Level 2, 5 Martin Place
Sydney NSW 2000 Australia
GPO Box 3698
Sydney NSW 2001
challenger.com.au
Telephone 02 9994 7000

25 July 2025

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

Re: APRA Consultation Paper: Capital settings for longevity products

Thank you for the opportunity to provide feedback on APRA's proposed enhancements to the capital framework for annuities and other products as set out in the consultation *Capital settings for longevity products* issued on 12 June 2025 (**Consultation Paper**).

Challenger welcomes APRA's recognition of the need to improve the regulatory capital framework to foster innovation and competitiveness in the longevity product market. Revisions to the framework will be an important contribution to meeting the Government's objective to enhance the retirement phase of superannuation by expanding options for retirees to manage longevity risk. These changes will contribute to a stronger, world-leading retirement system that assists Australians to have the income they need for a secure and dignified retirement.

The proposals outlined by APRA, particularly the more risk-sensitive approach to the illiquidity premium, represent a constructive step toward addressing key industry concerns about the current capital settings.

Our assessment of the proposed amendments has considered whether the changes will support a more competitive market for annuity products, without unduly compromising policyholder protection; consistent with APRA's objectives to avoid disincentivising the development and competitive pricing of annuity offerings, maintain insurer financial resilience, and improve alignment with peer jurisdictions.

In order to achieve these objectives, we believe that the amendments should:

- remove the pro-cyclical elements within the current capital standards which, even for insurers with a well-matched portfolio, unduly exacerbate financial stress during market events;
- reflect the reality that the Australian bond market does not currently offer the relevant assets to support full cashflow matching of long-duration liabilities;
- support competitive pricing of long-duration longevity products; and
- introduce risk controls that are appropriate given the level of risk-sensitivity of the new illiquidity premium.

We would be happy to elaborate on our submission and if you have any questions, please feel free to contact Challenger's Appointed Actuary, [redacted] at [redacted]

Yours faithfully

[redacted]
Chief Executive Officer
Challenger Limited

Executive Summary

In our view, which is supported by various independent bodies and comparisons to other jurisdictions, Australian retirees currently have a significant under-weight allocation to guaranteed retirement income products, which leads to sub-optimal utilisation of their retirement savings and longevity risk being borne by the individual (and ultimately the Government through fall-back reliance on the Age Pension). Challenger strongly supports APRA's review of the capital standards which is seeking to remove unnecessary obstacles to the development of a more innovative and competitive guaranteed retirement income market in Australia. Challenger believes that appropriate adjustments to the capital standards will bring important benefits to current and future retirees, and to the Australian financial system. These include:

- less pro-cyclical capital standards, which will attract more life insurers and capital to the sector;
- increased competition, which will lead to a better range of products and pricing for consumers and greater awareness of the benefits of guaranteed retirement income products;
- less volatile and more predictable insurer earnings, which should reduce insurers' cost of capital and therefore further improve pricing to customers; and
- a source of long-term capital to the Australian economy, as insurers grow their books and seek appropriate assets, as seen in countries such as the UK and USA which have much larger volumes of guaranteed retirement income products.

To achieve these benefits, we believe that it will be necessary to make a significant change to the determination of the illiquidity premium under Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital (**LPS112**). Anything less is unlikely to trigger the changes necessary to generate the benefits that could be made available to retirees and the Australian economy.

The key points from our submission are summarised below.

- APRA has indicated that it is not intending to adopt a full matching adjustment regime (such as that available under Solvency II), but rather is seeking to make available a more risk-sensitive illiquidity premium than that available under the current capital standards to insurers that adopt certain additional risk controls. Challenger supports this approach.
- APRA has suggested certain criteria that should apply to the reference index used to derive this more responsive illiquidity premium, including that it be "Australian". Challenger firmly believes that APRA's objectives would be better served by allowing international reference indices until such time as a sizeable long-term corporate bond market develops in Australia. Should an international reference index be adopted, the term over which a market-derived illiquidity premium is applied could then be extended from APRA's proposed 10 years to 30 years. We note that the current reference index published by the RBA is already comprised of a majority of foreign-currency denominated bonds (although issued by Australian corporates), and so the introduction of this proposed restriction seems unnecessary and would greatly diminish the effectiveness of the proposed reforms. The use of an international reference index would in no way compromise policyholder security, and would provide a better set of underlying instruments from the perspective of matching retirement income product liabilities. In other respects, we agree that the reference index should be investment grade, but also suggest that it be calculated by an independent index provider and be available daily.
- A change in the formulation of the risk adjustment (the deduction from available spreads over risk-free rates to account for potential default losses), given a reference index, is a critical element of the proposed reforms. The existing capital standards apply a "variable approach" i.e. the risk adjustment is a fixed proportion of the prevailing spread at the valuation date. As we demonstrate in our submission, it is simply not possible when using a variable approach to ensure both that the risk adjustment is sufficient when spreads are tight and that the risk adjustment is not overly conservative when spreads are wide. We strongly support the use of a "fixed approach" where the risk adjustment is a function of long-term spreads rather than prevailing spreads at the valuation date.
- While we support the introduction of risk controls, we recommend that those controls reflect the fact that APRA will not be allowing a full matching adjustment and so should not be as extensive as the controls that would be reasonable to apply under a full matching adjustment regime.

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Our submission commences with some general observations then follows the format of the Consultation Paper questions, with five sections:

- proposed changes to the illiquidity premium;
- risk controls;
- impact;
- scope; and
- other issues.

At the end of our submission, in line with APRA's request for cost-benefit analysis information, we have briefly set out our expectations of the potential implementation costs related to the proposals.

We strongly believe that the changes we have outlined in this submission will contribute towards a significant improvement in the availability of retirement income products to support Australians in retirement, with additional benefits for the Australian financial system and broader economy. While other initiatives will be required to fully realise these benefits, the proposals address a key barrier to the take-up of appropriate retirement income products by Australian retirees by enabling a broader supply of products to market.

General Observations

The Life and General Insurance Capital (**LAGIC**), APRA's capital framework for life insurers and general insurers, is based around two key concepts:

- a Capital Base, which is a version of net assets determined on a prudential basis; and
- a Prudential Capital Requirement (**PCR**), which, excepting any supervisory adjustments, equals a Prescribed Capital Amount (**PCA**) specified in the standards, and represents the minimum required level of Capital Base.

Prudential Standard LPS 110 Capital Adequacy (**LPS110**) includes the following definition.

> *The prescribed capital amount of a fund determined under the Standard Method is intended to be sufficient, such that if a fund was to start the year with a capital base equal to the prescribed capital amount, and losses occurred at the 99.5 per cent confidence level then the assets remaining would be at least sufficient to provide for the adjusted policy liabilities and 'other liabilities' of the fund at the end of the year. The other liabilities to be provided for exclude those liabilities that satisfy the criteria for inclusion in the capital base.*

Further, in its March 2011 paper *Response to Submissions on the Review of capital standards for general insurers and life insurers*, APRA described the quantum of assets equal to the adjusted policy liabilities (**APL**) as "*sufficient to provide for the central estimate of the liabilities at the end of the year*". In essence, the PCR creates a buffer of assets above the APL to withstand 99.5% of potential losses over a year, while the APL represents a quantum of assets that, if held consistent with the discount rate underlying the APL calculation, would be sufficient to defease the liabilities over the lifetime of those liabilities.

For many products, the nature of the liabilities warrants the use of a liquid risk-free rate in the valuation of the APL. However, other products have features that mean they can be considered "illiquid", and hence it is appropriate for the discount rate to incorporate an illiquidity premium.

Regardless, the principle is the same: the PCR provides a buffer to absorb losses that might occur over a year, and the APL represents the quantum of assets that is sufficient to defease the liabilities over time. Importantly, this assumes a liability run-off scenario (rather than a scenario where risk is transferred to a third party). The illiquidity premium therefore should represent the additional yield above the risk-free rate that could be earned over the remaining life of the liabilities, with a very high degree of confidence. This is equivalent to taking the yield on a broadly matching portfolio of assets, less an allowance for "worst-case" defaults.

In this construct, only defaults are relevant as they reduce the cash available to meet liabilities. Downgrades and other mark-to-market movements are not relevant as the liabilities are backed by the portfolio of assets that defease those liabilities.

In summary, for illiquid liabilities, it is appropriate that the APL be valued using a discount rate that incorporates an illiquidity premium based on available credit spreads that is sufficiently adjusted for potential losses over the period of liability run-off.

A number of offshore jurisdictions offer a dual approach to the calculation of the illiquidity premium, with a standard approach and a matching adjustment approach. The standard approach provides for an illiquidity premium based on the current credit spread of a reference portfolio, whereas the matching adjustment approach utilises the actual spread of an insurer's portfolio less a risk allowance. To qualify for the matching adjustment treatment, an insurer must demonstrate cashflow matching. APRA is essentially proposing a two-tier standard approach: a base standard approach (aligned to current capital standards without any specific risk controls) and an enhanced standard approach, with a more risk-sensitive illiquidity premium, which is only available should certain risk controls be in place.

Challenger supports this approach, noting that the risk controls that would be appropriate to qualify for the enhanced standard approach should not be as extensive as those that apply in other jurisdictions to qualify for a full matching adjustment.

Responses to Consultation Paper Questions

Section 1: Proposed changes to the illiquidity premium

Benchmark/reference

How should an insurer select an appropriate reference point/portfolio given the criteria imposed by APRA?

The criteria imposed by APRA are that the reference portfolio must be externally rated, Australian, investment grade with tenors up to 10 years.

Challenger is concerned that these constraints severely limit the ability to broaden the universe of credit assets for determining the reference portfolio. The primary concern relates to the "Australian" aspect of the criteria, but the tenor limit is also inappropriate given the purpose of the illiquidity premium is to apply to long-duration liabilities.

The current reference portfolio for determining the illiquidity premium under LPS112 is the portfolio of bonds underlying the RBA's *Non-financial corporate A-rated bonds – Yield – 3 year target tenor* series (the **RBA portfolio**).

The RBA notes that the data:

> *provides aggregate measures of corporate bond yields for Australian resident non-financial corporations (excluding real estate companies). The estimates are derived from a sample of fixed- and floating-rate bonds issued in Australian dollars, US dollars and euros, where the foreign currency-denominated bond yields of individual bonds are hedged into their Australian dollar-equivalent yield using cross-currency basis swaps and other relevant interest rate adjustments.*[1]

The RBA portfolio currently comprises 67[2] bonds issued by Australian corporates totalling $45b, with 41% in USD, 31% in AUD and 28% in EUR. The RBA portfolio has only 13 bonds with a remaining life greater than 10 years. The portfolio is highly concentrated to the materials (47%) and telecommunications (21%) sectors, and hence has a low level of diversification. The limited number of bonds and lack of longer tenor bonds in the RBA portfolio means it would not be adequate to create a well-matched benchmark for a long-duration liability portfolio, and the market value of the RBA portfolio is insufficient for Australian insurers to actually use the underlying constituent bonds to support their liability portfolios. Other domestic indices could be considered, however, they would still severely limit an insurer's ability to create a well-matched portfolio.

As a result, Challenger proposes the use of a global reference index, with the US market considered to provide the most appropriate alternative given its underlying characteristics and strong liquidity, especially in times of stress. Other markets tend to have lower secondary market volumes and hence can have stale pricing (an effect that is quite pronounced in the domestic market). The Bloomberg US Corporate Investment Grade Bond Index (Bloomberg code: **LUACSTAT**) is considered an appropriate index that represents the US investment grade corporate bond market.

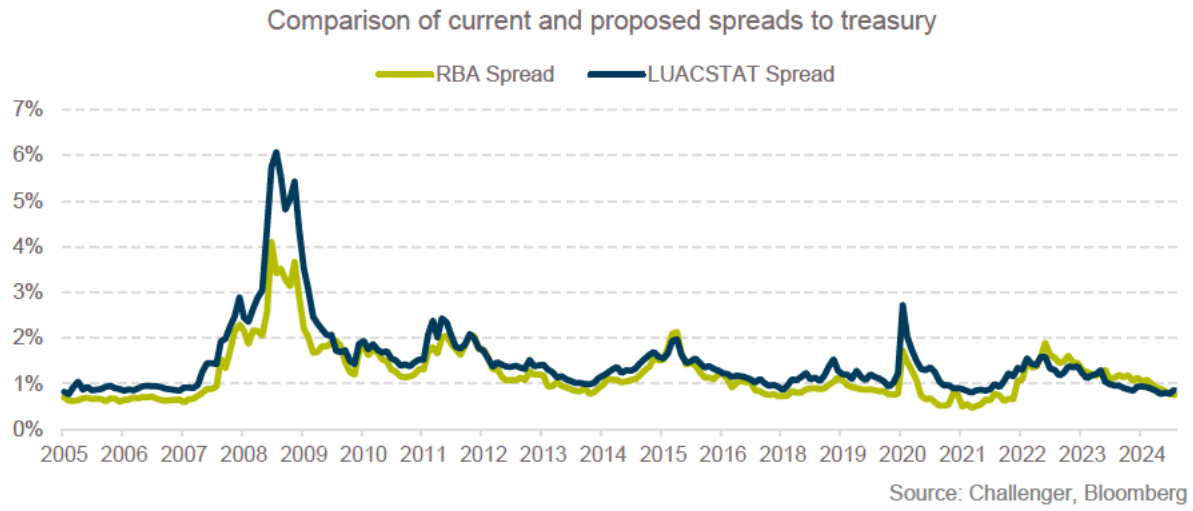
The portfolio underlying the LUACSTAT index currently comprises 8,426 bonds issued by global companies in USD, totalling A$10.6t. LUACSTAT currently has 3,195 bonds with a remaining life of greater than 10 years (and 1,948 bonds with a remaining life of greater than 20 years). LUACSTAT also offers far broader diversification both across sectors and geographically than any Australian index, with a large number of global issuers including those from Australia. The two largest sectors are financials (28%) and consumer staples (18%), however, the market value and the number of issuers provides a high degree of diversification. The LUACSTAT portfolio has an average of 271 (and a minimum of 82) bond maturities per year for the next 30 years, which with appropriate currency hedging (as also required for the RBA portfolio) makes it possible to create a (near) perfect cash flow match for liabilities. The market depth for index constituents is more than sufficient for Australian insurers to be able to use the underlying constituent bonds to support their liability portfolios.

[1] https://www.rba.gov.au/statistics/tables/xls/f03hist.xlsx
[2] https://www.rba.gov.au/statistics/tables/pdf/f03.pdf

It is worth noting that investing in any of the potential indices, whether an Australian index or LUACSTAT, would not provide a sufficient return to allow existing pricing levels to customers to be maintained. The reference index is primarily intended to serve as a benchmark that can used to derive an appropriate liability discount rate.

The use of an international index such as LUACSTAT could be an interim approach, with a domestic index to be adopted once the domestic bond market is more fully developed. The constraint of only using tenors of up to 10 years would seem to fall away were APRA to allow an index such as LUACSTAT as the reference portfolio.

The chart below compares the spread on the RBA index with that of LUACSTAT. The chart illustrates that the two series are highly correlated, and that adopting LUACSTAT would not be a large departure from the current approach.



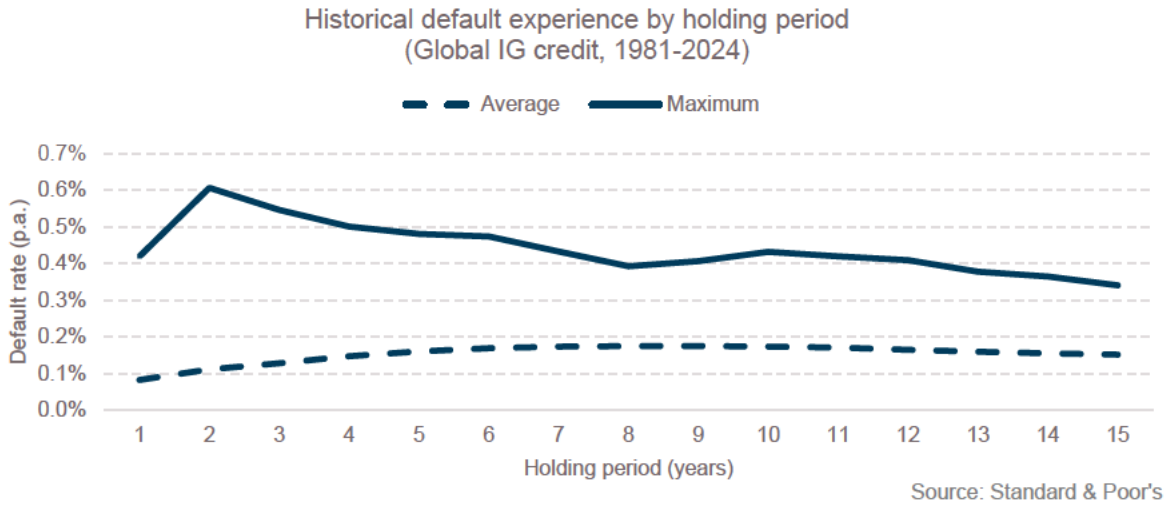
Factor applied to spread

How should an insurer determine the appropriate risk adjustment to the spread given a reference benchmark/portfolio?

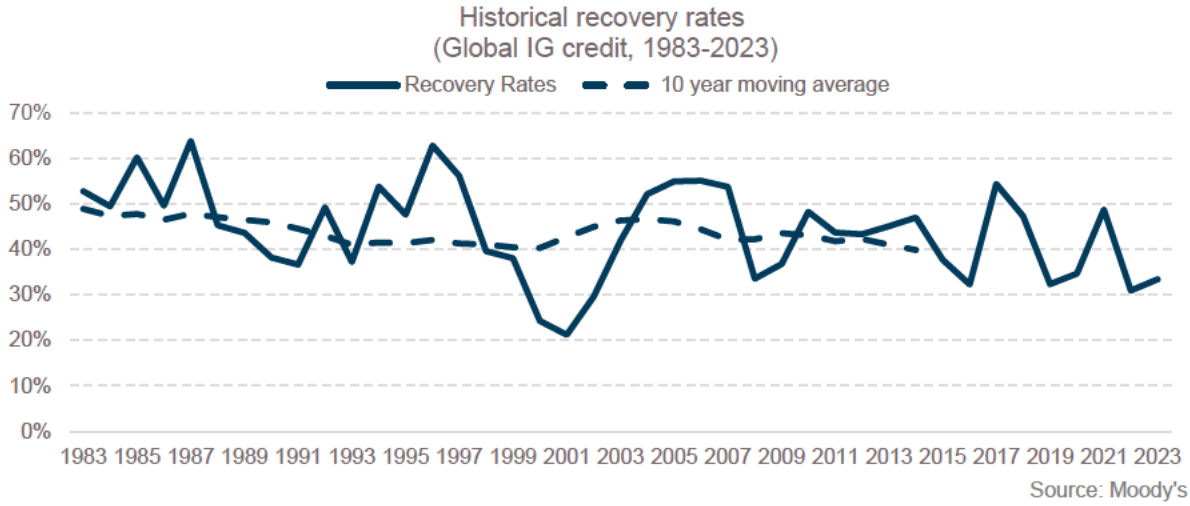
Given a reference portfolio, the appropriate risk adjustment should be determined by estimating the expected stressed (or "worst-case") losses of the reference portfolio.

To determine an appropriate risk adjustment, we have considered historical experience. Given the relatively small size and short history of the Australian corporate bond market, we have focused on global experience. The chart below compares average and maximum global annualised default rates by holding period for the period 1981 to 2024[3]. The chart illustrates the stable nature of annualised defaults, and the reducing volatility of defaults over longer time periods, translating into lower stressed default rates for longer time horizons. Considering holding periods of 5 to 12 years, maximum annualised defaults were around 0.40% to 0.45% p.a.

[3] S&P Global Ratings Inc., *Table 31: Static-Pool Cumulative Global Corporate Default Rates Among Investment-Grade Ratings, 1981–2024*, Default, Transition, and Recovery: 2024 Annual Global Corporate Default and Rating Transition Study

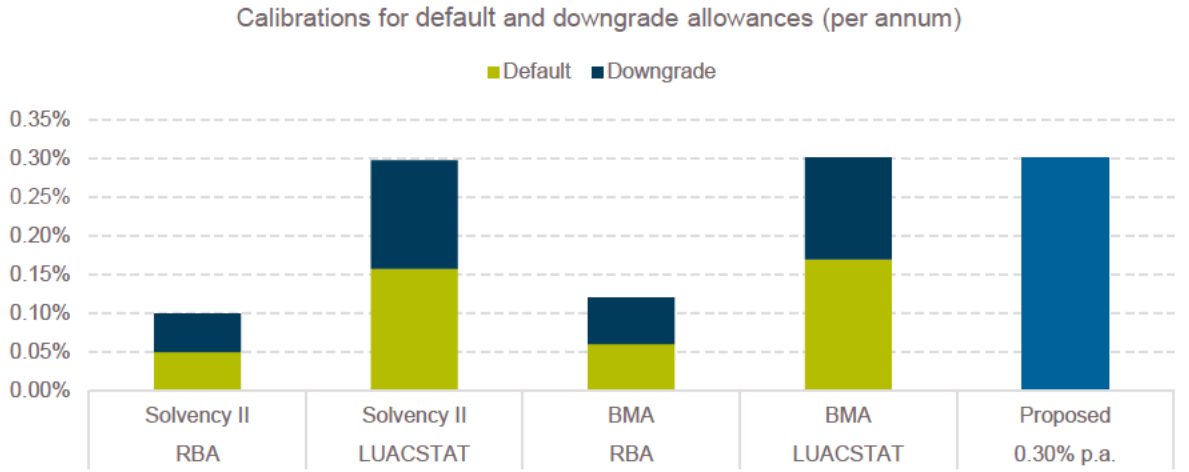


To estimate losses, a loss given default rate must be applied to defaults. The graph below shows Moody's timeseries of historical recovery rates for senior unsecured bonds, the main constituents of relevant reference indices. Recovery rates have been relatively stable, especially when considering longer holding periods as is appropriate for the purposes of calibrating an illiquidity premium.



Combining a stressed long-term default allowance of 0.45% p.a. with a recovery rate of 40%, suggests maximum historical loss rates of ~0.27% p.a., and adding a margin of safety, we propose that a risk adjustment of 0.30% p.a. for global investment grade credit indices would be appropriate.

A risk adjustment of 0.30% p.a. compares well against peer jurisdictions. The results in the chart below have been calculated by applying the Solvency II and Bermuda Monetary Authority (**BMA**) approaches to the current index constituents of both the RBA and LUACSTAT indices, and we have compared these to the 0.30% calibrated above based on the global investment grade bond universe.



Source: Challenger

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?

Challenger supports the use of a benchmark spread less a risk adjustment expressed as a prescribed percentage of the long-term average spread of the benchmark. This would allow for some variability of the risk adjustment over time based upon changes in the benchmark, while providing the largest counter-cyclical benefit during market stress events. The long-term (2000 to 2025) average spread of LUACSTAT is 1.48%. Combining this with the expected stressed losses result (0.30% p.a.) from the prior section suggests that the risk adjustment should be 20% of the long-term average spread.

Challenger has referred to the approach of peer regimes in forming this view. While it seems logical that spread levels should contain some information about expected future credit losses, the reality is that in periods of extreme volatility, spreads are exacerbated by reduced liquidity more so than a deterioration in the underlying long-term outlook for default losses. In its 2022 paper *Solvency II Review: Matching Adjustment and reforms to the Fundamental Spread*, the UK Prudential Regulation Authority (**PRA**) specifically noted that while long term 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*".

We also note that 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. The Government agrees that the incorporation of current spreads into the calculation of the fundamental spread would have significant negative impacts*".

As a result, Challenger suggests that the illiquidity premium should be calculated as:

$$ILP = CST - 20\%\ LTAST$$

where:

- CST is the current spread to Treasury of the reference portfolio; and
- LTAST is the long-term average spread to Treasury of the reference portfolio.

This parameterisation is a function of the default experience of global investment grade corporate credit issued in USD (i.e. LUACSTAT). Were APRA to select a different reference portfolio, the 20% parameter in the above formula may change, and it should be recalculated based on the relevant reference portfolio.

Long-term rate implementation

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?

Given the separation of the PCR and the APL is a key concept of LAGIC, as discussed earlier in the paper; an appropriate cut-off point for the illiquidity premium should be determined based on the reference portfolio, and not on the profile of an insurer's assets.

As mentioned previously, the RBA portfolio currently includes 13 bonds with remaining life of greater than 10 years. As a result, this reference portfolio does not provide sufficient data beyond 10 years. Alternatively, LUACSTAT currently includes 3,195 bonds with a remaining life of greater than 10 years, and 1,948 bonds with a remaining life of greater than 20 years. LUACSTAT has an average of 271 (and a minimum of 82) bond maturities per year for the next 30 years, after which the number of maturities declines materially. As a result, LUACSTAT provides data to support use of a market-derived illiquidity premium out to 30 years.

Consequently, should LUACSTAT be adopted as the reference portfolio, then the long-term rate for the illiquidity premium should apply from 30 years.

Could an insurer match cashflows to the cut-off point?

Assuming that the cut-off point is based on a reference portfolio as outlined in the response above, then an insurer could use the reference portfolio to match cashflows to the cut-off point. However, noting the purpose of the PCR, insurers should not necessarily be obliged to do so.

Should the increase be applied to the spot rate instead of the forward rate?

The increase should be applied to the forward rate, as cashflows beyond the cut-off point can be backed by assets with a duration equal to the cut-off point, such that the reinvestment risk only applies to time periods beyond the cut-off point (rather than all time periods from the valuation date for any cashflow beyond the cut-off point). This approach avoids an unnecessary step-change in the liability discount rate immediately after the cut-off point.

Long-term (ultimate) rate

How should an insurer determine an appropriate long-term illiquidity premium that is able to be earned under stressed conditions given reinvestment risk?

Stressed conditions for reinvestment occur when spreads are lower than expected when reinvestment is required. An insurer should determine a stressed (i.e. low) spread less the risk adjustment to determine an appropriate long-term illiquidity premium.

The lowest spread observed by LUACSTAT over the last 25 years is 0.74%. Challenger suggests this is a suitably low, stressed reinvestment spread. Subtracting from this the risk adjustment of 0.30%, arrives at a long-term illiquidity premium of 0.44%.

Cap

How should an insurer ensure that the illiquidity premium formula remains appropriate in extremely stressed circumstances?

We do not believe that any explicit cap on the illiquidity premium is required, rather, the parameterisation of the illiquidity premium calculation should contemplate extremes. In scenarios where the credit spread on our preferred reference portfolio, LUACSTAT, reaches extreme highs (around 600bp), the calculated illiquidity premium would be 570bp. This would have been appropriate in that scenario, as the risk adjustment of 30bp proved more than sufficient to cover subsequent losses.

As outlined above, the key principle is that the risk adjustment needs to reflect an appropriate (prudent) allowance for default losses. Further, part of the justification for the suggestion of LUACSTAT as the reference portfolio is that the USD investment grade corporate credit market is regarded as the most liquid of its kind, globally. As a result, referring to this market will give the most accurate measure of the illiquidity premium, especially in times of stress, where the AUD investment grade market is known to stop trading and hence have stale pricing.

Section 2: Risk controls

General observations on risk controls and cashflow matching requirements

In the Consultation Paper, APRA contemplates the introduction of risk controls in order to qualify for the more risk-sensitive illiquidity premium. It is important that these controls strike the right balance, encouraging prudent management of relevant risks but not becoming an undue impediment for insurers either in terms of limiting the

types of products that they would be willing to offer or adversely impacting the level of pricing that could be offered to customers. The implementation of overly restrictive risk controls that would be more appropriate under a comprehensive matching adjustment regime, in the absence of a full matching adjustment illiquidity premium, would undermine the intended benefits of the reforms, and potentially lead to no change in the status quo.

In our comments below, we have considered the risk controls that would be appropriate in the context of a highly responsive illiquidity premium in line with our proposals above. Should a less responsive illiquidity premium be implemented, then the controls should be less restrictive.

Appointed Actuary attestation

How should an insurer define cashflow matching within an acceptable level of risk?

To qualify for the more risk-sensitive illiquidity premium, Challenger suggests risk controls that are subject to Appointed Actuary sign-off as part of the Internal Capital Adequacy Assessment Process (**ICAAP**). This sign-off could be based on meeting conditions such as:

- the actual investment portfolio being able to earn a spread return at least equal to the illiquidity premium with a very high degree of confidence;
- projected asset cashflows (risk adjusted) meeting projected liability cashflows on a cumulative basis (inclusive of appropriate divestment and reinvestment assumptions);
- asset cashflows having a contractual obligation for payment (where this could include securities where the timing of that payment may be subject to best estimate assumptions);
- asset cashflows having a high degree of certainty, with a large majority coming from counterparties with an investment grade credit rating;
- divestment assumptions being supported by assets with deep liquidity; and
- reinvestment assumptions being based on appropriate long-term spreads less a risk adjustment.

These suggested risk controls effectively comprise a principles-based approach to achieve a significant level of cashflow matching. Importantly, the approach allows for appropriate divestment and reinvestment assumptions, given the nature of long-term liabilities and the types of assets that provide the best match, and the fact that the more risk-sensitive illiquidity premium being proposed is based on a reference index and not the actual portfolio of assets backing the liabilities. Consequently, there will be a level of mismatch between assets and liabilities, and each insurer will need to consider its risk appetite around the level of mismatch in its liability portfolio. We specifically note that LPS110 sets out that the ICAAP must include "*policies to address the capital impact of material risks not covered by explicit regulatory capital requirements*". Hence, companies will need to ensure that mismatch risk is considered within the ICAAP and be subject to Appointed Actuary sign-off.

How should an insurer define a stressed scenario?

As a risk control, the Appointed Actuary should undertake a stress scenario analysis that verifies that the total pool of assets supporting the liabilities would be sufficient to meet the liabilities. The stressed scenario should be based around a run-off scenario, where the insurer effectively holds its current asset portfolio and uses it to meet its liability obligations over time. This stressed scenario should consider all the risks that would affect the ability of the asset portfolio to meet liability payments as they fall due. For this reason, key factors should include an increase in default rates on debt assets, changes to paydown profiles on any securitised assets in the portfolio, changes in reinvestment spreads, and changes in policyholder behaviour related to exits. As with any stress testing, the calibration of these stresses should consider the extent to which all of these variables could move adversely at the same time. This should be embedded into the broader ICAAP and resilience testing program. In addition, the stress test should consider the level of diversification within the asset portfolio. A lack of diversification should lead to higher stresses than those that would be appropriate for a broadly diversified portfolio.

In undertaking this stress test, the pool of assets supporting the liabilities should be the APL plus an allocation of the PCR attributable to the relevant liabilities.

How should an insurer determine that it will attain the spread above risk free rate with a high level of confidence?

The insurer must have a high level of confidence that the illiquidity premium can be earned from its actual asset portfolio over the term of the liabilities. To make this assessment, the Appointed Actuary should consider the actual spread on the asset portfolio less a risk adjustment determined in a similar manner to the 30bp derived above for LUACSTAT, but based on the actual asset portfolio. As noted above, the level of diversification in the actual asset portfolio should be considered when assessing worst-case losses. Provided this risk adjusted spread meets or exceeds the illiquidity premium used in the determination of the APL, it would be reasonable to conclude that the assets are able to generate a sufficient return.

Compatibility of governance processes

How should an insurer demonstrate compatibility between its governance processes and adoption of the revised illiquidity premium?

Each component of the adopted risk controls, including consideration of the ability to earn the illiquidity premium, assumptions around divestments and reinvestments, and the stress testing, should be embedded into a number of governance processes including those related to investment decisions, credit risk management, and ALM; and they should also be supported by reporting to relevant management and Board committees, and attestations as part of the year-end APRA reporting processes.

Additional reporting

How should an insurer evidence cashflow matching with hold-to-maturity assets to APRA?

APRA has set out a number of attestations to be provided by the Appointed Actuary, where companies propose to use the more risk-sensitive illiquidity premium framework, including that "*liabilities are cashflow matched with hold-to-maturity assets within an acceptable level of risk over the period that the illiquidity premium is applied*". The primary evidence for APRA should therefore be this attestation. This can be supplemented by inclusion of a projection within the annual Actuarial Valuation Report illustrating cashflows for relevant assets and liabilities, with details of divestment and reinvestment assumptions, and a summary setting out net cashflows on both a yearly and cumulative basis.

In what level of detail should assets supporting annuities be reported to APRA?

We consider that individual asset level data could be provided to APRA on a quarterly basis, setting out the assets supporting liabilities valued using the more risk-sensitive illiquidity premium.

Restrictions on assets backing annuity liabilities and capital requirements

How should an insurer determine an appropriate asset mix to achieve both matching and the required yield without material changes to risk?

A core investment principle for any insurer issuing annuity business should be to invest in a diversified pool of assets that will produce cash flows to match its liabilities, allowing the insurer to extract an illiquidity premium from its investment portfolio while keeping reinvestment risk to acceptable levels. We would envisage this process would incorporate the risk controls related to cashflow matching that are ultimately adopted in the updated standards.

How should an insurer consider asset valuation, default and reinvestment risk in assessing illiquidity premium parameters?

When calibrating illiquidity premium parameters, insurers should assess whether the asset portfolio reliably delivers the illiquidity premium over the life of the liabilities, with due consideration to asset valuation, default, and reinvestment risks.

- **Asset valuation risk** arises where asset and liability valuations respond differently to market conditions. If the reference index used to derive the illiquidity premium is not sufficiently responsive to market movements, and/or the framing of the risk adjustment is not sufficiently counter-cyclical, it may lead to distortions between asset and liability valuations and so overstate the underlying risk exposures. While such distortions can impact

reported positions, provided there is a high degree of cashflow matching, obligations to policyholders would still be able to be met as and when they fall due. The risk would only be realised should assets need to be sold. For this reason, the stress testing discussed above should adequately cover the risk of variances in policyholder behaviour.

- **Default risk** should be addressed by making an adequate risk adjustment to the spread on an insurer's actual asset portfolio in forming the assessment of whether the asset portfolio can generate the illiquidity premium adopted in the valuation of the APL.
- **Reinvestment risk** arises due to any misalignment between timing of asset and liability cashflows, either due to variability in liability cashflows or asset cashflows. Reinvestment risk exposes the insurer to uncertainty in the illiquidity premium able to be earned on any amounts needing to be reinvested over the full liability horizon, particularly under adverse reinvestment conditions. This should be assessed through the stress scenario analysis discussed above.

Section 3: Impact

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 a more appropriate liability valuation in times of stress. This will have a number of impacts on asset allocation, including reducing the need to allocate to investments that can be liquidated in a short timeframe and increasing the weighting to debt assets. The proposed changes will also trigger a review of risk appetite, which could lead to further improvements in capital resilience.

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?

In Chapter 1, APRA sets out that "*one objective of the RIC is to improve retirement outcomes for individuals by increasing the availability of retirement income products that more efficiently manage longevity risk*"; and further that the "*adjustments to the capital framework for annuity products will be guided by the following objectives:*

- *APRA's capital requirements for life insurers are not a disincentive to the development and competitive pricing of annuity products*
- *maintaining the financial resilience of life insurers*
- *improving alignment with comparable peer jurisdictions*".

Considering the changes set out in Table A, Challenger considers that the selection of the benchmark (specifically the adoption of a broad-based international index) and the calibration of the risk adjustment (specifically the move to a semi-fixed risk adjustment rather than the current proportion of prevailing spread) will have the largest impact.

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?

Challenger agrees with APRA's position as noted in the Consultation Paper, that the proposed changes to capital settings "*should facilitate more competitive pricing without unduly increasing risks for policyholders*", noting that as also highlighted by APRA, due to a combination of other factors holding back demand for lifetime income streams, these changes by themselves are unlikely to be transformative for the sector.

The ultimate impact that these changes have will depend on the degree of risk-sensitivity of the reference portfolio and the size and format of the risk adjustment.

We consider that the primary benefit of the proposals will be driven through broader participation by insurers in the Australian guaranteed retirement income market by resetting the risks inherent in providing such products. An increase in the range of providers offering guaranteed retirement income products will lead to greater choice and product innovation, and will help to normalise the use of such products by retirees, leading to a more optimal utilisation of retirement savings to provide income in retirement. We consider that current annuity pricing in Australia is fair, and it compares well to pricing in other jurisdictions. Nevertheless, additional players in the market will naturally generate competition that will support ongoing competitive pricing of guaranteed retirement

income products, and to the extent the insurer's capital position and earnings become less volatile, its cost of capital should reduce, and this benefit can be expected to be shared with policyholders through better pricing outcomes.

Regardless of the level of improvements to pricing of retirement income products, the primary benefits of the proposed changes will be a more optimal utilisation of retirement savings to provide income in retirement, and hence we believe that it will be very worthwhile for APRA to make the proposed changes.

What potential unintended consequences might arise from the proposed changes?

The potential implementation of overly restrictive risk controls, specifically strict cashflow matching requirements that are more aligned to a full matching adjustment approach (where the spread on the actual asset portfolio forms the basis of the illiquidity premium), would erode the intended benefits of the reforms, and could result in maintenance of the status quo. Strict cashflow matching for long-term liabilities (particularly lifetime products) is unlikely to be feasible given the lack of a long-term domestic bond market, consequently, the risk controls that are adopted should accommodate a level of reinvestment risk.

Challenger is supportive, in the longer term, of a matching adjustment regime based around a strict cashflow matching portfolio, but the illiquidity premium under this regime would need to reference the earning rate of the actual portfolio, and not a reference portfolio, and would also require broader reforms to other components of the capital framework including asset risk charges, which are not currently being considered.

Section 4: Scope

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?

Challenger recommends the following changes to better align with international regulatory practices and enhance Australia's competitiveness as a destination for global insurers.

- **Rating agencies**: The list of recognised rating agencies under *Prudential Standard CPS 001 Defined terms* (**CPS001**) should be expanded, and the use of private ratings should be permitted without prior APRA approval if they meet public rating standards.
- **Surrender value floor**: Individual policy-level surrender value floors under LPS112 and LPS360 should be removed and replaced by termination value floors at statutory fund level, and capital charges for surrender risk, consistent with international standards (Solvency II, ICS, BMA).
- **Innovative capital structures**: Various offshore jurisdictions provide structures that allow complete segregation of different pools of liabilities, with discrete pools of capital supporting each different pool of liabilities. Changes to allow such capital structures may incentivise a broader range of institutional investors to provide capital to support retirement income products.
- **Product eligibility**: The illiquidity premium should be able to be applied to all products with illiquid liabilities, not just annuities, based on product features and behavioural factors, consistent with the principles-based approaches applied in peer jurisdictions.

We have elaborated on a number of these points in the sections below.

Rating agencies

Challenger requests the ability to include additional rating agencies for the purposes of applying a counterparty grade per the definitions under CPS001. This should consider the broader list of rating agencies used by regulatory bodies in other jurisdictions, and reflect the evolution of the rating agency market since the existing list was put in place. Challenger believes the inclusion of the Kroll Bond Rating Agency in particular is warranted based upon its rating process and increasing presence in debt market transactions.

Currently, the use of private ratings from a recognised rating agency to determine a counterparty grade is subject to APRA approval. Challenger would seek to use private ratings subject to meeting the below criteria, which will result in the counterparty grade being treated as a public external rating for reporting, capital calculation and similar purposes without prior APRA approval.

- The rating process from the rating agency provides a similar standard of information, rigour, analysis, approval process and reporting akin to a public external rating.
- Ratings are monitored and reviewed on an ongoing basis by the rating agency (i.e. not a point in time or hypothetical scenario rating).
- The asset has an issue / tranche level rating.
- The rating is for corporate or structured finance debt instruments.
- If the rating is confidential or unpublished, the insurer has access to initial and updated ratings analyses, changes, and comments, either directly from the rating agency or via a third-party platform (e.g. Intralinks).
- If confidentiality agreements, non-disclosure agreements or similar agreements are required to be agreed by the insurer to view ratings, then the insurer has the ability to provide the ratings to APRA or auditors if requested or required.

Surrender value floor

In its Consultation Paper, APRA has indicated that one of its objectives is "*improving alignment with comparable peer jurisdictions*". In this context, we specifically note that the outworking of LPS112 which references minimum termination values as defined in *Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values* (**LPS360**), is that the APL for a policy is subject to a minimum of 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 about policyholder behaviour, coupled with an appropriate allowance for the risk of adverse lapse experience.

- EU Directive 2015/35 dealing with Solvency II sets out the following principles in the preamble.
  - *(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 the following under section 3.2.1.3 "Policyholder behaviour".
  - *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 also their reaction to management actions;*
    - *How beneficial the exercise of options would be to policyholders under specific circumstances; and*
    - *Economic conditions.*
- The Insurance Prudential Standards published by the BMA in March 2024 in the section *Calculation principles specific to long-term business* of *Schedule XXVI - Schedule of Economic Balance Sheet Valuation Principles* sets out the following.
  - *Insurers shall ensure that no implicit or explicit surrender value floor shall be assumed for the amount of the market consistent value of liabilities for a contract of insurance*.

To improve alignment with peer jurisdictions, we recommend that APRA should:

- delete paragraph 6 of Attachment F of LPS112 which imposes the termination value floor at individual policy level; and
- delete paragraph 10(d) of LPS360 which re-defines the termination value for annuity policies as the risk-free best estimate liability and so imposes a floor materially in excess of the amount that the policyholder can receive on termination.

While this removes a layer of conservatism within the current LAGIC standards, we consider that the termination value floor at statutory fund level, in conjunction with the inclusion of an appropriate charge for surrender risk, in total will continue to result in an appropriate level of policyholder protection consistent with the intent of the LAGIC framework.

Innovative capital structures

Various offshore jurisdictions provide for structures that allow complete segregation of different pools of liabilities. This means that different sources of capital are able to back specific pools of liabilities. These structures have helped to attract a wider range of capital to the space, as institutional investors are able to underwrite a specific pool of liabilities, without having to take exposure to the entire insurance vehicle. Changes to allow similar structures in Australia may also incentivise a broader range of institutional investors to provide capital to the retirement income sector, thereby contributing to the growth and competitiveness of the sector, supporting APRA's objective of increasing the availability of retirement income products.

Product eligibility

While APRA's focus in undertaking the current consultation is longevity products (including annuities), there is a strong case to apply similar rules to any product with illiquid liabilities. A restriction based on definitions within superannuation rules is not appropriate from a prudential perspective. Rather, the illiquidity premium should apply to any products that meet criteria for being considered illiquid, either through explicit product rules limiting liquidity, implicit rules (such as surrender penalties) limiting liquidity, tax incentives, or other behavioural aspects. We note for completeness that in the UK, the PRA has historically adopted principles-based eligibility criteria for the matching adjustment, considering the insurance risk to which a product is exposed, and in 2024 explicitly extended eligibility to include income protection policies. We consider that this approach is appropriate and prudent.

Section 5: Other issues

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?

Application of an illiquidity premium to the valuation of a liability portfolio that has material levels of liquidity, particularly where market value adjustment mechanisms do not exist or surrender penalties are less material, is more challenging than for a traditional annuity portfolio, and would require a deep understanding of policyholder behaviour during periods of extreme stress.

Cost-benefit analysis

APRA has requested information on the compliance impact of the proposals, and any other substantive costs. We have considered the following costs that would be incurred in relation to the proposed changes.

- **Portfolio rebalancing**: While the proposals would be likely to lead to some rebalancing of Challenger's asset portfolio, with associated costs, this would only be done to the extent that it generated a net benefit to Challenger.
- **Ongoing compliance costs**: The primary ongoing compliance costs relate to the risk controls that are implemented, including the ongoing reporting requirements. We anticipate that these would be relatively modest, in the order of $100,000 p.a., and far less than the value of the benefits that would arise from the changes.

We also note that the implementation of a full matching adjustment regime (which is not being contemplated) would involve considerably greater implementation and ongoing compliance costs, both for individual insurers and APRA in undertaking its supervisory activities.