

● EPISODE 4 · DISCOUNT RATES

IFRS 17 Explained

Discount Rates

Top-Down vs Bottom-Up Approaches

Illiquidity Premium & PSAK 117 Application — decoded for Indonesian insurers.

● IFRS 17

● PSAK 117

● OJK / IAI

● GMM / BBA

$$r = r_f + \text{illiquidity premium}$$
Bottom-Up: $r_f + IP$ Top-Down: $r_{\text{asset}} - \text{credit spread}$
$$PVFCF = \sum CF_t / (1 + r)^t$$

CSM accretion @ locked-in rate

IFRS 17 Para 36 · B72-B85

PSAK 117 · OJK · IAI

Why Discount Rates **Matter** Under IFRS 17

A fundamental departure from IFRS 4 — discounting is now mandatory for all long-term insurance cash flows.



PVFCF Measurement

Current discount rates determine the **present value of future cash flows**. Higher rates reduce reported liabilities; lower rates increase them — directly affecting balance sheet size. [Para 36](#)



CSM Accretion at Locked-In Rate

The Contractual Service Margin accretes interest at the **locked-in inception rate**, not the current market rate. This isolates P&L profit recognition from subsequent market rate movements. [Para B72](#)



P&L vs OCI Election

Insurers elect whether insurance finance income/expenses flow through **P&L or OCI**. This accounting policy choice has material consequences for reported earnings volatility and equity presentation.



Liability Sensitivity to Rate Changes

Rate methodology and **liquidity premium calibration** have material consequences for reported liabilities and equity. Decisions here are among the most impactful actuarial judgements under IFRS 17.

IFRS 17 Para 36: The Three Requirements

IFRS 17 · PARA 36

IFRS 17 PARA 36 / IASB 2017–2023

*"Discount rates shall include only **relevant factors** — i.e. factors that arise from the **time value of money**, the characteristics of the cash flows, and the **liquidity characteristics** of the insurance contracts."*

Para B78 · TRG AP2 (Sept 2018): top-down approach must eliminate credit risk and other non-relevant factors from asset yields



REQUIREMENT 1

Time Value & Liquidity

Rates must reflect the time value of money and the liquidity characteristics of the insurance liability — not the asset portfolio.



REQUIREMENT 2

Observable Market Prices

Consistent with current market prices for instruments with matching timing, currency, and liquidity characteristics.



REQUIREMENT 3

Exclude Credit Risk

Must exclude the effect of the insurer's own credit risk and any other factors that do not affect insurance contract cash flows.

 Key implication: the discount rate reflects the **liquidity of the insurance liability** • not the insurer's asset portfolio or its own creditworthiness

Two Approaches: Top-Down vs Bottom-Up

IFRS 17 Para B80–B81 — Both methods must converge to the same discount rate reflecting insurance contract liquidity

↓

TOP-DOWN APPROACH
Para B80 — Start from asset portfolio yield

👛

Reference Asset Portfolio Yield
Own asset portfolio (e.g. corporate bonds)

~ 5.5%

—

⚠️

Credit Risk Premium
Expected defaults + downgrade risk

~ 1.0%

—

📉

Other Non-Relevant Factors
Asset-specific risk not in liabilities

~ 0.5%

=

✓

Discount Rate

~ 4.0%

↑

BOTTOM-UP APPROACH
Para B81 — Start from liquid risk-free rate

🏛️

Liquid Risk-Free Yield Curve
Government bond yield (e.g. SBN/SUN)

~ 3.5%

+

🔒

Illiquidity Premium
Compensation for insurance contract illiquidity

~ 0.5%

=

ℹ️

Dominant method globally — aligned with Solvency II Volatility Adjustment. 58% of insurers use a higher rate than EIOPA.

=

✓

Discount Rate

~ 4.0%

⚡

Convergence Principle: Both approaches must arrive at the same rate →

~ 4.0%

DISCOUNT RATE

←

🌐

Market Practice

Bottom-up dominant — 42% use EIOPA rate; 58% use higher

s spread embedded in illiquid IG bonds relative
pite the rally

tween illiquid and liquid IG bonds with similar dura

premium (RHS) — High Liquidity — Low Liquidity



LIQUIDITY PREMIUM — IG BONDS

an Sachs Global Investment Research

IFRS 17 PARA B81 · PSAK 117

The Illiquidity Premium

Definition, Estimation Methods & Regulatory Cap



DEFINITION & ECONOMIC RATIONALE

Extra return investors demand for holding illiquid assets. Insurance liabilities are illiquid — policyholders cannot easily "sell" their policy, justifying an IP add-on to the risk-free rate.



ESTIMATION METHODS

Three common approaches: **CDS Negative Basis** — spread between CDS and bond yields; **Covered Bond Spreads**; and **Structural Models** (e.g., Bank of England model).



PRODUCT VARIATION — LIFE VS P&C

IP varies significantly by product: long-term life annuities **30–100 bps**, reflecting high illiquidity; short-tail P&C contracts carry an IP **near zero**.



PSAK 117 OJK CAP

OJK guidance limits the illiquidity premium to **±0.5%** of the risk-free rate for the bottom-up approach. Applies to Indonesia Government Securities (SBN) yield curve as the base.

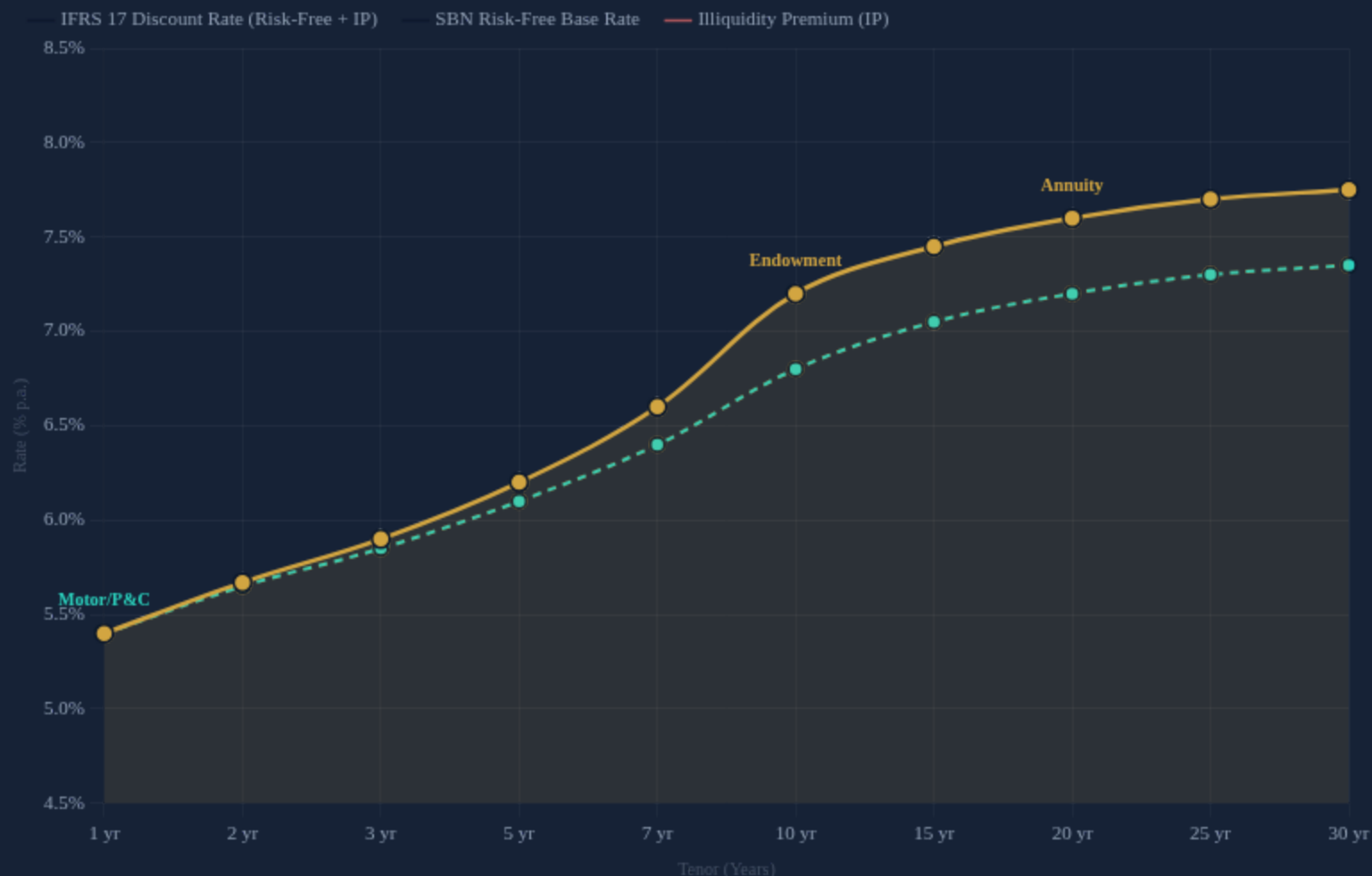
"Practical challenges include duration mismatches, currency mismatches, and liquidity premium estimation — all requiring careful actuarial judgment."

— SHASAT / WINKLER & KANSAL (2025)

Discount Rate Using a Yield Curve

DIFFERENT RATE FOR EVERY TENOR

ILLUSTRATIVE IFRS 17 DISCOUNT RATE YIELD CURVE — INDONESIA (SBN-BASED, BOTTOM-UP)



Illustrative only · Risk-free base: SBN yield curve (Bank Indonesia / DJPPR) · Illiquidity premium added per OJK guidance (max $\pm 0.5\%$) · Each liability cohort uses the rate matching its weighted-average tenor

WHY A CURVE, NOT A SINGLE RATE?

IFRS 17 Para 36 requires rates that reflect the **timing characteristics** of cash flows. A 1-year claim and a 30-year annuity have different time horizons — they must be discounted at **different rates** from the yield curve.

COHORT-MATCHED TENORS (PSAK 117)

OJK guidance requires the SBN yield curve to be applied as a **weighted average** matching the **tenor of each liability cohort**. Short-tail P&C cohorts use short-end rates; long-term life cohorts use long-end rates.

LOCKED-IN CURVE AT INCEPTION

The yield curve at the **date of initial recognition** is locked in for CSM accretion (Para 44(b)). Current curve is used for FCF measurement each period. The difference flows to **OCI** under Para 88.

PSAK 117 / OJK: Weighted-average SBN yield curve by cohort tenor $\pm$ illiquidity premium (max $\pm 0.5\%$). Not a single flat rate — each cohort gets its own point on the curve.

Cash Flow Discounting with a Yield Curve

EACH YEAR – ITS OWN RATE

PVFCF = PV(Outflows) – PV(Inflows) | Net CF = Outflow – Inflow | **Negative Net CF** = net inflow (premiums > outflows) | **Positive Net CF** = net outflow (outflows > premiums) | **Positive PVFCF** = net liability

Product: 5-Year Endowment Life (per policy)

Risk-Free: SBN Yield Curve + 0.40% IP

Maturity Benefit: Rp 1,000,000 at Year 5

YEAR (T)	INFLOW	OUTFLOW	NET CF (OUTFLOW – INFLOW)	SBN RATE	+IP	R _T	DF = 1/(1+R _T) ^T	PV OF NET CF
Year 1	300,000	150,000	-150,000	5.40%	+0.40%	5.80%	0.9452	-141,780
Year 2	300,000	150,000	-150,000	5.65%	+0.40%	6.05%	0.8893	-133,395
Year 3	300,000	150,000	-150,000	5.85%	+0.40%	6.25%	0.8319	-124,785
Year 4	300,000	150,000	-150,000	6.00%	+0.40%	6.40%	0.7773	-116,595
Year 5	300,000	1,150,000	+850,000	6.10%	+0.40%	6.50%	0.7299	+620,415
PVFCF = Σ PV(Net CF) Positive = Net Liability (Outflows > Inflows in PV terms)								+103,860

PVFCF (NET LIABILITY, RA = 0)

+Rp 103,860

PV(Outflows) > PV(Inflows) → Onerous Contract

▲ ONEROUS CONTRACT

PVFCF > 0 means PV of outflows exceeds PV of inflows. Assuming RA = 0, CSM = -103,860 → **negative** → **CSM = 0**. Loss of **Rp 103,860** recognised immediately in P&L at inception (Para 47–52).

🏗️ KEY PRINCIPLE

Each year's net CF is discounted at the **rate matching its own tenor**. Year 1 uses the 1-yr SBN rate (5.80%); Year 5 uses the 5-yr rate (6.50%). This is the yield curve applied per IFRS 17 Para 36.

🔒 LOCKED-IN AT INCEPTION

This curve is **locked in at initial recognition** for CSM accretion **Para 44(b)**. FCF is re-discounted at the current curve each period — the difference flows to **OCI** under Para 88.

OJK Guidance on Discount Rates

PSAK 117 (IFRS 17 Indonesia) — Actuarial Assumptions, Lampiran VI



DEFAULT METHOD

Bottom-Up with SBN Yield Curve

Start with the **Indonesia Government Securities (SBN/SUN) yield curve**, computed as a weighted average matching the **tenor of liability cohorts**. Add or subtract the illiquidity premium (max $\pm 0.5\%$) to arrive at the contract discount rate.



EXCEPTION

Top-Down for Distressed Insurers

Financially distressed insurers may apply the **top-down approach**, starting from the **monthly investment yield** of the actual asset portfolio. The illiquidity premium cap of **$\pm 0.5\%$** still applies under this exception.



ILLIQUIDITY PREMIUM

Cap: $\pm 0.5\%$ of Risk-Free Rate

OJK caps the illiquidity premium at **plus or minus 0.5%** for both bottom-up and top-down approaches. This reflects the liquidity characteristics of insurance contracts relative to the risk-free reference instruments used.



REPORTING MANDATE

Quarterly from Q1-2025

Quarterly financial statements under PSAK 117 are **mandatory from Q1-2025**, with the first submission due **15 May 2025**. Implementation governed by **POJK No. 22/2024** and **SEOJK No. 23/SEOJK.05/2024**.

| IFRS 17 PARA 88 — ACCOUNTING POLICY CHOICE

OCI Election: Managing P&L Volatility

Disaggregating insurance finance income/expenses between P&L and OCI



WITHOUT OCI ELECTION — ALL THROUGH P&L

Changes in **current discount rates** flow directly to P&L — creating significant earnings volatility as market rates move each reporting period.



WITH OCI ELECTION — SMOOTHER P&L

P&L reflects only finance income/expense at the **locked-in inception rate**. The difference between current rate and locked-in rate is absorbed by **OCI** (equity), not P&L.



Natural hedge with IFRS 9 — asset fair value changes also flow to OCI under IFRS 9, offsetting liability OCI movements. Must be applied consistently by portfolio group and cannot be changed retrospectively.

MARKET PRACTICE — MAJORITY OF GLOBAL INSURERS ELECT OCI TO REDUCE P&L VOLATILITY

Top-Down vs Bottom-Up: Decision Framework

OJK POJK NO. 22/2024



Key Takeaways & What's Next



TWO APPROACHES PERMITTED

Top-down (asset yield minus credit risk) and bottom-up (risk-free rate plus illiquidity premium) are both valid — each must reflect the liquidity characteristics of insurance contracts. — *IFRS 17 Para 36*



PSAK 117 DEFAULT: BOTTOM-UP

Indonesian insurers use the SBN (Government Securities) yield curve as the risk-free base, with an OJK-capped illiquidity premium of $\pm 0.5\%$. Top-down applies only for financially distressed insurers. — *OJK PSAK 117 Guidance*



IP VARIES BY PRODUCT TYPE

Life annuities & endowments: up to **0.5% IP** (OJK cap). Long-tail P&C (liability, workers' comp): small IP with LIC discounting. Short-tail P&C (motor, property): near-zero IP; PAA eligible. — *IFRS 17 Para B80–B81*



OCI ELECTION IS CRITICAL

Electing OCI for insurance finance income/expenses shields P&L from interest rate volatility. Most global insurers elect OCI — must be documented and applied consistently across portfolios. — *IFRS 17 Para 88 · POJK 22/2024*



COMING NEXT — EPISODE 5

The PAA (Premium Allocation Approach) — When Can You Use It and How Does It Work?

Simplified measurement for short-duration contracts · Eligibility criteria · PAA vs GMM trade-offs for Indonesian P&C insurers



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