector equivalents.
20. The authors of this paper understand the Canadian Boards have applied a CDS type approach, and used A and BBB rated bonds – which tend to have a higher inherent illiquidity premium than more highly rated bonds, as well as a higher credit risk premium. They also appear to make a further adjustment to allow for the more illiquid nature of the workers' compensation liabilities compared to bonds.
21. Prior to the adoption of IFRS 17 the Canadian Boards' discount rates were set on an investment return basis, rather than a risk free basis.

Ongoing work

22. The Australian Actuaries Institute has established a working group to consider technical approaches to estimating the illiquidity premium for public sector schemes, particularly those with very long duration statutory liabilities such as workers' compensation and catastrophic injury schemes.
23. The working group is aiming to complete its work during the 2025 calendar year.