International
View on Discount Rates

September 30, 2020 edition

Discount rates stabilized in Q3-2020. Assets continue recovery.

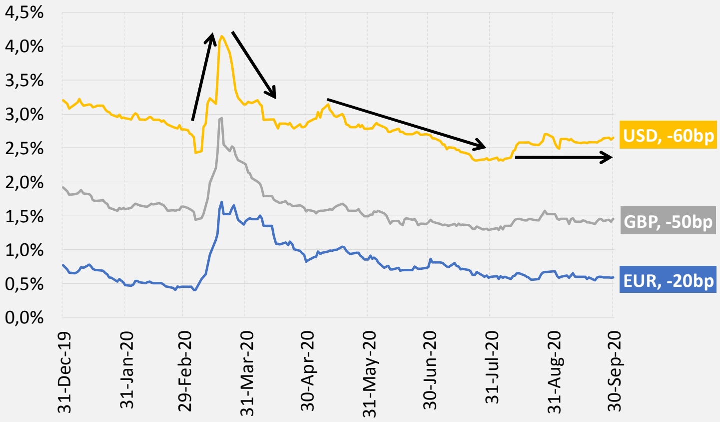
Global bond yields, which determine the discount rate of your companies' pension liabilities under IFRS and US GAAP accounting, have stabilized in Q3-2020. This after the sudden spike in March following the Covid-19 panic and the steady drop thereafter in Q2-2020. The difference between December 31, 2019 and September 30, 2020 rates is different around the world. GBP and USD rates are down -40 to -60bp from last yearend, while EUR rates are -20bp lower.

On average **discount rates** are down **-30bp** from last yearend in the main currency zones.

Unfunded liabilities could therefore be **+4%** higher than last yearend.

Funded liabilities could still suffer from the **equity** crash in March, although markets have continued their **recovery** in Q3-2020.

Discount rate evolution 31-Dec-2019 until 30-Sep-2020 (in %)
(Iboxx Corporate AA bond yields for duration of 10+ years)



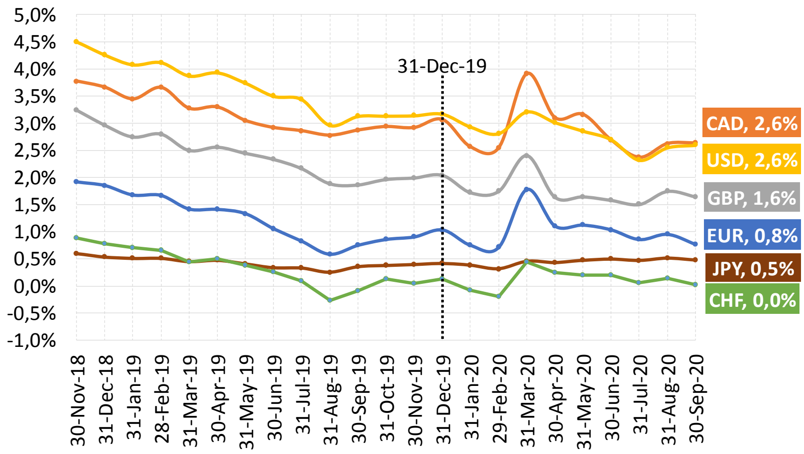
Discount rates mostly lower than at YE19

Early 2020, in fear of the economic consequences of the Covid-19 outbreak in Asia, bond yields fell globally as investors fled to the safety of high quality bonds. Yields spiked globally in March with panic sales of equities and bonds, when the worldwide impact of the virus became clear.

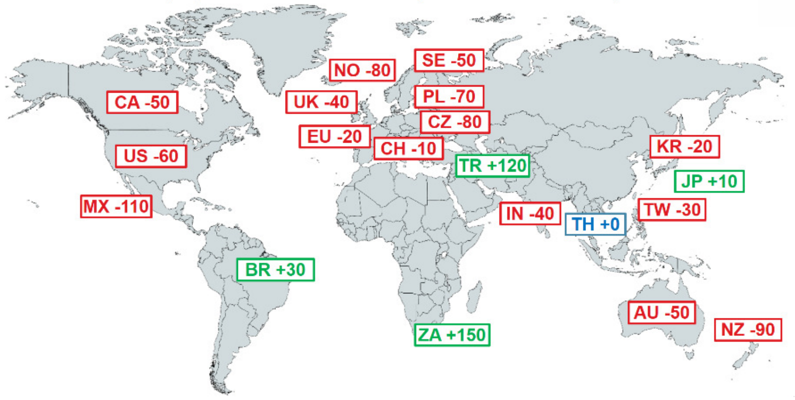
Unprecedented measures taken by central banks as well as public finance support fighting the pandemic's economic effects, have since brought back confidence and stability to the financial markets. Both equity and bond markets made significant recovery in Q2 and Q3-2020.

In Q3-2020 most discount rates remained unchanged or went slightly down. Compared to December 31, 2019 most discount rates are now significantly lower.

Discount rate evolution 31-Dec-2018 until 30-Sep-2020 (in %)
(Aon Corporate AA bond yields for selected duration[1])



Discount rate evolution 31-Dec-2019 until 30-Sep-2020 (in bp)
(Corporate AA or Government bond yields for selected duration[1])



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Unfunded liabilities around 4% higher in 2020

Unfunded employee benefit liabilities could increase on average 4% in the main currency zones due to changes in discount rates since yearend 2019. In the other currency zones, the picture is quite similar.

	Selected duration[1]	Discount rate 31-Dec-18	31-Dec-19	30-Jun-20	30-Sep-20	Year-to-date increase/(decrease) Discount rate	Unfunded liability
Main currency zones							
USA	12	4,3%	3,2%	2,7%	2,6%	(0,6%)	7,2%
Eurozone	15	1,8%	1,0%	1,0%	0,8%	(0,2%)	3,0%
UK	20	3,0%	2,0%	1,6%	1,6%	(0,4%)	8,2%
Canada	15	3,7%	3,1%	2,7%	2,6%	(0,5%)	7,6%
Japan	10	0,5%	0,4%	0,5%	0,5%	0,1%	(1,0%)
Switzerland	15	0,8%	0,1%	0,2%	0,0%	(0,1%)	1,5%
					Average main currency zones	**(0,3%)**	**4,4%**
Other currency zones							
Australia	10	3,7%	2,5%	2,5%	2,0%	(0,5%)	5,0%
Brazil	10	4,8%	3,1%	3,2%	3,4%	0,3%	(2,9%)
Czechia	10	1,9%	1,6%	0,8%	0,8%	(0,8%)	8,2%
India	10	7,5%	6,9%	6,3%	6,5%	(0,4%)	3,8%
Mexico	10	8,8%	6,9%	5,9%	5,8%	(1,1%)	10,9%
New Zealand	10	2,4%	1,8%	0,9%	0,9%	(0,9%)	9,3%
Norway	10	2,6%	2,3%	2,3%	1,5%	(0,8%)	8,2%
Poland	10		2,1%	1,3%	1,3%	(0,8%)	8,2%
South-Africa	10		9,6%	10,6%	11,1%	1,5%	(12,7%)
South-Korea	10	2,6%	2,3%	2,1%	2,1%	(0,2%)	2,0%
Sweden	10	1,7%	1,2%	0,9%	0,7%	(0,5%)	5,1%
Taiwan	10	1,0%	0,7%	0,5%	0,4%	(0,3%)	3,0%
Thailand	10	2,6%	1,5%	1,4%	1,5%	0,0%	0,0%
Turkey	10	16,0%	11,7%	12,7%	12,9%	1,2%	(10,1%)
					Average other currency zones	**(0,2%)**	**2,7%**
					Overall average	**(0,3%)**	**3,2%**

Inflation expectations slightly lower

The long-term inflation rate expectations decreased since yearend 2019. In the Eurozone, consumer price-based inflation has dropped -20bp, while the retail price index in the UK is down -10bp year-to-date.
A lower inflation rate generally decreases inflation-dependent liabilities. Although the actual impact will be subject to the definition of the benefit plans valued.

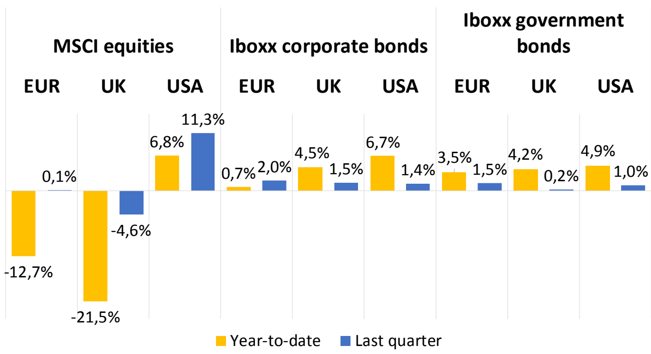
Based on a survey among professional forecasters, the European Central Bank has lowered in Q3-2020 its long-term inflation target by -10bp but remains significantly higher than the markets' implied inflation expectations.

	Selected duration[1]	Inflation rate 31-Dec-18	31-Dec-19	30-Jun-20	30-Sep-20	Year-to-date increase/ (decrease)
Eurozone CPI[2]	15	1,7%	1,4%	1,2%	1,2%	(0,2%)
UK RPI[2]	20	3,4%	3,2%	3,1%	3,1%	(0,1%)
ECB longterm target for Eurozone		*1,9%*	*1,7%*	*1,7%*	*1,6%*	*(0,1%)*

Bonds recovered in 2020, but not all equities.

For funded liabilities the situation can be different. The Covid-19 panic caused a large-scale sale of equities and bonds in Q1-2020. Since, markets have significantly recovered, with in Q3-2020 positive bond returns and strong equity performance in the US.

Equity and bond returns 31-Dec-2019 until 30-Sep-2020
(Year-to-date and Last month returns)



The year-to-date returns are significantly negative for equities in UK and Europe, while US equities and all bond indices show positive returns. This implies that funded liabilities could still be under additional pressure, compared to unfunded liabilities, if they are heavily weighted toward Eurozone or UK equities.

Looking ahead

The reaction of governments and central banks on Covid-19 seems to have steadied bond and equity markets around the world for now. We observe however that some countries are already experiencing a second peak in Covid-19 cases, while others are only now experiencing their first. This adds to other uncertainties, like the upcoming US election and ongoing Brexit negotiations, which may influence the market in Q4-2020. Also, in the longer-term, uncertainty remains about the evolution of the virus, the economic recovery and the impact of the large government budget deficits that have been created. Companies should therefore closely monitor the evolution of discount rates and asset returns over the next months.

Aon can help mitigate your companies' exposure to balance sheet liabilities, for instance by giving advice on discount rates and other assumptions, investigating the possibility to settle your companies' liabilities, or reviewing funding options. If you would like help on this feel free to contact your Aon consultant.

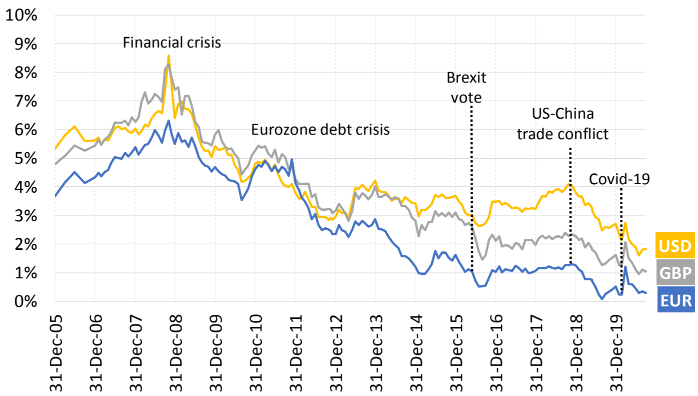
Background information

Employee benefit liabilities under IFRS and US GAAP accounting are calculated as the present value of your companies' future pension obligations, adjusted for any available assets in an external funding vehicle. This present value is based on a discount rate derived from the yields on high quality corporate bonds with durations similar to that of these obligations, or on government bond yields if the corporate bond yield market is not deep enough.

What balance sheet impact your company can expect from a change in discount rate, depends on several factors. Important are the regional spread of your company, the duration profile of the liabilities and the size of the discount rate change. Also, other financial and demographic assumptions and the return on any available assets impact the liability.

Over the last decade discount rates showed a steady drop in most major currency zones, mainly caused by central banks' measures to avoid a global recession. In 2019 discount rates had dropped on average 70bp due to the escalating trade conflict between the USA and China, interest rate cuts by central banks and the fear of a global economic slowdown or recession.

Discount rate evolution 31-Dec-2005 until 30-Sep-2020 (in %)
(Merrill Lynch Corporate AA bond yields for duration of 10 years)



Data sources

Discount rate and inflation rate

For the main currency zones a single equivalent rate was derived from the yield curve using cash flows representative for employee benefits in these markets. For the other currency zones, the rate was selected from the yield curve for a duration of 10 years. All rates were rounded to the nearest 10bp.

Main currency zones – Yield curve source for the discount rate	
USA	Aon US corporate AA bond universe curve (Aon d-Tool)
Eurozone	Aon Eurozone corporate AA curve (Aon d-Tool)
UK	Aon UK single agency corporate only AA curve (Aon d-Tool)
Canada	Aon Canadian new AA curve (Aon d-Tool)
Japan	Aon Japanese curve (Aon d-Tool)
Switzerland	Aon Swiss corporate AA bond curve (Aon d-Tool)

Other currency zones – Yield curve source for the discount rate	
Australia	G100 discount rate curve (milliman.com)
Brazil	Government bond rates (NTN-B, anbima.com.br)
Czechia	10y government bond yield (investing.com)
India	Zero coupon sovereign rupee yield curve (ccilindia.com)
Mexico	10y government bond yield (scotiabank.com.mx)
New Zealand	Risk-free discount rate for accounting valuation (treasury.govt.nz) (3)
Norway	Discount rate for corporate bonds (regnskapsstiftelsen.no) (3)
Poland	Government bond rates (bondspot.pl)
South-Africa	Nominal zero coupon bond yield curve (iress.com)
South-Korea	Corporate AA bond yields (kis-net.kr)
Sweden	Aon Swedish mortgage bond yield curve
Taiwan	Government bond index report (tpex.org)
Thailand	Zero coupon government bond yield curve (thaibma.or.th)
Turkey	Government bond rates (Bloomberg)

Main currency zones – Yield curve source for the inflation rate	
Eurozone	Aon Eurozone inflation swap curve (Aon d-Tool)
UK	Aon UK market implied break-even rate curve (Aon d-Tool)

Asset return

Equity returns are based on MSCI net index evolution data published on investing.com. Corporate bond returns are based on total return index level data for the iboxx investment grade corporate bonds as published on markit.com, and for government bond returns this is based on their investment grade sovereign and sub-sovereign bonds data. For USA, only the domestic bonds were considered. For UK, only non-gilts data was considered.

Notes

(1) Selected duration is based on the average observed duration of employee benefit liabilities in Aon's Global Survey of Retirement Plan Accounting Assumptions.

(2) CPI: consumer price index, RPI: retail price index.

(3) The discount rate for these countries is only published a few times per year. The most recent rate is reflected in this document.

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Aon International Retirement and Investment

The global retirement landscape is evolving at a rapid pace.
Combinations of legislative, political and economic change
pose both significant threats and create significant opportunities for DB and DC pension schemes. Setting and executing a successful global retirement strategy is therefore essential to managing potential risks; from effective benefits design and global mobility arrangements to the governance of financial and operational decision-making on a local, regional and multinational scale.

Aon's market-leading capabilities make us the perfect partner to help you through your unique multi-country pension challenges. Our international expertise across our broad portfolio enables us to provide integrated and comprehensive solutions, from the management of global retirement plans to the co-ordination of local retirement services. However large or small our clients' needs, we can help to empower results every step of the way.

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