CALI Council of Australian Life Insurers

[redacted]
General Manager Policy
Australian Prudential Regulation Authority

By email: PolicyDevelopment@apra.gov.au

25 July 2025

Dear [redacted],

Proposed changes to capital framework for annuity products

The Council of Australian Life Insurers (CALI) is the trusted voice of life insurance in Australia. We support Australians to make informed choices about their future and advocate for national policy settings that expand their access to the life insurance protection that suits them when they need it most over their lifetime.

The need to boost retirement-phase outcomes for Australians was noted in the Federal Government's response to the 2023-24 'Superannuation in retirement' consultation which called for better retirement products through 'targeted improvements to the existing innovative income stream regulations'[1].

CALI is supportive of the Australian Prudential Regulation Authority's (APRA's) consultation proposing changes to the capital framework for annuity products as we note the current capital requirements to be one of the limiting factors to the development of a vibrant and diverse market for longevity products.

CALI notes that the proposals put forward by APRA are an important first step to competition enabling capital settings for annuities, whilst maintaining risk standards. CALI encourages APRA to implement capital settings that align to international jurisdictions, notably the United Kingdom and the European Union.

The major benefit of the proposed changes (and future changes) is that over time more participants will be attracted to the annuity market, which will improve market dynamics in this critical sector as Australia deals with the challenges of an ageing population, and improve pricing to customers. Other benefits include:

- The proposed changes will benefit insurers through a higher illiquidity premium that will reduce capital requirements and allow liabilities to be better matched to underlying assets.
- This could therefore encourage insurers to take a more expansive investment approach to benefit in the pricing of any potential new annuity products but may also provide a further competitive advantage to those who are already more sophisticated in this area.

[1] Improving the retirement phase of superannuation

- Better pricing and a more competitive market for retirement income streams will support better retirement outcomes from superannuation for members

CALI's response to the consultation questions are presented in the Annexure, we note several key recommendations:

- **A principles-based approach:** CALI strongly supports a principle-based approach which will allow for differentiated action based on experience and sophistication of the life insurer.
- **The illiquidity premium:**
    - In line with the LAGIC framework for many other risks faced by life insurance companies, the illiquidity premium should be assessed by the Appointed Actuary using a principle-based approach that reflects the underlying risks. A more prescribed approach could be used for life insurers with less robust risk management processes.
    - If all the proposed risk controls are implemented, there will be smaller and more limited changes to the illiquidity premium. Insurers with proven capability and prudent risk controls should be afforded greater discretion in setting the illiquidity premium.
- **Broadening of permitted asset class:** The Australian corporate debt universe is relatively narrow, with a duration that is materially shorter than the duration of a typical lifetime annuity portfolio and can become illiquid in times of stress and therefore not move in an appropriate way. The assessment of the illiquidity premium should not be restricted to Australian assets only.
- **Broadening the scope of products:** The eligibility criteria of LPS 112 should be increased to allow annuity products to be able to use an illiquidity premium if there are product features/charges designed to ensure the long term and illiquid nature of the product.
- **Minimising model redevelopment:** Mechanically from a life insurer perspective, the proposed changes should be relatively uncomplicated to implement in the capital calculation and should not require significant model development.

CALI would welcome a discussion with the APRA policy team to discuss this submission. Please reach out to [redacted] ([redacted]) copy to [redacted] ([redacted]).

Kind regards,

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[redacted]
Chief Executive Officer
Council of Australian Life Insurers

CALI Council of Australian Life Insurers

Annexure – Response to consultation questions

Section 1: Table A – Proposed changes to redesign the illiquidity premium

Illiquidity premium formula components	Current	Potential changes	APRA Questions	Member comments
Factor applied to Spread	33%	Increase Factor applied to Spread 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	(A) How should an insurer determine the appropriate risk adjustment to the spread given a reference benchmark/portfolio? (B) Should the risk adjustment be expressed as a prescribed percentage of the long-term average spread, with the illiquidity premium equal to	**In respect to Q(A):** CALI recommends a principle-based approach where the overarching principle is that the capital requirement should reflect the risk. As industry practices will continue to evolve a principle-based approach will be more relevant than a prescribed approach which will become outdated when specified in a standard or not reflect the relative sophistication and practices of individual Life Insurers. The spread should be adjusted to reflect the certainty of payments required to match insurance liabilities. For any given index the risk adjustment should reflect an allowance for default losses within that index at the 99.5% level, annualised over the payment term of the liabilities. **In respect to Q(B):** The most suitable risk adjustment would be to subtract an allowance for prudent default losses from 100% of the current benchmark spread. This allowance needs to consider defaults over the payment term of the liabilities, noting that investment grade debt will in many cases be downgraded before default. A possible source of

Illiquidity premium formula components	Current	Potential changes	APRA Questions	Member comments
			the benchmark spread less the risk adjustment?	information here is the default data produced by Standard and Poor's (S&P) on a 'static pool' basis. For consistency with the broader capital standard framework, this allowance should be set at a prudent level and should avoid any double counting of default risks included in the Prescribed Capital Amount (LPS114 and LPS112). The alternative of expressing the illiquidity premium as a (higher) factor percentage of current spreads will increase the average illiquidity premium but it retains the procyclical approach which means excess capital is required for market cycles, that are unrelated to the insurance liabilities. Another possible alternative is to set the illiquidity premium at a high proportion of the current spread (for example 95%) less a conservative allowance for long term defaults, which would mean that in periods of significant stress there would be a modest increase in the risk adjustment.
Benchmark/ Reference	A spread on 3-year bond	Broaden the universe of credit assets for determining the reference point/portfolio. Insurer can determine from appropriate index: externally rated, Australian, Investment Grade	(C) How should an insurer select an appropriate reference point/portfolio given the criteria imposed by APRA?	**In respect to Q(C):** The reference portfolio should aim to match cashflows, where possible, otherwise key rate duration buckets. The reference portfolio should be based on published, investment grade indices and derivatives and be broad as possible (including explicitly stating that they can be broader than the Australian market) such that concentrations of exposures including by industry sector and geographic region are within risk appetite and should also reflect the tenor of the insurer's liabilities.

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Illiquidity premium formula components	Current	Potential changes	APRA Questions	Member comments
		with tenors up to 10 years		Given the more restricted nature of the Australian market, a global benchmark would be more suitable (hedged appropriately to $AUD). Reference indices may include traded instruments such as interest rate and inflation derivatives that support the matching objectives. A weighted average of benchmarks may be appropriate to achieve the target outcome. If longer term liability cashflows extend beyond the term of available indices, then the Appointed Actuary should consider the demonstrated ability of the company to achieve an illiquidity premium in the longer term. Constraints beyond the requirements for Investment Grade should be avoided to prevent including arbitrary requirements that are unrelated to cashflows and duration matching.
Long-term Rate Implementation	10 years	Increase long-term rate implementation from 10 years to between 10 and 20 years	(D) 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?	**In respect to Q(D):** Any cut-off, if required, should be determined by the extent of mismatch between asset and liability cashflows, so capturing the risk that reinvestment of cashflows from maturing assets will be at low spreads. There is no justification for a cut-off if cashflows are sufficiently closely matched. The cut-off point could be the tenor to which the insurer is able to match cashflows to the standard implied by the risk control, the Appointed Actuary attestation, or perhaps the longer of that tenor and the tenor of the reference index.

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Illiquidity premium formula components	Current	Potential changes	APRA Questions	Member comments
			(E) Could an insurer match cashflows to the cut-off point? (F) Should the increase be applied to the spot rate instead of the forward rate?	However, in keeping with the principle-based approach such rules will introduce arbitrary constraints that assumes a one-size-capability across the industry. Instead, APRA could consider these rules as a minimum standard to which life insurers with limited experience would adhere. Where life insurers can demonstrate extensive experience with strong processes and controls under different markets and can achieve an appropriate spread, the appropriate term is to be determined by the Appointed Actuary. **In respect to Q(E):** Yes, and beyond generally which supports including overseas market and traded long term derivatives. **In respect to Q(F):** The increase should be applied to the forward rate.
Long-term (Ultimate) Rate	20 bp	Increase of long-term illiquidity premium from 20 bp to between 30 bp to 45 bp	(G) How should an insurer determine an appropriate long-term illiquidity premium that is able to be earned under stressed conditions given	**In respect to Q(G):** It is appropriate to increase the long-term rate. When cashflows are closely matched, deducting an annualised allowance for the 'worst-case' default level from the current spread is an appropriate way to determine the illiquidity premium throughout the future life of the portfolio, including under stressed conditions. Provision would be required in the capital scenarios to ensure that defaults are not double counted under stress scenarios.

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Illiquidity premium formula components	Current	Potential changes	APRA Questions		Member comments
				reinvestment risk?	
Cap	150 bp	Increase cap from 150 bp to between 300 bp to 350 bp	(H)	How should an insurer ensure that the illiquidity premium formula remains appropriate in extremely stressed circumstances?	**In respect to Q(H):** By using a risk adjustment based on long-term spreads rather than current spreads, the illiquidity premium will react appropriately in stressed circumstances in the context of a cashflow matched portfolio. However, we understand APRA is concerned about the risk that this increased illiquidity premium will not be earned over the lifetime of the liabilities. We consider that, in a well-matched portfolio, the critical risk is around asset default and that periods of extreme market volatility in the past have been driven in most cases by reductions in market liquidity rather than concerns about the long-term credit outlook. The key mechanism by which an insurer can remain confident of earning the illiquidity premium through time (including in extremely stressed circumstances), is through minimising default risk by holding a diversified asset pool, and active management of credit risk. A cap should not be required as it is an arbitrary requirement that is unrelated to the matching principle. Alternatively, APRA could consider a 'pressure-release' for circumstances where due to the arbitrary settings of the cap, the cap will apply, and a Life Insurer may be forced to sell assets at an inappropriate time.

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Section 2: Table B – Proposed changes to redesign the illiquidity premium

Risk Control	Questions	Member comments
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	(A) How should an insurer define cashflow matching within an acceptable level of risk? (B) How should an insurer define a stressed scenario? (C) How should an insurer determine that it will attain the spread above risk free rate with a high level of confidence?	**In respect to Q(A):** Cashflows need to be matched to expected liabilities where possible, else matching key rate duration. Given the inherent uncertainty around lifetime payments, some mismatch must remain. Maintaining an acceptable level of risk for this is already an ICAAP requirement. We note the response to Q(C) below as an important detailed supplement to this response. **In respect to Q(B):** The stressed scenario needs to contemplate an increase in default rates and consider the extent of mismatch between assets and liabilities and should be embedded into the broader ICAAP and resilience testing program. Provision would be required in the capital scenarios to ensure that defaults are not double counted under stress scenarios. **In respect to Q(C)**: Earning the illiquidity premium can be compromised through defaults, which are monitored through the credit function, and the related areas of forced sales and reinvestments, both of which are monitored through cashflow matching. In addition to the above, the proposed Appointed Actuary attestations may require some refinement. As currently drafted, they may pose several practical challenges, for example: - Cashflow matching may not always be a realistic expectation, especially at longer tenors, even though assets may exist (e.g.

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Risk Control	Questions	Member comments
		because of frictional costs, liquidity and parcel size of assets). Greater latitude is required to allow matching via duration buckets rather than full cashflow matching. - CALI queries whether the "without resorting to selling assets in … stressed period" attestation condition is appropriate. This could impose too tight a constraint as it would seem to imply that an insurer must be able to meet all benefit payments from cashflow in the stressed scenario. This aspect should focus instead on whether an insurer would be forced to sell illiquid assets. If an insurer is purposely holding an allocation to more liquid assets as a safeguard against potentially elevated outflow in a stressed period, this should be regarded as an appropriate and prudent approach which ought to facilitate a positive Appointed Actuary attestation (rather than prevent it). - Further, the Appointed Actuary could state the basis of their assessment of what is a "high level of confidence".
Insurer demonstrates compatibility between its governance processes and the adoption of the revised illiquidity premium.	(D) How should an insurer demonstrate compatibility between its governance processes and adoption of the revised illiquidity premium?	**In respect to Q(D):** Choice of the illiquidity premium is naturally part of the Investment Government Framework. Current governance processes for investment decision-making will incorporate revisions to the illiquidity premium. Senior Executive ALM monitoring and credit monitoring, manage closely the risk around earning the illiquidity premium, maintaining cashflow matching and making an appropriate allowance for defaults respectively. The Executive committee reports through to the Board.

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Risk Control	Questions	Member comments
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	(E) How should an insurer evidence cashflow matching with hold-to-maturity assets to APRA? (F) In what level of detail should assets supporting annuities be reported to APRA?	**In respect to Q(E):** Several jurisdictions require asset level and cashflow matching reporting to the regulator where policy liabilities are calculated on a full matching adjustment basis. Given APRA's aim to improve alignment with overseas jurisdictions, a significant increase in reporting should only be considered if Australia moves much closer to a matching adjustment approach. The insurer could evidence cashflow matching with hold-to-maturity assets through the Appointed Actuary's attestation which would involve showing the duration profile of assets backing the product compared to the duration profile of the liabilities of the product. The evidence can be included in the Actuarial Valuation Report (AVR). APRA could provide more details on the meaning of hold-to-maturity. From an accounting point of view, hold-to-maturity does not mean assets can never be sold. An asset can be classified as hold-to-maturity and be sold in case of significant changes in the issuer's creditworthiness or other unforeseen circumstances that affect the company's ability to hold securities (incl. unforeseen liquidity needs). A better way to think about hold-to-maturity in this context is the investment philosophy rather than an accounting view. **In respect to Q(F):** In this context, we consider that for reasons of efficiency APRA first order can rely on the required attestation of the Appointed Actuary. This can be supplemented by and annual report with gross and net cashflows for assets, liabilities and any derivative instruments. Asset level detail can be provided to APRA on an annual basis by those entities that adopt the alternative illiquidity premium calculation. The level of information to be provided ought to be proportionate to

Risk Control	Questions	Member comments
		the level of discretion that is applied in determining the illiquidity premium.
Restrictions on assets backing annuity liabilities and capital requirements.	(G) How should an insurer determine an appropriate asset mix to achieve both matching and the required yield without material changes to risk? (H) How should an insurer consider asset valuation, default and reinvestment risk in assessing illiquidity premium parameters?	**In respect to Q(G):** The approach proposed by APRA derives the illiquidity premium from a reference portfolio based on Investment Grade market indices rather than the company's assets. As with all other elements of APRA's prudential framework, there are no requirements on how a life company's assets are invested. The asset mix decision is an outworking of the company's strategy, including its Risk Management Framework. Additional capital is then held if assets do not match the liabilities. **In respect to Q(H):** It is the reference portfolio that sets the illiquidity premium. For the insurer's actual assets to be able to meet payments as they fall due, the insurer's asset portfolio needs to earn an illiquidity premium over the life of the liabilities, with a high level of confidence. The illiquidity premium may not necessarily be the same as in the reference portfolio. Hence default is the key risk. Additional capital is held if the actual assets differ from the reference portfolio. In practice the importance reinvestment risk will be a function of the level of cashflow (or key rate duration) matching. We note however that if the reference portfolio 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.

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Risk Control	Questions	Member comments
		Reinvestment risk can be reduced by matching the tenor of the asset to that of the liabilities. The illiquidity premium is best reflected as the spread less the allowance for (worst-case) defaults. In addition to the above, CALI queries whether this question is conflating two different issues. - There are currently no restrictions on asset mix for life insurers – but insurers need to hold more capital against riskier/unmatched asset strategies. - The higher illiquidity premium is proposed to be based on a reference index and is conditional on maintaining a reasonable degree of matching. Hence, as proposed by APRA, we infer that the actual asset mix adopted by the insurer would not determine the illiquidity premium e.g. where the insurer's portfolio of backing assets is riskier (has a higher WARF score) than the reference index. - In which case, this might create a helpful separation of the issues: - APRA should control the choice of reference indices that are eligible for determining the quantum of illiquidity premium (per the suggestions further above). - Reasonable matching should remain a pre-condition to accessing the higher illiquidity premium. - But the insurer remains free to select a matched asset strategy that comprises riskier assets than the reference index (where it is the latter which is being used for determining the illiquidity premium). - The insurer derives no additional illiquidity premium benefit (in the liability discount rate) from those riskier assets. - The insurer still must hold the requisite additional capital, per the APRA capital standards, for the delta between the asset composition (and associated APRA capital requirements) of the

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Risk Control	Questions	Member comments
		reference index and the riskier asset composition of the insurer's chosen (matched) asset strategy. - And if the insurer departs from a matched strategy, the insurer should lose the benefit of the higher illiquidity premium, since the matched condition is no longer satisfied. - Insurers should remain free to adopt whatever asset strategy they consider appropriate – but access to the higher illiquidity premium will be conditional upon reasonable matching, and the quantum of the illiquidity premium will be conditional upon the reference index (not an insurer's riskier asset strategy). - One might also argue that a material change to risk is a natural consequence of searching for higher credit-spread assets. Insurers may already be taking spread risk in portfolios and/or may stretch for more spread returns regardless of whether these changes are made or not.

Section 3: Consultation paper questions

Consultation Paper questions		Member comments
Proposed changes to the illiquidity premium	1. APRA seeks general feedback on the approach as well as feedback on the questions outlined in Table A of this Paper.	See table A responses above – especially in respect to adopting a principle-based approach. Although an incremental change (with limited scope for short-term material impact) CALI is supportive of the changes to the illiquidity premium. CALI encourages further future consideration to encourage increased competition through new product offerings to provide better outcomes for Australian retirees.
Risk controls	2. What risk controls outlined in Table B would you suggest as being appropriate, effective and practically achievable for industry?	The controls set out by APRA around cashflow and key rates duration matching and confidence of earning the assumed illiquidity premium will capture in an appropriate manner the key inherent risks created by this change and are both effective and practically achievable.
	3. APRA seeks feedback on the questions outlined in Table B of this Paper.	See table B responses above.
	4. Are there other risk controls APRA should consider	CALI recommends controls be recast on a principles basis under the Appointed Actuary, in line with other elements of the LAGIC framework.

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Consultation Paper questions		Member comments
Impact	5. What impact will the change in illiquidity premium have on your entity's asset allocation and capital resilience (e.g. ICAAP)?	The proposed changes will improve the resilience of the capital position through giving a more appropriate liability valuation in times of stress. Over time this might lead to higher exposure to investment grade fixed interest provided these generate the appropriate cashflow and key rate duration matching.
	6. Having regard to the overall objective of the changes (as outlined in Chapter 1), which changes set out in Table A would have the greatest impact?	The selection of the reference portfolio and the calibration of the Risk Adjustment will have the largest impact.
	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 to this, do you view it as worthwhile for APRA to make the proposed changes?	A potential benefit of the proposed changes (and future changes) is that over time more participants will be attracted to the annuity market, which will improve market dynamics in this critical sector as Australia deals with the challenges of an ageing population, and improve pricing to customers.
	8. What potential unintended consequences might arise from the proposed changes	The largest potential for an unintended consequence is within the selection of an appropriate reference portfolio. The Australian corporate debt universe is relatively narrow, with a duration that is materially shorter than the duration of a typical lifetime annuity portfolio and can become illiquid in times of stress and therefore not move in an appropriate way. CALI

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Consultation Paper questions		Member comments
		strongly recommends the inclusion of international markets.
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?	There is scope for better recognition of the diversification benefit associated with uncorrelated asset classes. Further, under the current LPS 112, illiquidity premium can only be applied to certain types of products. This includes "other types of annuities where there are no insurance risks other than longevity and servicing expenses ". There are retirement income products with risks outside of longevity and servicing risks which charges/market value adjustments in the case of withdrawals or death which are currently excluded from the ability to benefit from an illiquidity premium. We believe there should be consistency and that having a product with a fee/penalty/adjustment applied to the value of any withdrawal will discourage withdrawals and the product should be considered illiquid. Many immediate lifetime annuities allow withdrawals subject to the Capital Access Schedule and mark-to-market adjustments for changes in interest rates. This ability to make withdrawals does not impact their ability to apply an illiquidity premium. The eligibility criteria of LPS 112 should be increased to allow annuity products (with risks other than only longevity and servicing expenses) to be able to use an

Consultation Paper questions		Member comments
		illiquidity premium as long as there are product features/charges designed to ensure the long term and illiquid nature of the product.
Other issues: products with withdrawal/surrender risks	10. As outlined in Chapter 2 – Other issues, if the illiquidity premium were to apply to products with withdrawal/surrender risks, how would an insurer ensure that the illiquidity premium is appropriate and achievable under both normal and stressed circumstances?	**Basis of application of the illiquidity premium** APRA's current application of the illiquidity premium should be more targeted. The primary driver should be whether a liability is "callable" early at the option of the policy owner and how material the consequences of such early calls could be for the insurer. By way of example, disabled life reserves (DLRs) are generally not callable early at the option of policy owners. Such DLRs should therefore have access to the illiquidity premium. Uncertainty of cashflows (due to biometric risk) is not an appropriate reason for restricting access to an illiquidity premium. A DLR may have more uncertain cashflows than a lifetime annuity but, if DLR cashflows shorten or extend, neither of these outcomes poses an "early call" risk for the insurer. A lifetime annuity with a surrender/commutation benefit has a greater "early call" risk attaching to it in the initial years of the policy than does a DLR. Further, a lengthening in DLR cashflows (due to lower-than-expected claim termination rates) does not alter the illiquid nature of the prior best estimate DLR cashflows nor the profile of assets backing those original BE cashflows.

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Consultation Paper questions	Member comments
	Terminal Value calculation The application of illiquidity premium (and the proposed change to it) is only effective for Risk Free Best Estimated Liability (RFBEL) calculation, but not for Terminal Value (TV) calculation. However, LPS 360 (Paragraph 10d) requires that TV cannot be less than the RFBEL at policy level. This is in addition to LPS 112's (attachment F) requirement of comparing TV and RFBEL at statutory fund level. This means, any product where most policies have the TV applying would be disadvantaged due to not being able to benefit from the proposed LPS112 changes, and unfortunately this is the case for - The provider of retirement products which provides a deferred annuity with capital return (even with a penalty) on withdrawal - New entry to the market (as this TV applies during the early years of growth of business) - Product is healthily priced (i.e. RFBEL would be lower than initial premium representing expected profitability, whereas TV would be the initial premium, less penalty) As such, without releasing the requirement in LPS360 of TV cannot be less than RFBEL at policy level, the benefit of the proposed LPS112 may not be reflected on new entrant with innovative and sustainably priced retirement income products.