Actuaries Institute.

25 July 2025

General Manager
Policy Development
Policy and Advice Division
Australian Prudential Regulation Authority

Email: policydevelopment@apra.gov.au

Dear Sir/Madam,

Consultation: Capital settings for longevity products

The Actuaries Institute (the 'Institute') welcomes the opportunity to respond to the Australian Prudential Regulation Authority ('APRA') Consultation Paper outlining proposals designed to improve the capital framework for annuity products ('Consultation Paper').

The Institute is the peak professional body for actuaries in Australia. Our members work in a wide range of fields including insurance, superannuation, investments and retirement incomes, banking, enterprise risk management, data science and AI, climate change impacts and government services. The Institute has a longstanding commitment to contribute to public policy discussions where our members have relevant expertise. The comments made in this submission are guided by the Institute's 'Public Policy Principles' that any policy measures or changes should promote public wellbeing, consider potential impacts on equity, be evidence-based and support effectively regulated systems.

The Institute believes that many Australians retirees could enjoy higher standards of living if lifetime income products such as annuities played a larger role in the retirement system. When considered among the mix of product solutions for funding retirement, annuities distinctly deliver a guaranteed income stream. We therefore see annuities as an effective option for retirees wanting to increase confidence and manage the risk of exhausting their own financial resources during retirement (longevity risk).

Australia's annuities market is currently small compared to the size of Australia's broader retirement income system and we share APRA's commitment to removing unnecessary obstacles that impede the development of more innovative and competitively priced longevity products. This will better support the Australian insurance market in being an attractive and internationally competitive location for investors to deploy capital, including the annuity market (consistent with the Australian Government's objective of expanding options for retirees to manage longevity risk).

We strongly support APRA's initiative to improve the current capital framework by adjusting capital requirements for these products through a redesigned, market-sensitive illiquidity premium and rewarding sound risk management practices. We believe this is an appropriate approach that protects policyholders' interests.

To inform the detailed design, we offer our suggestions for how APRA's proposals could be refined to align more closely with well-developed regimes and markets globally, in particular the balance between a prescriptive vs principles-based approach, the design and applicability of the illiquidity premium, and appropriate risk control settings. In addition, we see a further need for more holistic alignment and

greater integration between APRA's capital framework for life insurers (LAGIC[1]) and broader Government policy on retirement (e.g. announced targeted improvements to the existing innovative income stream regulations), including as they evolve.

We recommend:

- **Stronger alignment to comparable international jurisdictions regarding the level of illiquidity premium allowances, as well as the risk-sensitivity of these allowances**.

  We agree with APRA's observations in the Consultation Paper that LAGIC imposes relatively higher capital requirements for annuity products than other comparable jurisdictions. International developments since the introduction of LAGIC, for example the matching adjustment provisions under Solvency II and discount rates utilising supporting asset spreads for eligible liabilities under the International Association of Insurance Supervisors (IAIS) Insurance Capital Standard (ICS), have created a sizable gap between Australia and other comparable jurisdictions in this area, which continues to widen[2].

- **Specific benchmark/reference indices used to derive the illiquidity premium should be reflective of the portfolio characteristics of an individual insurer.**

  The benchmark/reference indices should be able to be constructed (with appropriate discretion given to the Appointed Actuary) based on its suitability, primarily having regard to:

  - being investable and providing a reasonable representation of the characteristics and expected spreads achievable by the underlying investment assets in the insurer's portfolio;
  - having an appropriate duration matching that of the insurer's liabilities; and
  - having an appropriate level of diversification.

  We believe allowing a level of discretion is important as it acknowledges the different stages of development that insurers may be in. The level of discretion permitted could be tied to the demonstration of a sufficient standard of capability and risk controls by the insurer.

  Regardless of whether the benchmark/reference indices are prescribed, we do not believe the benchmark/reference indices should be restricted to those with securities exclusively issued in Australia (which offer more limited opportunity to meet the above factors).

- **The risk adjustment deducted from the spread on the benchmark/reference index should reflect a prudent (but not overly conservative) allowance for losses from defaults and downgrades of assets over the term of the book of annuity business, and should be insensitive to short term market movements in the value of the spread.**

  On this basis, our view is supportive of APRA's proposal that the risk adjustment be expressed as a percentage of long-term spreads (rather than the other option of a factor applied to the prevailing spread). We believe this is critical, otherwise the resulting illiquidity premium will not be appropriately market sensitive and will retain a material portion of the pro-cyclicality under the existing LAGIC framework.

[1] Life and General Insurance Capital (LAGIC) is APRA's capital framework for life insurers and general insurers.
[2] E.g. Solvency II in the EU, and equivalent proposals in the UK creating 'Solvency UK'.

Appropriate consideration should be given to the distinction between illiquidity premium allowance in the capital base (LPS 112) and a stressed allowance to reflect the associated risks (LPS 114), consistent with other assumptions under the LAGIC framework.

- **The level of additional risk controls and governance (including any Appointed Actuary attestation requirements) should be commensurate with the level of risk not already reflected in the amount of capital held and proportionate when compared to key peer jurisdictions.**

  Other jurisdictions provide a reference point around the trade-off between risk controls and capital treatment. The Consultation Paper's potential changes include an illiquidity premium of 50% - 65% of A spreads, which is broadly comparable in quantum to both the Volatility Adjustment under Solvency II and the Standard Approach under the Bermudan capital regime. In both cases however, these approaches in their respective regimes entail moderate requirements in respect of risk guardrails, largely around liquidity management. In addition to these 'basic' approaches, both regimes also make available a more advanced, risk-sensitive approach with higher thresholds in respect of risk management, cashflow matching and reporting requirements and correspondingly lower resulting capital requirements.

  Our view is that the proposed risk controls in the Consultation Paper are broadly suitable for a risk adjustment that is expressed as a prescribed percentage of the long-term average spread based on an appropriate index that is reflective of an insurer's asset and liability portfolio, but too onerous if the risk adjustment is expressed as a percentage of current spreads. We consider the appropriate level of controls should ultimately be driven by the final formulation of the illiquidity premium.

  We recommend that when assessing the appropriateness of a proposal, APRA should consider the relativity to comparable jurisdictions across the capital requirements and risk controls of that proposal on a holistic basis.

- **The products where an illiquidity premium (and associated risk guardrails) applies in the valuation of the liabilities under LPS 112 should be determined via a principles-based assessment of illiquidity rather than applying to a specified list of products.**

  The majority of lifetime income streams sold in Australia are sold with a death benefit and consequently can be surrendered. Despite having a surrender benefit, these liabilities can often be considered illiquid due to the level of surrender penalties and other product features designed to comply with the Capital Access Schedule and that disincentivise early withdrawal. However, the current LAGIC framework is restrictive in terms of defining a narrow list of criteria a product must meet to qualify.

  We believe a principles-based approach is best suited for the current context and navigating future industry developments, especially in the context of innovation that is occurring in retirement income. This includes non-annuity insurance liabilities that are classified as being highly illiquid on similar principles (e.g. Disability Income Disabled Lives Reserves), noting that disabled lives reserves are considered illiquid by other capital regimes including ICS.

- **A strong step towards a principles-based philosophy, with a sound and functional basis**.

  We note APRA's comments in the Consultation Paper that the current small size of Australia's annuities market suggests that substantial changes to the current framework are not justified at this time. While we acknowledge the current size of the market is a factor, we do not believe it should be a major determinant of the resulting impact of the changes or approach in light of the need for growth in the market to support the Government's objective of expanding options for

retirees. Prudential settings can influence market capacity and scale to meet the funding needs for an ageing population and to accommodate any policy changes to encourage more Australians to manage their longevity risk.

We consider that a similar construct to more principles-based regimes in respect of the illiquidity premium, such as Solvency II (including in particular the Matching Adjustment), ICS (with its approach to assessing liability characteristics to determine the appropriate discount rate to value liabilities) and corresponding risk guardrails, represents an appropriate capital basis for lifetime income streams in Australia in the longer term, for which the changes currently being proposed are an important first step.

- **In time APRA should consider a range of other changes to the LAGIC framework for annuities to increase the availability of retirement products to retirees.**

  The current illiquidity premium represents one of several areas of the current standards that could be re-assessed to enhance the ability of insurers to develop retirement products and bring them to market, including adjustments to asset concentration levels in LPS 117 to enable insurers improved access to global reinsurance capability, allowing a principles-based assessment of insurance stress margins and asset correlation factors, and the termination value basis specific to annuities (refer to our response to Question 9 in the Attachment).

We set out in the Attachment our specific responses to the questions in the Consultation Paper.

The Institute may be contacted to discuss this submission. If you would like to do so, please contact the Institute via (02) 9239 6100 or public_policy@actuaries.asn.au.

Yours sincerely

(Signed) Elayne Grace
Chief Executive Officer

Attachment: Specific responses to Consultation Paper questions

1. Responses to Questions in Consultation Paper from 'Consultation Paper questions'

Area	Question	Response
Illiquidity Premium Proposals	1. APRA seeks general feedback on the approach as well as feedback on the questions outlined in Table A of [the Consultation] Paper.	1.The Institute's detailed responses to questions outlined in Table A of the Consultation Paper are set out in the table below.
Risk controls	2. What risk controls outlined in Table B [of the Consultation Paper] would you suggest as being appropriate, effective and practically achievable for industry?	2. We consider that APRA has identified the most appropriate and effective risk controls, on matching and confidence of the ability to earn the illiquidity premium. It is our view that the strength of the risk controls required to demonstrate the ability of the insurers to achieve the assumed illiquidity premium should be aligned to the risk sensitivity of the illiquidity premium, and to the level of discretion applied. Our assessment is that the APRA proposal contains risk controls more aligned to the Matching Adjustment without comparable risk sensitivity. Jurisdictions that have adopted a form of matching adjustment require strong risk controls to be in place for those companies that use the matching adjustment, with an alternative approach (such as the volatility adjustment under Solvency II) which has a less risk sensitive illiquidity premium than the matching adjustment, and correspondingly a lower level of risk control. For example, the level of controls associated with the use of a matching adjustment under Solvency II, including asset reporting and evidence of cashflow matching, would be appropriate only if the illiquidity premium adopted by APRA was similarly risk sensitive to the Solvency II approach. ICS adopts a similar approach, constructing discount rates utilising yields on permissible assets for liabilities with compatible characteristics, supportable by specified guardrails. This consistency is fundamental to APRA's aim of improving alignment with other jurisdictions. Consideration of numerical thresholds has not been performed for this submission, however they form an integral part of the framework and critically the degree to which cashflow matching and realisation of the expected investment return should be demonstrated must reflect overall capital levels and not be overly restrictive, if the illiquidity premium itself is not suitably risk sensitive. In this regard, we consider therefore that a range of risk controls may be appropriate depending on the overall level of risk sensitivity of the illiquidity premium. Demonstration of the 'hold-assets-to-maturity' ability of the insurer at a broader portfolio level can be considered through evidence related to expected cashflow matching in the Actuarial Valuation Report (AVR), connections to internal risk management and investment strategy policies in the FCR, and stress and scenario testing in the context of the Internal Capital Adequacy Assessment Process (ICAAP). Other jurisdictions provide reference points (e.g. the Accumulated Cashflow Shortfall test prescribed by Solvency II). The Institute welcomes APRA's proposal for an attestation from the Appointed Actuary (AA) in relation to risk controls. We believe governance and attestation requirements should clearly sit within the risk management framework already required by the current regulatory regime (including Financial Condition Report (FCR), AVR, ICAAP Statement & Report, Risk Appetite Statement (RAS) and Recovery and Exit Plan (REP)).

Area	Question	Response
		We consider that, in the context of governance processes more broadly, it is critical that investment decisions (and governance around these decisions, for example, in the form of an investment committee) give consideration to the ability of an insurer to earn the illiquidity premium on the asset side of the balance sheet.
	3. APRA seeks feedback on the questions outlined in Table B of [the Consultation] Paper.	3.The Institute's detailed responses to questions outlined in Table B of the Consultation Paper are set out in the table below.
	4. Are there other risk controls APRA should consider?	4. There are a range of other controls that could be used to confirm the suitability of the liability valuation basis, noting that the controls must be commensurate with the risk sensitivity of the final illiquidity premium. These proposals could potentially be used in place of APRA's proposals (in the event the illiquidity premium is insufficiently risk sensitive to warrant highly constrained controls) or in addition to APRA's proposals to ensure that the insurer has a range of analytic tools to perform ongoing monitoring of the assets and liability matching position: • Simplification of adjustments to reference benchmarks that reflect the specific details of an insurer's assets and liability profile. APRA would be required to confirm the suitability of the adjustment, and should be notified by the insurer if it was intended to change. • Portfolio level assessment of assets with fixed returns and intended to be held to maturity, and identification of assets where cashflows do not exhibit significant variability. • Expected liquidity of the asset portfolio, and the speed with which an insurer expects it can liquidate parts of the portfolio if required. • Asset concentration monitoring, across key concentration risk factors such as geography, counterparty, industry etc.
Impact	5. What impact will the change in illiquidity premium have on your entity's asset allocation and capital resilience (e.g. ICAAP)?	5. These are commercial matters for insurers hence the Institute cannot provide detailed comments. However, we consider that the move towards a more risk sensitive illiquidity premium should improve capital resilience for insurers in respect of annuity business and similar illiquid liabilities due to reduction of pro-cyclicality that under LAGIC could incentivise insurers to crystallise losses in a market downturn despite assets and liabilities being well matched.
	6. Having regard to the overall objective of the changes (as outlined in Chapter 1 [of the Consultation Paper]), which changes set out in Table A would have the greatest impact?	6. We would expect that the selection of the reference index and the calibration of the risk adjustment together will have the greatest impact on capital levels and capital sensitivity. However, the identification of required risk controls is likely to have the largest impact on insurers operationally.
	7. Taking into consideration the totality of change APRA is proposing and the likely responses of insurers to these changes, what change in annuity pricing do you view as reasonable to expect as a result? Given your answer	7. The Institute is not commenting on pricing in this submission (noting this is a commercial matter for insurers), however we consider that moves towards a more risk sensitive illiquidity premium, which brings Australia more into line with other jurisdictions, will contribute to a more dynamic industry with a greater capacity to develop innovative and effective risk solutions to support the Australian community.

Area	Question	Response
	to this, do you view it as worthwhile for APRA to make the proposed changes?	
	8. What potential unintended consequences might arise from the proposed changes?	8. Depending on further clarification of the outstanding questions, some potential unintended consequences arising from the proposed changes could include: • If the illiquidity premium is not based on deducting from a total spread a risk adjustment that is expressed as a prescribed percentage of the long-term average spread, then this could create a capital basis that is still pro-cyclical (as described in response to question 5 above). In Australia's relatively shallow markets for long dated instruments, this may cause stresses as the annuity market grows and several insurers react the same way. • In the case of a benchmark being prescribed, market crowding could be an unintended consequence, where multiple insurers pursue similar strategies to optimise the illiquidity premium, potentially inflating asset prices and compressing yields in specific segments. • In moving away from a 'one size fits all' approach, it is important that APRA set clear guardrails for insurers to ensure appropriate application of the updated requirements across the industry, and suitable consideration is given to the impact of an insurer transitioning between simple and more sophisticated illiquidity premium allowances. • The potential for increased reporting and governance requirements for insurers.
Scope	9. Beyond illiquidity premium, what other changes would you recommend to the LAGIC framework for annuities in future, so that APRA can support life insurers to increase the availability of retirement products to retirees? How would you prioritise these future changes?	**<u>Termination value basis</u>** *General Comments* In its Consultation Paper APRA has indicated that one of its objectives is "*improving alignment with comparable peer jurisdictions*". The APRA standards set a floor for the adjusted policy liability equal to the minimum termination value for that policy. Since the introduction of LAGIC, a number of jurisdictions in recent years have explicitly moved away from this treatment, towards a basis that allows for a more realistic assumption in respect of policyholder behaviour, coupled with an appropriate allowance for the risk of adverse lapse experience including: EU Directive 2015/35 dealing with Solvency II which in the preamble sets out the following principles: "*(11) In order to ensure that the analysis of the financial position of the insurance or reinsurance undertaking is not distorted, the technical provisions of a portfolio of insurance and reinsurance obligations may be negative. The calculation of technical provisions should not be subject to a floor of zero.* *(12) The transfer value of an insurance or reinsurance obligation may be lower than the surrender values of the underlying contracts. The calculation of technical provisions should not be subject to surrender value floors*." The Insurance Capital Standards (ICS) Level 1 and Level 2 texts published in December 2024 by the International Association of Insurance Supervisors (IAIS) set out under section 3.2.1.3 "Policyholder behaviour", that: "*The likelihood that policyholders will exercise contractual options, including lapses and surrenders, is taken into account with a prospective view, considering in particular: Past and expected behaviour of policyholders, considering*

Area	Question	Response
		also their reaction to management actions; How beneficial the exercise of options would be to policyholders under specific circumstances; and Economic conditions." To improve alignment with peer jurisdictions, we recommend that APRA should remove the termination value floor from the calculation of the adjusted policy liability. *Specifically related to annuities* If the termination value floor is retained, we recommend the special rules under LAGIC that apply only for policies that provide an annuity – including that the termination value of each such policy cannot be less than the Risk Free Best Estimate Liability of that policy (LPS 360 paragraph 10(d)) – be removed, so that annuities are treated like other life insurance products (in respect of the determination of the greater of the termination value and Risk Free Best Estimate Liability being performed at a portfolio level). **LPS 117 – Asset Concentration limits** Current asset concentration limits within LPS 117 are defined as a proportion of the total value of assets in the statutory fund (typically 25%). While under current annuity volumes these limits are not constraining these products, should volumes increase significantly it will quickly become unfeasible to reinsure those products and access the diversification benefits and investment management capability that several reinsurers can provide. We consider that adjustments to concentration limits, either via adjustments to LPS 117 or adjustments to permissible reinsurance structures (e.g. collateralised reinsurance) permit a more competitive market and remove significant barriers to entry. **LPS 115 – Principles-based longevity stress** LPS 115 currently prescribes a 20% longevity stress, rather than being principles-based like other claims stress margins. A principles-based assessment – similar to other insurance stress margins - permits a capital basis that is more reflective of the risks of an insurer. **LPS114 – correlations** 80% correlation in LPS 114 applying to asset classes that don't have any other classification, but historically have lower correlation – with such assets used by longevity providers to back liabilities. **Prioritisation** Each of the above changes could be implemented by calibrating the existing prudential standards; as such, all of the above potential changes to the LAGIC framework could be considered simultaneously as part of a subsequent round of review/changes. We note that some of the above changes would impact the LAGIC framework for products other than annuities.
Other issues: products with withdrawal/surrender risks	10. As outlined in Chapter 2 – Other issues [of the Consultation Paper], if the illiquidity premium were to apply to products with withdrawal/surrender risks, how would an insurer ensure that	The vast majority of lifetime income streams sold in Australia are sold with a death benefit, and consequently can be surrendered. However we consider that it is still appropriate that these products be considered illiquid since the value that is paid on surrender is (sometimes materially) lower than the policy liability. When considering the appropriateness of the illiquidity premium, the insurer would need to consider the circumstances, if any, where the policyholder could surrender their policy for a value in excess of the present value of future expected cashflows were

Area	Question	Response
	the illiquidity premium is appropriate and achievable under both normal and stressed circumstances?	the policy to remain in-force. This depends on the basis of the liability valuation in the capital position. Where there is an assessment that a material surrender risk exists, the product will likely not qualify for an illiquidity premium. Linked to the above, further clarification is also sought regarding the scope of products to which the illiquidity premium applies. Currently, this scope is limited to annuities, funeral bonds, fixed term/rate business, and other types of annuity products where the only insurance risks present are longevity and servicing expenses. It would be helpful to understand how the application of the illiquidity premium aligns with or extends to innovative retirement income stream products. Specifically, how the illiquidity premium framework accommodates the unique features or risk profiles of these newer product types.

2. Responses to Questions in Consultation Paper from 'Table A – posed changes to redesign the illiquidity premium'

Illiquidity premium formula component	Potential changes	Question	Response
Benchmark/ Reference	Broaden the universe of credit assets for determining the reference point/portfolio. Insurer can determine from appropriate index: externally rated, Australian, Investment Grade with tenors up to 10 years	11. How should an insurer select an appropriate reference point/portfolio given the criteria imposed by APRA?	11. An appropriate reference index should represent an asset mix appropriate for a portfolio of annuity liabilities, which we believe should have regard to the following primary factors: • Being investable and providing a reasonable representation of the characteristics and expected spreads achievable by the underlying investment assets in the insurer's portfolio. • Having appropriate cash-flow matching characteristics (including with regard to the duration of the insurer's liabilities). • Having an appropriate level of diversification, which should consider various dimensions (e.g. industry sector and geography). This reflects that the index should be able to be invested to ultimately earn the illiquidity premium on the assets over the duration of the annuity liabilities (for example, in the event of wind-up or run-off of the insurer). Since the quality and duration characteristics will vary by insurer depending on their risk appetite and the product features offered (for example, fixed term vs lifetime annuities), it is appropriate for the construction of the benchmark/reference index to allow discretion. We believe this construction should be left to the judgement of the Appointed Actuary (similar to other elements of judgement left to the Appointed Actuary under LAGIC). In the eventuality that APRA mandates a single reference benchmark index, at a minimum we believe simplified adjustments to the reference benchmark index should be permitted to cater for the unique characteristics of each portfolio to give a more appropriate matching basis (potentially subject to risk controls such as APRA approval after the insurer has received Appointed Actuary advice). Importantly we also note that (while desirable for a number of other reasons) we do not believe the benchmark/reference indices should be restricted to those that exclusively relate to securities issued in Australia. This reflects the limited choice and availability to meet required criteria if this is the case, compared to other markets (e.g. the US) with a wider range of indices (and underlying issuers, noting Australian indices typically have disproportionate weight on financials and government issuers) available that may better reflect the primary factors (noting that if the insurer then invests in for example a US index, the foreign exchange risk will need to be hedged). For example, the Bloomberg US Aggregate Credit Statistics (LUACSTAT) index, which had a modified duration of approximately 6.8 years at 31 May 2025 (compared to 3.2 years for the Bloomberg Australia Corporate Credit Index (BACR0)).

Illiquidity premium formula component	Potential changes	Question	Response
Factor applied to Spread	Increase from 33% to between 50% to 65% Or determine the illiquidity premium from current spreads less a risk adjustment that is expressed as a prescribed percentage of the long-term average spread	12. How should an insurer determine the appropriate risk adjustment to the spread given a reference benchmark/portfolio?	12. The risk adjustment deducted from the spread[3] on the benchmark/reference index used to determine the illiquidity premium should reflect a prudent (but not overly conservative) allowance for losses from defaults and downgrades of assets over the term of the book of annuity business, since this is what can cause a failure to meet policyholder payments. This reflects our view (supported by views in other comparable jurisdictions globally) that the risk adjustment should be representative of an assessment of the tail risk of credit deterioration/default in the asset portfolio, i.e. such that a very high probability remains of ultimately earning the illiquidity premium on the assets over the duration of the annuity liabilities. The long-term nature of annuity liabilities is highly relevant here, as this is the horizon over which such a probability should be analysed (consistent with the setting of best estimate actuarial assumptions related to other aspects like longevity, and their stressed treatment under LAGIC), also noting that the derived long-term default probability will then be expressed as an annualised default rate which can be considered in conjunction with the annual spread earnings. If the index is appropriately selected (as discussed in the response to Question 11 above), we would expect that the asset mix of the insurer would be broadly comparable with this reference index, consequently the risk adjustment should also be a reasonable indication of the risk within the insurer's asset pool, which is a desirable result. This reflects that, if adjusted policy liabilities are calculated by reference to an appropriate index, it follows that the risk adjustment should reflect as closely as possible the risk within that specific index, over the lifetime of the corresponding liabilities. For insurers taking a simplified approach (i.e. who choose not to adopt the proposed changes), we consider APRA's proposal to retain the existing allowance is appropriate. Appropriate consideration should be given to the distinction between a 'base' illiquidity premium allowance in the capital base (LPS 112) and a stressed allowance to reflect the associated risks (LPS 114), consistent with other assumptions under the LAGIC framework. We also note for completeness that 'risk adjustment' is a defined term within accounting standard *AASB 17 Insurance Contracts* hence to avoid confusion it may be preferable to use a different term (such as 'risk allowance', 'loss allowance' or 'default loss allowance').

[3] Deducted from the total spread over risk free rates to determine the illiquidity premium. The Consultation Paper proposes an illiquidity premium factor of between 50% and 65% of the prevailing spread, which is equivalent to a risk adjustment of between 35% and 50% of the prevailing spread.

Illiquidity premium formula component	Potential changes	Question	Response
		13. Should the risk adjustment be expressed as a prescribed percentage of the long-term average spread, with the illiquidity premium equal to the benchmark spread less the risk adjustment?	13. The risk adjustment should be expressed as a proportion of the long-term average spread, with the illiquidity premium equal to the prevailing benchmark spread less the risk adjustment. Historical analysis of credit spread movements over a range of time periods demonstrate that periods of substantial spikes in spreads (associated with economic events or shocks) are typically short-lived in the context of the duration of annuity liabilities, indicating that prevailing spreads are an unreliable proxy for estimations (even on a prudent basis) of long-term future losses from asset defaults and downgrades at that point in time. Rather, long-term average spreads (i.e. spreads averaged over a longer period, commensurate with the duration of the underlying liabilities) are a more appropriate proxy, noting that these spreads should also be consistent with the inherent risk of the underlying benchmark/reference index. We note that: • The Standard and Poor's (S&P) Annual Global Corporate Default and Rating Transition Study for 2024 report illustrates cumulative defaults over a 15 year time horizon for investment-grade debt (which will likely make up the majority of a reference index) with a dataset commencing in 1981, and shows average cumulative defaults of 2.38% and maximum cumulative defaults of 4.99%, equivalent to annualised default rates of 0.16% and 0.34% respectively. While the specific reference index chosen will unavoidably differ from the S&P data, this is a useful datapoint. • While spread levels for an index can contain indications of expected future credit losses within that index, the majority of instances in the past where spread levels have been particularly volatile have been driven by reduced liquidity rather than deterioration in the long-term outlook for default losses. Given APRA's expressed aim of improving alignment with other jurisdictions, we note on this topic: • In its 2022 paper *Solvency II Review: Matching Adjustment and reforms to the Fundamental Spread* the UK Prudential Regulation Authority (PRA) specifically notes that while credit spreads "contain useful information as to future risk signals … when credit spreads are unusually high or low then the extent to which they contain useful information on future risk signals becomes more limited." • In its November 2022 response to the consultation around the (post-Brexit) Review of Solvency II, the UK Government indicated that "Solvency UK will not include current spreads in the fundamental spread. The Government will instead legislate as necessary to maintain the existing methodology, which only relates to spreads over long time periods.

Illiquidity premium formula component	Potential changes	Question	Response
			The Government agrees that the incorporation of current spreads into the calculation of the fundamental spread would have significant negative impacts". On this basis, our view is supportive of APRA's proposal that the risk adjustment be expressed as a percentage of long-term spreads and should therefore not be materially sensitive to movements in prevailing spreads, otherwise the resulting illiquidity premium will not be appropriately market sensitive. We believe this is critical. A risk adjustment that is proportional to prevailing spreads means pro-cyclical outcomes can arise, where insurers can be forced to sell assets during times of market stresses, crystallising losses on asset values at the 'bottom of the market', due to the mismatch that arises between the **valuation** of assets and annuity liabilities in such circumstances.
Long-term Rate Implementation	Increase from 10 years to between 10 and 20 years	14. Given the profile of its assets, how should an insurer determine an appropriate cut-off point for the illiquidity premium reverting to the long-term rate?	14. The cut-off to apply a long-term rate for the illiquidity premium should be market-based and ultimately tie in with the underlying reference index selected. At this stage, a maximum of 20 years would be appropriate given the (current) lack of available assets beyond this point. This would also be consistent with the approach to cut-off points used in overseas jurisdictions.
		15. Could an insurer match cashflows to the cut-off point?	15. This is considered as part of discussion around Questions 19-21 and 23-24.
		16. Should the increase be applied to the spot rate instead of the forward rate?	16. We believe the increase should be applied to the forward rates (as it is applied currently under LPS112).
Long-term (Ultimate) Rate	Increase of from 20 bp to between 30 bp to 45 bp	17. How should an insurer determine an appropriate long-term illiquidity premium that is able to be earned under stressed conditions given reinvestment risk?	17. Consistent with the answer to Question 12 above, the long term (ultimate) illiquidity premium should reflect a life insurer's ability to earn such a spread over an appropriate period of time (commensurate with the liabilities). Stressed conditions and risks (including reinvestment risk) should be in the context of such a time period. Any long-term (ultimate) rate should be data-based and utilise long-term historical data (both related to Australia and other jurisdictions), wherever possible. For example, consideration of the levels of prevailing spreads observed historically – their minimum, standard deviation, percentiles and other statistical aspects. This may indicate that a long-term (ultimate) rate higher than 45bps could be appropriate, even on a prudent basis. While it would be appropriate for the long-term (ultimate) rate to be prudent, our view is it shouldn't be overly conservative.

Illiquidity premium formula component	Potential changes	Question	Response
			We reiterate our point above that consideration should be given to the distinction between a 'base' illiquidity premium allowance in the capital base (LPS 112) and a stressed allowance to reflect the associated risks (LPS 114) – including reinvestment risk – consistent with other assumptions under the LAGIC framework.
Cap	Increase from 150 bp to between 300 bp to 350 bp	18. How should an insurer ensure that the illiquidity premium formula remains appropriate in extremely stressed circumstances?	18. The cap should be considered in the context of the comments noted in response to Question 13 above around market-insensitivity and pro-cyclicality of illiquidity premia, as a fixed level of cap may have similar effects during periods of extreme stress; i.e. the presence of a fixed-level cap (even at 350bps) may incentivise life insurers during such periods to shift toward safer, more liquid assets, reducing exposure to credit and creating reinvestment risk even if the period during which the stressed market conditions is short in the context of the corresponding annuity liabilities. As noted in the response to Question 11, ultimately the illiquidity premium allowance should relate to the level of confidence of the value of defaults within the asset pool over a suitable duration (given this is a major determinant of yield ultimately expected to be earned on the assets). Similar to the response to Question 17, the cap should be data-based and utilise long-term historical data (both related to Australia and other jurisdictions), wherever possible. For example, consideration of the levels of prevailing spreads observed historically, and how persistence some of these were over time. We note that some relevant historical periods of stresses to reference could include: • March 2020 (COVID) • 2008/2009 (Global Financial Crisis) which indicate that heightened spreads during these stressed market conditions were not explained by ultimately higher observed defaults in the longer term. Back-testing the outcomes on insurers (including their capital position, and any volatility in this as a result of the cap 'not biting', then 'biting', and then no longer 'biting' again) can inform this.

3. Responses to Questions in Consultation Paper from 'Table B – Proposed risk controls'

Area	Risk Control	Question	Response
Actuarial	Appointed Actuary attestation: • Liabilities are cashflow matched with hold-to-maturity assets within an acceptable level of risk over the period that the illiquidity premium is applied • Insurer can meet benefit payments as they fall due without resorting to selling assets in both a normal and stressed period • Insurer will attain spread above risk free rate with a high level of confidence	19. How should an insurer define cashflow matching within an acceptable level of risk?	**General comments** We consider it an important aspect of the proposed framework that the AA is required to attest to key aspects of the financial management of an insurer to justify the valuation of liabilities in its portfolio. There are several risk management strategies may be employed in addition to cashflow matching: • Appropriate liquidity management, combined with a detailed understanding of liability profiles and risk assessments of liquidity characteristics of key asset classes and markets, may provide a suitable risk mitigant against a requirement of testing that shows that surrender penalties are sufficient to cover any losses realised through sales of assets in a stressed period. • A primary reliance on debt-related investments with highly predictable and non-bespoke/optional cash flow characteristics. • Asset concentration, so that while a portfolio may exhibit favourable cashflow characteristics it is not over-exposed to any individual market sectors or segments. • A robust portfolio construction and investment governance framework that demonstrates strong capability in assessing and managing the trade-offs between generating investment returns, asset-liability mismatches, diversification, credit quality, cash flow predictability and liquidity, and overall capital requirements. • Continual assessment of the credit quality of the asset portfolio. **Specific responses** 19. An acceptable level of risk with relation to cashflow matching must be considered within the context of overall regulatory capital requirements. Mis-matched cashflows are a single risk within an overall framework. In the event that the illiquidity premium is materially less than the expected yield on the portfolio of supporting assets, the level of cashflow matching required to manage the risk of not earning the illiquidity premium should be comparatively less. Solvency II firms that utilise a matching adjustment for the purpose of valuing liabilities are able to hold imperfectly matched assets as a part of the matching portfolio provided that the payments from the assets are contractually bounded and the imperfectly matched assets comprise a restricted component of the portfolio. Potential frameworks that might be used include: • Demonstration that asset cashflows are suitably predictable at a portfolio level. • Specifying a proportion of assets supporting liabilities are from classes that will be held to maturity.

Area	Risk Control	Question	Response
			• Explicit cashflow modelling, in a comparable form to the Accumulated Cashflow Shortfall test prescribed by Solvency II Consideration of numerical thresholds has not been performed for this submission, however they form an integral part of the framework and critically the degree to which the matching should be demonstrated must reflect overall capital levels. The calibration of the acceptable level of risk relating to cash flow matching should be considered as part of an insurer's RAS and reflective of the broader risk management framework approved by the Board with advice from the AA.
		20. How should an insurer define a stressed scenario?	20. Currently life insurers test stressed scenarios as a part of capital testing and the resilience of capital to those stresses is typically discussed in an insurer's ICAAP. We would support insurers conducting "reverse stress testing" as a part of this initiative, to understand under what conditions would an insurer be required to sell assets at a price that may adversely affect the capital position of the insurer. This should include an increase in spreads on debt assets, combined with increased numbers of surrenders. This aligns to the point about guardrails above whereby an insurer may sell assets to provide required liquidity, but it is possible to manage asset exposures such that there are assets that are historically shown to be more easily liquidated in dislocated markets.
		21. How should an insurer determine that it will attain the spread above risk free rate with a high level of confidence?	21. A framework to measure the likelihood of achieving the illiquidity premium needs to consider the following factors: • The degree to which the cashflows within the supporting assets are fixed and are known with a high degree of confidence. • For assets where cashflows are not fixed, the degree to which the potential variation in cashflows might impact the overall ability of the insurer to achieve the yield assumed in the valuation of liabilities. • Given the above, an assessment of the residual risks faced by the insurer in achieving the yield, with the most material being the risk of default from counterparties within the asset portfolio (and concentrations of exposure across all the relevant dimensions) and the risk of materially lower yields being available upon maturity of assets and required re-investment. The most subjective component of such a framework is the assessment of the residual risks, in particular the risk of default, which may be assessed using a rating framework or internal default assessment model incorporating actual experience where appropriate. It should be noted that the AA attestation should consider the likelihood of a certain strategy achieving the illiquidity premium with a high probability based on an assessment using a framework such as set out above, the AA cannot attest that the insurer will attain the spread with certainty.
Governance	Insurer demonstrates compatibility between its governance processes and the	22. How should an insurer demonstrate compatibility between its governance	22. For an insurer to adopt the revised illiquidity premium, the overarching requirement is that the insurer can over the life of the liabilities, earn the illiquidity premium on the asset portfolio backing

Area	Risk Control	Question	Response
	adoption of the revised illiquidity premium.	processes and adoption of the revised illiquidity premium?	policy liabilities, with a very high degree of confidence. Other governance considerations are important in so far as they contribute to achieving that level of confidence. Within this framework: • Investment decisions at a point in time should be considered in the context of earning the (current) illiquidity premium. • An insurer should have an appropriately constituted Asset Liability Management (ALM) committee that receives and considers reporting in relation to performance of the asset portfolio against the illiquidity premium. • The ALM committee should also monitor the level of cashflow matching between assets and liabilities at portfolio level, with oversight on the level of matching achieved by assets with highly predictable cash flows vs other assets. • Emerging credit performance should be monitored to ensure the risk adjustment assumption remains appropriate. • insurers should already have a process in place to monitor surrender and longevity experience and consider the ongoing appropriateness of the best estimate basis, however this process increases in importance with the changes in illiquidity premium.
APRA Reporting	Additional reporting to APRA related to the illiquidity premium, for example: • Evidence of cashflow matching with hold-to-maturity assets including under stressed scenarios • Assets supporting annuities must be separately identified	23. How should an insurer evidence cashflow matching with hold-to-maturity assets to APRA? 24. In what level of detail should assets supporting annuities be reported to APRA?	23. The annual AVR submission can be utilised to support the application of the proposed illiquidity premium. This justification may include evidence related to expected cashflow matching, connections to internal risk management and investment strategy policies that demonstrate the level of hold-to-maturity applied. Additionally, stress testing can also be integrated into the ICAAP stress and scenario testing to ensure appropriateness of the illiquidity premium and the assets backing the liabilities under a stressed environment. As currently required under Actuaries Institute Professional Standard PS 102 the FCR will then include a summary of the methodology applied to calculate the liability for annuity business, and the risk associated with this methodology, including the illiquidity premium. 24. The level of asset data for regular APRA reporting should be proportional to the level of discretion applied in determining the illiquidity premium. Given the formula approach is reliant on risk controls and cashflow matching, evidence of these may be more appropriate than additional asset information.

Area	Risk Control	Question	Response
Capital Asset Restrictions	Restrictions on assets backing annuity liabilities and capital requirements.	25. How should an insurer determine an appropriate asset mix to achieve both matching and the required yield without material changes to risk?	25. Insurers face a trade-off between generating the required yield, cash flow matching, managing investment risk and overall capital requirements. The balance between these and the level of risk an insurer can take with respect to any of these factors should be considered in the insurer's RAS and broader risk management framework, and the process for selection and monitoring of the asset mix should take place in this context. Assets should be invested in a manner that generates cashflows to closely match the corresponding liabilities, with a low level of default risk, which will require a high proportion of investment grade debt, of an appropriate tenor. However within the construct it is also critical that the assets are appropriately diversified, for example, across industry sectors. Given the limitations of the Australian bond market we consider this will require a significant allocation to overseas markets with deeper and longer duration bond markets; with appropriate hedging of the currency mismatch.
		26. How should an insurer consider asset valuation, default and reinvestment risk in assessing illiquidity premium parameters?	26. For the insurer to be able to meet payments as they fall due, the insurer's asset portfolio needs to earn the illiquidity premium over the life of the liabilities, with a high level of confidence. Hence the degree to which cashflows generated by the asset portfolio are known with a high degree of confidence (e.g. interest and principal payments made on high quality senior debt instruments) and probability of default are the key risks, since these are the key factors which impact payments to policyholders. In the theoretical situation where liability cashflows are matched perfectly with highly predictable yields generated from the asset portfolio, there is no requirement for reinvestment or sale of assets, hence asset valuation and reinvestment risks are largely mitigated. However in practice the importance of asset valuation and reinvestment risk will be a function of the level of cashflow matching and the quality of the cash flows generated by the assets backing the liabilities. The significance of reinvestment risk is also dependent on an insurer's duration profile. The insurer's RAS, risk management framework, and investment governance processes should consider the appetite and limits around these risks and a greater degree of scrutiny applied to assets with greater variability in cashflows or subject to higher default risk. We note however that if the reference index is not appropriately sensitive to market movements, asset valuation risk becomes very important since assets and liabilities will not move in sync in times of stress (in worst case leading to technical insolvency). We also note that we view it as appropriate that assessment of the illiquidity premium under LPS 112 reflect a 'best estimate' basis with stress tests applied to risks including valuation and default considered as part of the requirements of LPS114.