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Dear [REDACTED]

RE: Capital settings for longevity products – Information Paper

The Financial Services Council (FSC) welcomes the opportunity to comment on APRA's Information Paper outlining proposed changes to capital settings for longevity products. The FSC supports the direction of these reforms, which aim to promote a more competitive and sustainable market for annuity and other longevity-linked products. These changes are timely and necessary, particularly in light of the Retirement Income Covenant, which has sharpened the focus on delivering better retirement income outcomes for superannuation fund members.

While the retirement income market remains heavily concentrated in account-based pension products, the proposed reforms have the potential to support greater product innovation and improve access to income streams that provide protection against longevity risk. Expanding the availability of such products will provide consumers with more choice and help address identified gaps in the retirement phase of superannuation.

It is critical that APRA's final approach strikes the right balance between maintaining prudential soundness and enabling innovation. While many of the proposed changes are well-targeted and appropriate, there are a number of areas where further clarification and refinement will be essential to ensure the framework is effective, proportionate and fit for purpose.

This submission highlights several key areas where clarification or adjustment would support better implementation outcomes. In addition, a detailed response to the specific questions posed in the consultation is provided at *Attachment A - Consultation Paper Question Responses*.

About the Financial Services Council

The FSC is a peak body which sets mandatory Standards and develops policy for more than 100 member companies in one of Australia's largest industry sectors, financial services. Our Full Members represent Australia's retail and wholesale funds management businesses, superannuation funds, and financial advice licensees.

The financial services industry is responsible for investing more than \$3 trillion on behalf of over 15.6 million Australians. The pool of funds under management is larger than Australia's GDP

and the capitalisation of the Australian Securities Exchange and is one of the largest pools of managed funds in the world.

Support for the Proposed Changes

The FSC and its members are broadly supportive of APRA's proposed changes to capital settings for annuity and longevity products. The reforms represent a positive and necessary step toward better aligning prudential settings with the long-term nature of retirement income liabilities and encouraging a more competitive and innovative market for guaranteed income products.

Under the current framework, overly conservative treatment of illiquidity and limited recognition of cashflow matching have constrained the commercial viability of annuity products. The proposed changes would help address these issues by:

- Improving product pricing and consumer outcomes through more accurate recognition of illiquidity premiums, potentially allowing for higher annuity payments to retirees;
- encouraging product innovation and market diversity, supporting a broader range of longevity-linked offerings in line with the objectives of the Retirement Income Covenant;
- enhancing competition by reducing barriers to entry and allowing a wider group of life insurers to offer annuity products on a level playing field;
- better aligning capital requirements with underlying risks through recognition of hold-to-maturity investment strategies and long-term matching; and
- improving capital resilience by reducing pro-cyclicality and making the capital framework more risk-sensitive and stable across economic cycles.

The FSC supports APRA's goal of strengthening the retirement income system while maintaining prudential soundness and looks forward to engaging further as implementation details are finalised.

RECOMMENDATION 1

Proceed with the proposed reforms, as they are expected to improve competition, enhance pricing outcomes for retirees, and strengthen capital management frameworks.

Asset Allocation and Capital Resilience Impacts

The proposed changes are expected to influence insurer asset allocation decisions by encouraging increased investment in longer-duration, higher-yielding debt instruments that more closely match the profile of annuity liabilities. In particular, the revised illiquidity premium framework may incentivise greater exposure to investment-grade corporate bonds and global

fixed income assets, especially where the domestic bond market lacks sufficient depth.

FSC members note that the impact of these reforms will vary depending on each insurer's investment strategy. Insurers with more conservative or highly rated portfolios may see limited benefit if the revised benchmark spread reduces the calculated illiquidity premium. This may, in turn, favour those providers already operating with more complex or credit-oriented strategies, potentially entrenching market advantages for incumbents.

While the direction of the changes is expected to support stronger asset–liability matching and improve the economic alignment of capital requirements, their effect on resilience under stress may be mixed. As the proposed approach reduces the pro-cyclicality of capital requirements relative to the current framework, it does not fully eliminate it. In stress scenarios where spreads widen due to rising credit risk, asset values will still decline more than liability values unless the illiquidity premium fully offsets the spread increase, which is unlikely. As such, capital requirements may still rise, albeit to a lesser extent than under the current regime.

From a capital management perspective, however, the changes are still expected to improve capital efficiency under normal conditions by removing pro-cyclical distortions that can otherwise amplify capital strain during periods of market volatility.

Operational Considerations

While some FSC members consider the proposed changes to be broadly feasible to implement, this may not be the case for all providers. The risk controls APRA intends to implement (particularly around reporting, monitoring and compliance) are not yet clearly defined. Depending on their scope, these controls could impose a significant operational burden.

Implementation may be relatively straightforward for insurers who choose not to adopt the alternative standards, or who update their capital calculations without materially changing investment strategy. However, for those seeking to fully leverage the proposed changes to reduce the cost of offering annuity products, implementation is likely to be more complex. This may require substantial changes in asset allocation, as well as the development of new internal capabilities in investment management and portfolio monitoring, or the outsourcing of these functions to specialist providers.

RECOMMENDATION 2

Explore further flexibility or transitional options to minimise any unintended impacts of the new framework to ensure that it does not unintentionally encourage excessive credit risk or disadvantage more conservative providers.

Implementation Practicalities and Clarifications

FSC members consider the proposed changes to be largely practical to implement, with minimal model redevelopment required once final parameters and guidance are released.

However, several areas would benefit from further clarification to ensure consistent and efficient implementation across the industry. These areas include:

- **Appointed Actuary Attestation** - Further detail is needed on the format and process for the proposed attestation by the Appointed Actuary. The FSC suggests this requirement could be met through enhancements to the Actuarial Valuation Report under CPS 320, rather than a standalone process;
- **Cashflow Matching and Hold-to-Maturity Treatment** - While data on asset-liability matching is already collected as part of standard ALM practices, the reference to “hold-to-maturity” assets may imply a stricter standard than currently applied. If interpreted narrowly, it could limit portfolio flexibility or discourage efficient investment decisions; and
- **Scope of Products** - APRA should clarify which products fall within the scope of the revised illiquidity premium framework. It would be useful to confirm whether and how the changes apply to emerging retirement income products that combine insurance and investment features.

Further clarity in these areas would assist FSC members with their understanding of the changes to ensure a smooth implementation of the changes can occur with reduced regulatory burden and cost.

RECOMMENDATION 3

Further guidance to be provided on actuary attestations, cashflow matching and the scope of products as part of the final framework to support consistency and avoid unintended implementation challenges.

Advice Accessibility and Product Uptake

Although APRA’s review rightly focuses on the capital framework, other barriers are also limiting the broader uptake of appropriate retirement income solutions, including products that specifically address longevity risk, such as lifetime annuities.

In practice, many consumers struggle to access advice on appropriate retirement income solutions, including products designed to address longevity risk, such as lifetime annuities. There are relatively few advisers with the necessary training and accreditation to provide advice in this area.

The cost of personal advice remains high, often putting it out of reach for consumers with modest superannuation balances. At the same time, superannuation trustees are also limited in their ability to provide simple, scaled advice directly to consumers in a cost-effective way.

While these matters are primarily being addressed through Treasury’s Delivering Better

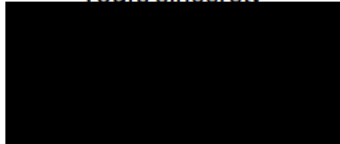
Financial Outcomes reforms, APRA can recognise the important role of accessible advice in supporting better retirement outcomes. This would strengthen the case for regulatory settings that support more accessible advice in retirement.

RECOMMENDATION 4

APRA recognise the role of proposed reforms designed to increase the accessibility of advice, including in support of awareness and uptake of appropriate retirement income solutions (including products that address longevity risk where this is appropriate for the individual).

The FSC welcomes the opportunity to meet to discuss the matters outlined in this submission. If you would like to arrange a meeting, please do not hesitate to contact me.

Yours sincerely



Policy Manager, Investments and Superannuation

Attachment A: Consultation Paper Question Responses

Table A – Proposed changes to redesign the illiquidity premium	
Factor applied to spread	<i>How should an insurer determine the appropriate risk adjustment to the spread given a reference benchmark/portfolio?</i> An appropriate liability discount rate can be constructed from a reference interest rate by applying a deduction to reflect inherent credit and liquidity risks. This is typically expressed as 100% of the reference interest rate less a deduction for expected future defaults in the reference portfolio – the “Risk Adjustment.” <i>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?</i> The FSC considers that the Risk Adjustment is best expressed as a percentage of the long-term average spread, rather than the current spread. This approach helps mitigate the effects of market cyclicity, recognising that wider spreads often reflect lower liquidity rather than higher credit risk.
Benchmark/Reference	<i>How should an insurer select an appropriate reference point/portfolio given the criteria imposed by APRA?</i> An appropriate reference portfolio should: - Consist of investment-grade debt instruments; - Be globally diversified to avoid sectoral biases present in the domestic market; and - Have a tenor that aligns with the duration of the liabilities, without arbitrary caps. Global fixed income markets (particularly the United States) may offer more appropriate instruments than are available in Australia. However, it is important to recognise that investing in non-Australian dollar instruments introduces additional currency and policy risks, which should be considered when constructing and calibrating the reference portfolio.
Long-term Rate Implementation	<i>Could an insurer match cashflows to the cut-off point?</i> Insurers can feasibly match cashflows beyond the current 10-year horizon. However, due to limitations in the depth and tenor of the Australian fixed income market, a well-matched portfolio will likely require material investment in offshore fixed income assets, particularly in the US. <i>Should the increase be applied to the spot rate instead of the forward rate?</i>

	The increase should be applied to the forward rate to avoid ‘cliff risk’ and to ensure consistency with market-consistent valuation principles.
Long-term (Ultimate) Rate	<i>How should an insurer determine an appropriate long-term illiquidity premium that is able to be earned under stressed conditions given reinvestment risk?</i> When liabilities are cashflow-matched, the illiquidity premium earned effectively represents the excess return on the asset portfolio relative to the reference rate, net of expected defaults. Historical experience and stress-tested models should inform the sustainable premium.
Cap	<i>How should an insurer ensure that the illiquidity premium formula remains appropriate in extremely stressed circumstances?</i> The FSC agrees that the formula must be robust under stress. Expressing the Risk Adjustment as a percentage of long-term average spreads on a benchmark index can provide resilience and consistency in stressed conditions.
Table B – Proposed risk controls	
Appointed Actuary attestation	<i>How should an insurer define cashflow matching within an acceptable level of risk?</i> Cashflow matching should be addressed within an insurer’s Internal Capital Adequacy Assessment Process (ICAAP). While exact matching is limited by market uncertainty, insurers should aim to minimise mismatch risk and structure portfolios to provide earlier liquidity where feasible. <i>How should an insurer define a stressed scenario?</i> A stressed scenario should assume elevated default rates and consider the degree of asset-liability mismatch. These assumptions should be embedded within the insurer’s broader ICAAP and resilience testing programs. <i>How should an insurer determine that it will attain the spread above risk free rate with a high level of confidence?</i> This should be supported by historical performance, actuarial analysis, and internal modelling, allowing insurers to demonstrate confidence in achieving the expected spread under a range of conditions.
Additional reporting to APRA	<i>How should an insurer evidence cashflow matching with hold-to-maturity assets to APRA?</i> The FSC supports APRA being able to rely on the attestation of the

	Appointed Actuary, as proposed in the consultation. If required, this can be supported by an annual report outlining projected gross and net cashflows from assets, liabilities, and relevant derivatives. <i>In what level of detail should assets supporting annuities be reported to APRA?</i> Asset reporting should occur at the individual asset level on a quarterly basis. This level of detail is achievable and appropriate for regulatory oversight.
Restrictions on assets	<i>How should an insurer determine an appropriate asset mix to achieve both matching and the required yield without material changes to risk?</i> The objective should be to ensure the asset portfolio provides the required cashflows to meet liability payments as they fall due. If cashflows are matched appropriately, insurers can achieve the required yield while managing risk exposures within acceptable parameters.
Additional consultation paper questions	
Proposed changes to the illiquidity premium	<i>APRA seeks general feedback on the approach as well as feedback on the questions outlined in Table A of this Paper.</i> Please see general feedback on the proposals contained within the body of the letter.
Risk controls	<i>What risk controls outlined in Table B would you suggest as being appropriate, effective and practically achievable for industry?</i> The FSC supports the risk controls proposed by APRA, particularly those relating to cashflow matching and demonstrating confidence in achieving the illiquidity premium. These controls are both practical and effective, provided they allow for flexibility in implementation given the diversity of product design and asset sourcing across the industry.
Impact	<i>What impact will the change in illiquidity premium have on your entity's asset allocation and capital resilience (e.g. ICAAP)?</i> The FSC considers that the proposed changes will strengthen capital resilience by providing a more appropriate valuation of liabilities, particularly during periods of market stress. As a result, we expect to see a gradual increase in the weighting of debt assets in insurers' balance sheets. The enhanced alignment of liability valuation with asset characteristics will support more efficient capital management and reinforce ICAAP frameworks. <i>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?</i>

The FSC considers that the selection of the reference benchmark and the calibration of the Risk Adjustment will have the most significant impact on both liability valuations and product pricing. These parameters directly influence the magnitude and stability of the illiquidity premium and are central to the success of the proposed reforms.

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?

The FSC anticipates that the proposed changes will enable modest reductions in annuity pricing, largely due to lower capital requirements for appropriately cashflow-matched portfolios. However, the broader and more meaningful benefit will be increased competition in the annuity market, allowing more life insurers (beyond the dominant provider) to offer competitively priced retirement income products without increasing policyholder risk. In this context, the FSC views the proposed changes as worthwhile and aligned with APRA's policy objectives.

What potential unintended consequences might arise from the proposed changes?

A key potential unintended consequence relates to the selection of the reference index. The Australian corporate bond market is relatively narrow and shorter in duration compared to the liability profile of typical lifetime annuities. If a domestic index is mandated, it may fail to capture the risk characteristics relevant to long-dated liabilities, particularly under stressed conditions. This may inadvertently discourage the use of more appropriate global fixed income assets for matching purposes.

In addition, life insurers may face offsetting costs that reduce the benefit of lower capital requirements. These include increased reporting and compliance obligations, as well as the need to build more sophisticated investment capabilities. Smaller or less specialised insurers may face challenges in implementing the asset strategies needed to fully realise the intended capital efficiency gains.

There is also a risk of overconcentration in illiquid instruments, such as long-dated corporate bonds. While these may optimise capital treatment, they could reduce portfolio flexibility and increase exposure to credit and default risk. Finally, the framework may reduce responsiveness to market conditions, as some insurers may hesitate to rebalance portfolios if such changes risk disqualifying assets from

	receiving the illiquidity premium.
Scope	<i>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?</i> The FSC recommends that future enhancements to the LAGIC framework include recognition of diversification benefits from asset classes with low correlation to broader financial markets. Additionally, refinements to capital charges for longevity risk and product innovation (such as deferred or pooled annuities) should be prioritised. These changes would encourage product development and enhance the financial security of retirees.
Other issues: products with withdrawal/surrender risks	<i>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?</i> Application of the illiquidity premium to liabilities with material policyholder liquidity options presents significant challenges. The FSC considers that this would require sophisticated modelling and a deep understanding of policyholder behaviour, especially under stressed market conditions. For products with high surrender risk, the illiquidity premium would likely need to be constrained or excluded to ensure prudential soundness.