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TAL submission to Capital Setting for Longevity Products consultation

TAL Life Limited welcomes the opportunity to provide input on APRA's consultation on capital settings for longevity products.

TAL is supportive of APRA's commitment to enable a more innovative and competitively priced longevity products, along with the Government's objective to expanding options for retirees to manage longevity risk.

TAL acknowledges APRA's proposal to allow greater flexibility in the magnitude of parameters within the prescribed formula for calculating the illiquidity premium, alongside a framework that better reflects the underlying risks. This represents a positive and constructive step forward in supporting the development of the retirement income market. We recognise that competitive pricing plays only one role out of many in addressing the low take-up of annuities in Australia, with underlying challenges being more structural in nature and extending beyond pricing considerations alone.

In reviewing the proposed changes to the illiquidity premium framework, TAL recognises there is a continuum of potential approaches ranging from a prescribed approach to a risk and principles-based approach. TAL recommends the determination of the illiquidity premium to be risk and principles-based in the long term as it encourages ongoing, sustainable development and innovation.

TAL recommends:

A more risk-based approach that encourages and rewards sophisticated risk management practices.

TAL believes the industry should move towards a risk-based approach as the market is rapidly maturing for sophisticated larger players. A prescribed approach may be more suitable for new entrants, while entities with mature ALM practices and risk controls should be able to access additional flexibility in illiquidity premium parameters subject to demonstrating appropriate ALM risk management through principles-based assessment.

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Flexibility in reference portfolio selection based on liability characteristics.

The selection of an appropriate reference portfolio should be grounded in a principles-based approach that prioritises the construction of a replicating portfolio tailored to the specific characteristics of the underlying liability structure. TAL believes insurers should not be restricted to local markets and should be open to international markets such as the US, which has deeper markets for available assets that may help improve durational mismatches.

Risk adjustment methodology based on long-term fundamentals rather than short-term market conditions.

The risk adjustment should be calculated based on fundamental components of credit risk - specifically probability of default multiplied by loss given default, plus appropriate allowances for downgrade risk and other non-hedgeable risks. This should reflect long-term default/downgrade risk rather than short-term market conditions to avoid unwarranted volatility, especially in times of stress.

Extension of illiquidity premium to all illiquid liabilities with predictable cashflows.

The liquidity premium should apply consistently wherever there are illiquid liabilities, including any benefits paid as predictable cashflows such as disability income benefits. This principles-based approach would best support innovation occurring in retirement income.

The Insurance Capital Standard (ICS), issued by the International Association of Insurance Supervisors (IAIS), is the emerging global capital standard that takes a principles-based approach to applying illiquidity premiums to illiquid liabilities. The key guidance outlines permissible adjustments to risk-free rates by classifying liabilities into three buckets: top, middle, and general. This approach broadens the application of illiquidity premiums beyond annuities to include disability income Open Claims Reserves (OCR).

Under AASB17, Fulfilment Cash Flows (FCF) must account for the illiquidity characteristics of liability cash flows, allowing illiquidity premiums for certain liabilities. TAL currently applies illiquidity premiums to its annuity, traditional non-participating account, IBNR, and OCR liabilities.

Both of these standards take a consistent and principles based approach across all illiquid liabilities rather than just an annuity product only category, and TAL recommends that it would be appropriate to extend this to LAGIC.

It is also worth noting that TAL backs part of its OCR liabilities with a life insurance group annuity contract. The proposed adjustments would extend the inconsistency in treatment of the assets and liabilities in this regard as TAL cannot apply an appropriate illiquidity premium to OCR for LAGIC capital, but the group insurer could to the equivalent liability. This differential treatment creates regulatory inconsistencies within the same economic arrangement.

TAL is concerned that the restrictive treatment of illiquidity premiums (currently limited to annuities) may create and incentivise regulatory arbitrage opportunities. A more efficient approach would be to apply illiquidity premiums consistently to illiquid liabilities in general, reflecting their true economic characteristics and ensuring consistent regulatory treatment across similar risk profiles to support appropriate risk management across the life insurance industry.

Risk controls proportionate to the level of discretion applied.

The level of additional risk controls and governance should be commensurate with the level of risk not already reflected in capital held and proportionate when compared to peer jurisdictions. Risk controls

should leverage existing mechanisms under APRA's regulatory framework, including Appointed Actuary attestation through the FCR, AVR, and ICAAP processes, and review by external audit.

Technical Framework Considerations:

TAL supports APRA's approach of expressing the risk adjustment as a percentage of long-term average spreads rather than current spreads, which provides necessary objectivity while maintaining appropriate risk sensitivity. Historical credit spread experience shows that market spreads materially over-respond to stress events relative to actual default risk, making prevailing spreads an unreliable proxy for estimating losses from asset defaults.

TAL believes that the treatment of asset risk in the Prescribed Capital Amount (PCA) should be consistent with any allowance for the illiquidity premium. Under stress conditions, the illiquidity premium used for liabilities should be consistent with the increase in spreads for the chosen benchmark, properly reflecting default risks while recognising differences in illiquidity between assets and liabilities.

Broader LAGIC Framework Enhancements:

Beyond illiquidity premium improvements, TAL recommends APRA consider additional changes to support retirement product development, including:

- Principles-based longevity stress margin calibrated by the Appointed Actuary, aligning with approaches used for other stress margin factors
- Addressing components of the Asset Risk Charge (ARC) that currently favour short duration bonds, introducing reinvestment risk that interacts with illiquidity premium magnitude and duration
- Reviewing the standard formula's inability to capture probability of downgrades
- More holistic alignment between LAGIC and broader Government policy on retirement products

Implementation Impact:

For TAL specifically, the proposed changes will have an immaterial impact on the current annuity portfolio but will enable more risk sensitive capital levels and higher capital resilience for future guaranteed annuity business that avoids unnecessary asset derisking in times of stress. We believe these changes will promote market competition however we acknowledge that competitive pricing is only one component in bolstering retirement segment activity.

TAL is supportive of the proposed changes and views this as a constructive step toward embedding risk-based principles in the industry's determination of illiquidity premium while providing appropriate time and opportunity for market experience to develop as the industry matures.

We anticipate that the Australian retirement income market will continue to develop and mature in the coming years, creating opportunities for more sophisticated risk management approaches. The proposed changes represent a foundation for this evolution while maintaining appropriate prudential standards. It will also support the development of the long term Australian corporate bond market.

The attached submission provides our detailed technical response to the consultation questions. We would welcome the opportunity to discuss any aspects of our submission in further detail.

About TAL

TAL is one of Australia's leading life insurers. Together with our partners, we protect over 5 million Australians against the financial risks of death, disability, and illness. In 2023-24 we paid more than \$4 billion in claims to over 50,000 customers and their families. We provide life insurance cover in several different ways – through our partnerships with superannuation funds, financial advisers, and directly to customers through digital and other platforms.

TAL is a part of the Japan based Dai-ichi Life Group. Starting with the Dai-ichi Life Insurance Company, which was established in 1902 as Japan's first mutual insurance company, today the Dai-ichi Life Group is one of the world's largest life insurance groups. Dai-ichi Life Group is also one of the world's leading providers of retirement income products.

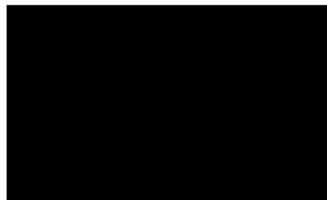
For further information

Should you have any questions regarding the information in this submission, or about TAL generally, we would be pleased to assist. Please contact in the first instance [REDACTED], General Manager Actuarial, on [REDACTED], or by email at [REDACTED].

Yours sincerely,



Chief Financial Officer
TAL



Chief Risk Officer
TAL

Table 1 – Feedback on high-level Consultation Paper questions

Area	Question and Response
Illiquidity Premium Proposals	1. APRA seeks general feedback on the approach as well as feedback on the questions outlined in Table A of [the Consultation] Paper. TAL's detailed responses to questions outlined in Table A of the Consultation Paper are set out in the table below. TAL welcomes APRA's initiative to review the capital standards to support increased activity in the retirement segment. TAL acknowledges APRA's proposal to allow greater flexibility in the magnitude of parameters within the prescribed formula for calculating the illiquidity premium, alongside a framework that better reflects the underlying risks. This represents a positive and constructive step forward in supporting the development of the retirement income market. TAL also recognises that the ability to offer competitive annuity pricing plays only one role out of many in addressing the low take-up of annuities or other lifetime income stream products in Australia. The underlying challenges are more structural in nature and extend beyond pricing considerations alone. In reviewing the proposed changes to the illiquidity premium framework, TAL recognises there is a continuum of potential approaches ranging from a prescribed approach to a risk and principles-based approach. TAL recommends the determination of the illiquidity premium to be risk and principles-based in the long term as it encourages ongoing, sustainable development and innovation, acknowledging that APRA may choose to take a hybrid approach whilst the market matures. The proposed changes represent a constructive step toward embedding risk-based principles in the industry's determination of the illiquidity premium while providing appropriate time and opportunity for market experience to develop as the industry matures. TAL encourages APRA to enable a principles and risk-based approach wherever possible to supplement prescriptive approaches as it will support the market developing and maturing at a time where the consequences of any downside risks are relatively limited. With APRA's proposed changes, TAL views that the move towards a risk-based approach as important for the sophisticated larger players, whilst a prescribed approach may be more suitable for new entrants. For entities with mature ALM practices and risk controls, TAL believes that it is appropriate to access the additional flexibility in the illiquidity premium parameters subject to demonstrating the appropriateness of the selected parameters using principles-based assessment suggested in our response below. The treatment of asset risk in the Prescribed Capital Amount (PCA) should be consistent with any allowance for the illiquidity premium. In particular, LPS 114 specifies an increase in credit spreads and a risk of default. Under the stress, the illiquidity premium used for the liability should be consistent with the increase in spreads for the chosen benchmark under the assumed stress conditions. It is important to recognise the increase in spreads specific in LPS 114 excludes default risks, which are considered separately. With the correct treatment the PCA will reflect the default risk that is inherent in the assets and differences in illiquidity between the assets and liabilities.

2. What risk controls outlined in Table B [of the Consultation Paper] would you suggest as being appropriate, effective and practically achievable for industry?

There should be a clear view on the asset strategy where risk controls should include:

Appointed Actuary Attestation Framework

With expanded flexibility in parameters in the determination of the illiquidity premium, it is practical and prudent to delegate the compliance of risk controls via an Appointed Actuary attestation process.

This can be performed in one of the FCR, AVR, or ICAAP, but may also be a separate paper that is provided to APRA where the AA is seeking approval of changes from the standard approach, for example where the AA proposes to make adjustments to the reference portfolio subject to APRA approval. It would also be subject to review from the external auditor.

Quantitative Analysis (assess ability to earn illiquidity premium in current market conditions)

To demonstrate the illiquidity premium is appropriate, it would be appropriate that the insurer be required to perform quantitative analysis including:

- Cash flow matching
- Matching by key rate duration buckets for longer term cashflows
- Hold-to-Maturity capability
- Reinvestment risk quantification
- Stress testing

This would be both forward looking as well as an analysis of actual experience.

Policy Integration and Governance

Internal investment policies and other relevant policies should also reflect the management philosophy for products which utilise the illiquidity premium. In TAL's case, this would be governed by the Investment Governance Framework, which is overseen by the Asset and Liability Committee (ALCO).

Ongoing Monitoring Requirements

This would include analysis of the following that would be included as part of the attestation framework:

- Matching effectiveness / matching ratio
- Credit rating monitoring
- ALM matching experience – analysis of actual versus expected illiquidity premium realisation to validate assumptions and identify emerging risks
- Reinvestment effectiveness
- Asset concentration

3. APRA seeks feedback on the questions outlined in Table B of [the Consultation] Paper.

TAL's detailed responses to questions outlined in Table B of the Consultation Paper are set out in the table below.

4. Are there other risk controls APRA should consider?

Further information can be found in Table A and B below where other risk controls APRA could consider include:

- Ongoing monitoring of matching effectiveness / matching ratio i.e. regular assessment of how well assets and liabilities remain aligned over time. These can include matching ratios, duration gap analysis, sensitivity and stress analysis.
- Credit quality of the portfolio – regular credit quality surveillance, concentration risk and early warning indicators of credit deterioration.
- Illiquidity premium validation - monitoring the actual vs expected illiquidity premium to validate assumptions and identify emerging risks.
- Reinvestment effectiveness - how successfully maturing assets are reinvested whilst maintaining the illiquidity premium.

Impact

5. What impact will the change in illiquidity premium have on your entity's asset allocation and capital resilience (e.g. ICAAP)?

There would be an immaterial impact to TAL given current annuity volumes are low. TAL plans to write more guaranteed annuity business in the future, particularly via our superannuation partners, and the change in the illiquidity premium will, all other things being equal, result in a more appropriate level of capital and higher capital resilience than with the current basis.

For guaranteed lifetime annuity new business, TAL would naturally increase assets allocated to those in or equivalent to the reference benchmark portfolio (or any agreed adjustments to it).

6. Having regard to the overall objective of the changes (as outlined in Chapter 1 [of the Consultation Paper]), which changes set out in Table A would have the greatest impact?

TAL believes that the ability to select a reference benchmark and the factor spread would have the greatest effect, as it enables the insurer to reflect the characteristics of the underlying assets into the liabilities, via the spread over the risk-free rate. There would need to be a material increase in the factor spread to ensure sufficient risk sensitivity in the liabilities to achieve the aims of supporting the growth in the annuity market.

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?

TAL expects that the proposed changes will have a moderate impact to guaranteed annuity pricing, benefiting customers and supporting the development of the marketplace. Although this move will allow insurers to offer more competitive annuity rates, TAL acknowledges that competitive pricing is a small component in the pursuit of bolstering market activity in the retirement segment. Additionally, our research shows that the annuity rate is not always the most important consideration for the purchase of annuity.

Overall, TAL is supportive of the proposed changes and view this as a constructive step toward embedding risk-based principles in the industry's determination of an appropriate illiquidity premium while providing time and opportunity for the market to develop and mature.

8. What potential unintended consequences might arise from the proposed changes?

There are some potential unintended consequences from the proposed changes:

- One consequence that APRA should be aware of is that the determination of the reference benchmark would likely have a material impact on the demand for corporate debt assets in or equivalent to that benchmark. Given the potential size of the annuity market that could develop over the next decade or two, this may result in material investment flows into either the Australian or international capital markets. It would be ideal if an Australian reference benchmark could be constructed that meets the needs of the Australian retirement income market and supports the Australian economy through supply of longer dated debt at more attractive borrowing rates to corporate Australia. Given the current corporate debt supply limitations in the Australian market, TAL believes it therefore appropriate to utilise international reference benchmarks, but importantly, the ability to adjust the reference benchmark could provide a mechanism for APRA to also support the extension of the Australian corporate debt market into longer dated securities. Giving insurers the ability to specify and adjust the reference benchmark is the mechanism to achieve this. This could involve joining an Australian benchmark at shorter durations with an international one at longer durations and adjusting the duration attachment point over time as the debt market hopefully expands.
- If APRA decides to maintain a prescriptive formulaic approach to the calibration of the illiquidity premiums, then an unintended consequence of this is that it will provide a disincentive for insurers to enhance their ALM and liquidity risk management frameworks for this business.

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?

The longevity stress margin should be principle-based and calibrated by the Appointed Actuary, aligning with the approach used to calibrate other stress margin factors, and subject to the standard liability valuation assumption review by external audit. For new entrants, the prescribed formula could remain available as an starting reference point. The current prescribed stress of a uniform 20% reduction in mortality rates across all ages is intended to capture all aspects of longevity risk — including mis-estimation, mortality improvement trend risk, basis risk, and others. However, this formula does not distinguish between diversifiable and non-diversifiable components of longevity risk. A risk- and principle-based approach would enable insurers to reflect their specific exposure to longevity risk more appropriately.

The components of the ARC (e.g. credit spread stress) favours short duration bonds which introduces reinvestment risk. This interacts with the magnitude and duration of the illiquidity premium, reflecting the actual matching level and horizon. Additionally, the standard formula does not capture the probability of downgrades.

Separately APRA should consider that the illiquidity premium should apply consistently wherever there are illiquid liabilities. This includes any benefits that are paid as a predictable cashflow, such as disability income open claim reserves.

As per the IAIS's Insurance Capital Standard (ICS) the key guidance outlines permissible adjustments to risk-free rates to be applied to the illiquid liabilities. This approach broadens the application of the adjustment beyond annuities to include the OCR. Specifically, under paragraphs 131-138 it is required to classify the liabilities into a three-bucket approach i.e. Top, Middle and General bucket depending on the nature of the liabilities. A

different yield curve adjustment is determined for each bucket. For example, insurance liabilities are eligible for the Top bucket if they meet all of the following criteria (para 133):

- a) They belong to the category of life insurance and disability annuities in payment with no cash benefits on withdrawal, taking into account (e) below.*
- b) The portfolio of assets to cover the insurance liabilities is identified and, together with the corresponding liabilities, it is managed separately, without being used to make payments relating to other business of the IAIG.*
- c) The expected cash flows of the identified portfolio of assets replicate the expected cash flows of the portfolio of insurance liabilities in the same currency up to the LOT of the risk-free yield curve for the relevant currency. Any mismatch, addressed through the carry forward of cash generated from excess asset cash flows at previous maturities, does not give rise to material risks. Carry forward of cash is limited to 10% of the total undiscounted liability cash flows up to the LOT. Where insurance liabilities are backed with assets denominated in a different currency cash flows are taken into account in the cash flow testing, provided that the currency mismatch is fully hedged and the cost of hedging is deducted from the asset cash flows.*
- d) The contracts underlying the insurance liabilities do not include future premiums.*
- e) The portfolio of insurance liabilities includes either no surrender option for the policyholder or only a surrender option where the surrender value does not exceed the value of the assets identified for this portfolio at the reporting date and at all future points in time.*

Following ICS's framework, TAL would be eligible to classify both annuities and the OCR into the 'Top' bucket which is reflective of the ICS standard moving towards a principle-based risk focussed approach.

Under AASB17, Fulfilment Cash Flows (FCF) must account for the illiquidity characteristics of liability cash flows, allowing illiquidity premiums for certain liabilities. TAL's current practice already reflects this principle and applies the illiquidity premiums to its annuity, traditional non-participating account, IBNR, and OCR liabilities. A consistent approach between accounting and capital frameworks is thus recommended.

Both of these standards take a consistent and principles based approach across all illiquid liabilities rather than just an annuity product only category, and TAL recommends that it would be appropriate to extend this to LAGIC.

It is also worth noting that TAL back part of its OCR liabilities with a life insurance group annuity contract. The proposed adjustments would extend the inconsistency in treatment of the assets and liabilities in this regard as TAL cannot apply an appropriate illiquidity premium to OCR for LAGIC capital, but the group insurer could for the equivalent liability. This differential treatment creates regulatory inconsistencies within the same economic arrangement.

TAL is concerned that the restrictive treatment of illiquidity premiums (currently limited to annuities) may create and incentivise regulatory arbitrage opportunities. A more efficient approach would be to apply illiquidity premiums consistently to illiquid liabilities in general, reflecting their true economic characteristics and ensuring consistent regulatory treatment across similar risk profiles to support appropriate risk management across the life insurance industry.

Other issues: products with
withdrawal/ surrender risks

10. As outlined in Chapter 2 – Other issues [of the Consultation Paper], if the illiquidity premium were to apply to products with withdrawal/surrender risks, how would an insurer ensure that the illiquidity premium is appropriate and achievable under both normal and stressed circumstances?

An insurer would need to consider where under normal or stressed circumstances that the illiquidity premium can be maintained where the surrender value of a policy exceeds the expected future cashflows. This may be somewhat mitigated by applying surrender penalties to ensure that the surrender values are below the expected future cashflows or in stressed situations may only consider partial illiquidity premiums. In TAL's view, the principles based risk framework is the right approach to determine and manage the illiquidity premium for other products with withdrawal / surrender risks, as it would need to be appropriately adjusted for these additional risks.

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

Table A – Feedback on proposed changes to redesign the illiquidity premium			
Illiquidity premium formula component	Current	Potential changes	Question and Response
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 with tenors up to 10 years	1. How should an insurer select an appropriate reference point/portfolio given the criteria imposed by APRA? TAL believes that the selection of an appropriate reference point/portfolio should be grounded in a principles-based approach that prioritises the construction of a replicating portfolio tailored to the specific characteristics of the underlying liability structure. In supporting a principles risk-based approach, TAL's view is that the universe of assets that it may invest in should not be constrained to the local markets and is open to international markets such as the US and Europe which have deeper markets for longer duration corporate debt assets that may help in harvesting the illiquidity premium supporting long duration liability cash flows. This also encourages competition and reward for those that are able to better match liabilities at longer durations. In addition, it is in TAL's view that companies should ideally not be restricted to using a prescribed index as products can have different liability profiles. It may be entirely appropriate that multiple reference benchmarks are used if the liability profiles are sufficiently different reflecting unique annuity product characteristics (e.g. duration, death / withdrawal / surrender benefits). Reference benchmarks may include traded instruments such as interest rate and inflation derivatives that support the matching objectives. A weighted average of indices and derivatives may be appropriate to achieve the appropriate outcome. The Appointed Actuary should have the flexibility to either determine or make adjustments to a reference benchmark to reflect the underlying liabilities and their specific risk characteristics. The reference portfolio should consider the asset characteristics, market observability (i.e. whether assets are actively traded with observable market prices), the degree of diversification / concentration risk, and the duration profile.
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	2. How should an insurer determine the appropriate risk adjustment to the spread given a reference benchmark/portfolio? TAL believes that a comprehensive risk-based approach should be the foundation for determining the appropriate risk adjustment to the spread. This approach should be grounded in empirical evidence and established actuarial principles. The risk adjustment should be calculated based on the fundamental components of credit risk, specifically the probability of default multiplied by loss given default, plus an appropriate allowance for downgrade risk, currency risks (if applicable) and other non-hedgeable risks including model risk. This methodology aligns with international standards

percentage of the long-term average spread

such as the Solvency II framework, where the fundamental spread reflects the risks retained by insurers and captures the risk of default and credit downgrades.

Due to the shortage of indices in Australia, it may be challenging to find a suitable index for long duration liabilities, TAL is open to explore global indices where such indices do not exist locally. This recognises the limited size of the Australian financial market and is consistent with TAL's strategy of seeking to diversify its asset risk premium by investing into deep, developed overseas markets. For example, the usage of a combination of local and global indices may be considered - for short term duration liabilities use Australian indices and for longer term use global indices. Global markets like the US have more data hence more credible experience on credit spreads and default rates which enhances the accuracy of estimating the illiquidity premium. They are also significantly deeper, more liquid and more diversified. Reference to a single domestic corporate bond credit-based index should not be prescribed as it may be too restrictive and constrain product development and pricing.

TAL believes it is important to support the development of the medium and long duration Australian corporate bond market, and the reference index should ideally start with a reference to the Australian market where it is sufficiently deep, liquid and diverse, and then switch to a global index thereafter. This would support the development of both the Australian annuity market, as well as economic growth through the supply of longer duration corporate debt at reasonable yields.

TAL recognises that the ability to select a reference portfolio is the most significant step towards a risk-based approach. However, this may be undermined by the use of default parameters in other aspects of the illiquidity premium. Therefore, we believe that for sophisticated players who choose to exercise this flexibility, adequate risk controls must be established to support the justification of the remaining parameters in determining the illiquidity premium.

The effectiveness of the Asset-Liability Management (ALM) strategy should be a primary consideration in applying the risk adjustment. Sound ALM practice requires alignment between assets and liabilities to manage risks effectively, and modern ALM monitoring should equip insurers with real-time data to make informed risk management decisions. The risk adjustment should therefore reflect the insurer's demonstrated ability to maintain effective cashflow matching and hold assets to maturity under various stress scenarios.

Historical experience should be leveraged to inform and calibrate the risk adjustment. This historical calibration should be based upon long-term credit default rates including over stress periods to ensure the risk adjustment reflects a comprehensive view of default risk rather than short-term market conditions that largely reflect risk perceptions and liquidity risks.

The risk adjustment methodology should ultimately balance the need for risk-sensitive capital requirements with practical implementation considerations, ensuring that insurers can demonstrate the appropriateness of their approach through quantitative analysis, stress testing, ongoing monitoring of actual versus expected performance, supported by appropriate risk controls with governance.

3. 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?

TAL supports the approach of expressing the risk adjustment as a percentage of the long-term average spread, with the illiquidity premium calculated as the benchmark spread less the risk adjustment. This methodology aligns with established principles-based approaches and provides the necessary objectivity while maintaining appropriate risk sensitivity.

			The risk adjustment can be appropriately represented as either a fixed basis point amount or as a percentage of the long-term spread, providing clear and consistent measurement across the industry. It should reflect the long-term default / downgrade risk rather than short term market conditions as it may introduce unwarranted volatility especially in times of stress. That is, any basis should avoid unnecessary liquidating matching assets in times of stress. The long-term average spread should be updated periodically based upon the data available specific to the reference benchmark. It is suggested that this would be at least annually, and a long-term average be calculated (at least 10 years, data permitting). Historical credit spread experience in times of stress (e.g. 2020 COVID-19 pandemic, 1997 Asian financial crisis and the 2008 Global Financial Crisis) shows that market spreads over-respond to stress events relative to actual default risk. The principles-based approach should be grounded in the concept of a replicating portfolio that reflects the actual characteristics of the liability cashflows. Investment decisions should reflect the most up-to-date valuations and quality assessment across the entire opportunity set, with careful consideration of the costs and risks associated with illiquidity. As mentioned earlier, the opportunity set need not be limited to Australia. The reference benchmark cannot be disconnected from the actual liability characteristics. The reference portfolio should reflect the illiquidity characteristics of the insurance contracts, and ALM functions should invest relative to the reference portfolio. The benchmark should be based on assets that are practically investable, liquid, and observable, with the flexibility for the Appointed Actuary to make appropriate adjustments based on the asset portfolio and specific retirement product benefit structures and features.
Long-term Rate Implementation	10 years	Increase long-term rate implementation from 10 years to between 10 and 20 years	4. 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? The cut-off point should reflect the duration beyond which asset and liability cash flows no longer maintain effective matching, requiring a corresponding reduction in the illiquidity premium which reflects potential reinvestment risks. The insurer should conduct a comparison of asset maturities against liability durations to identify any significant gaps or excessive reliance on future reinvestment. The cut-off point should be determined by assessing reinvestment risk where analysis should identify periods where the insurer becomes materially dependent on reinvestment at uncertain future rates. 5. Could an insurer match cashflows to the cut-off point? Yes, an insurer can match cashflows to the cut-off point (by definition), though the feasibility and effectiveness of this matching will depend on several key factors, primarily the insurer's investment strategy, past effectiveness in accessing future margins and the availability of long-duration assets in the market. 6. Should the increase be applied to the spot rate instead of the forward rate? It is TAL's view that the illiquidity premium be applied to the forward rate as it provides greater sensitivity to the duration specific risks. It is technically more correct as it aligns to the forward duration risks around reinvestment, particularly for longer liability durations.

Long-term (Ultimate) Rate	20 bp	Increase of long-term illiquidity premium from 20 bp to between 30 bp to 45 bp	7. How should an insurer determine an appropriate long-term illiquidity premium that is able to be earned under stressed conditions given reinvestment risk? It is difficult to prescribe what the ultimate long-term rate should be as it depends on the investment strategy, replicating approach and risk appetite. In principle it should be based upon the replicating portfolio where this can be quantified using techniques similar to those used for generating economic scenarios. A stochastic credit model can be calibrated using historical data on illiquidity premia, defaults, and loss given default, incorporating mean-reversion and regime-switching dynamics to reflect the mean-reverting behaviour of credit spreads. The selected long-term illiquidity premium should be one that remains supportable even under stressed conditions generated by the model. It is important to acknowledge that inherent model risk and expert judgement will play a role in both the calibration of the model and the definition of stress scenarios as no model can perfectly capture the complexity of credit markets during extreme stress events. In the event APRA takes a more prescriptive approach, we note long term analysis of US corporate debt suggests that the ultimate illiquidity premium (e.g. 75bps for US investment grade debt) is materially higher than APRA's proposal (30 to 45bps) even for relatively risk controlled strategies, hence APRA's proposal appears to be on the lower end of what could be justified. There could be additional risk controls to enable mature risk players to more specifically calibrate their long-term ultimate rates to their portfolios subject to AA and APRA review. It is worth noting that TAL uses an ultimate long term forward rate for nominal yields for valuation purposes at the 60-year duration mark. Given the shorter duration of corporate relative to government debt, it is appropriate that the long-term ultimate illiquidity premium rate start earlier, at around 20 years. As at 30 June 2025, the risk-free nominal forward rate at duration 20 was 6.23%. At this duration, a long-term ultimate illiquidity premium of say 75bps would represent a 12% increase above the risk-free nominal rate, which does not seem excessive.
Cap	150 bp	Increase cap from 150 bp to between 300 bp to 350 bp	8. How should an insurer ensure that the illiquidity premium formula remains appropriate in extremely stressed circumstances? TAL supports the removal of the cap as it acts against the purpose of what the liquidity premium is trying to achieve. The consequence of a cap means that in times of severe stress which typically does not reflect a change in real credit defaults, asset movements will be disconnected from liability movements, resulting in reductions to net assets. This will consequently put pressure on an insurance company to liquidate portfolios at times of stress, which typically can be at the bottom of the market. It is precisely this outcome that is not desirable for a life insurance company that is focused on long-term ALM. In the event that ARPA includes a cap we recommend that it should be referenced to analysis on the reference benchmark, ensure that it is not conservative (to minimise the risk of the above), and that there are additional risk controls that can be flexed with AA and APRA review / endorsement / approval. Framing the cap in terms of a statistical risk appetite (e.g. a 1 in 40 year stress equivalent to TAL's Target Surplus risk appetite) would be a useful way to ensure consistency of approach across the industry for varying reference benchmarks.

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

Table B – Feedback on proposed risk controls		
Area	Risk Control	Question and Response
Actuarial	Appointed Actuary attestation: - Liabilities are cashflow matched with hold-to-maturity assets within an acceptable level of risk over the period that the illiquidity premium is applied - Insurer can meet benefit payments as they fall due without resorting to selling assets in both a normal and stressed period - Insurer will attain spread above risk free rate with a high level of confidence	9. How should an insurer define cashflow matching within an acceptable level of risk? Cashflow matching within an acceptable level of risk should be defined through a comprehensive framework that demonstrates effective alignment between assets and liabilities while maintaining appropriate risk controls. - Cashflow matching – demonstrate assets meet liability cashflows on a year-on-year basis where beyond a certain period such as 10 years, years may be grouped into larger buckets (e.g. 5 yearly) reflecting the strong correlation between forward rates with similar terms. Any mismatch should be immaterial. - Hold to maturity – demonstrate sufficient liquidity elsewhere in balance sheet. - Reinvestment risk – compare asset maturities versus liability duration to identify material gaps / over reliance on reinvestment to fill gaps. This should limit the illiquidity premium for liabilities that are not yet matched. An insurer should also consider proportionality in defining the cashflow matching within an acceptable level of risk. Where insurance companies have materially less volumes of retained risk and levels of capital supporting the portfolio this will influence the degree of risk control/matching compared to a well-established player that has proportionally a larger amount of capital backing the liabilities. The acceptable level of risk should be included in the Risk Appetite Statement and agreed by the Board based upon AA advice. 10. How should an insurer define a stressed scenario? Scenarios should be consistent with ICAAP, target surplus framework and ICS to ensure coherent risk management across all regulatory and internal requirements. Stress scenarios should reflect the unique characteristics of the credit markets supporting the selected indices. Scenarios should include explicit consideration of management actions assumed during the stress period such as asset rebalancing capabilities, liquidity management actions, capital management measures and operational responses to changing market conditions. 11. How should an insurer determine that it will attain the spread above risk free rate with a high level of confidence? An insurer can use quantitative analyses suggested in responses 1d) and 2) to assess confidence of achieving the spread above risk free rate. In particular, the effectiveness of reinvestment is a key factor to consider. Back-testing of assumptions in the ALM model should form part of the core component of the confidence assessment. The governance process should provide appropriate oversight and validation of the confidence assessment e.g. independent review, expert oversight, documentation and escalation processes.

Governance	Insurer demonstrates compatibility between its governance processes and the adoption of the revised illiquidity premium.	12. How should an insurer demonstrate compatibility between its governance processes and adoption of the revised illiquidity premium? In addition to the Table 1 question 2) above, other governance considerations would include: • Including illiquidity premiums in the Investment Governance Framework. • Forming ALM committees which receive regular reporting on ALM performance • Ensuring credit performance is being monitored • Monitoring of surrender and longevity experience and how that impacts the best estimate basis
APRA Reporting	Additional reporting to APRA related to the illiquidity premium, for example: • Evidence of cashflow matching with hold-to-maturity assets including under stressed scenarios • Assets supporting annuities must be separately identified	13. How should an insurer evidence cashflow matching with hold-to-maturity assets to APRA? The primary evidence should be through the Appointed Actuary attestation. This may include evidence of the quantitative analyses as suggested in our response to Table 1 question 2) where it also may be an addition to the AVR (or FCR or ICAAP). For considerations around hold-to-maturity, insurers could provide portfolio turnover data (asset sold / total portfolio) as quantitative evidence of hold-to-maturity intent and capability. 14. In what level of detail should assets supporting annuities be reported to APRA? The level of reporting should be proportionate to the level of discretion applied in determining the illiquidity premium and its materiality on the overall capital position. Lower levels of discretion and materiality should be supported by higher level / aggregate reporting to APRA (and vice versa). Evidence of cashflow matching may be appropriate in addition to asset information.
Capital Asset Restrictions	Restrictions on assets backing annuity liabilities and capital requirements.	15. How should an insurer determine an appropriate asset mix to achieve both matching and the required yield without material changes to risk? The asset mix decision is an outworking of the company's strategy, including its Risk Management Framework. TAL believes best practice is for an insurer to determine an appropriate asset mix that balances cashflow matching, yield requirements where: • The asset mix should in principle match the liability cashflows in timing and amount, achieves a sufficient yield above the risk-free rate and does not materially increase overall credit, liquidity or market risk i.e. optimise yield without increasing capital charge • Assets have a balanced credit quality profile, be appropriately diversified, not disproportionately increase the ARC under LPS 114 or materially increase Target Surplus requirements and have a hold to maturity intent.

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

Asset Valuation Considerations

- Use of appropriate valuation methodologies that reflect the illiquid nature of assets
- Regular assessment of asset valuations to ensure liquidity parameters remain appropriate during stress
- Recognition that illiquid assets may trade at discounts to theoretical fair value affecting the sustainability of the illiquidity premium

Default Risk Assessment

Default risk should be quantified using historical data or modelled probability of default for each asset class incorporating loss given default risk, expected credit risk and scenarios that may model impact of downgrades.

Reinvestment Risk

Should be assessed with stress scenarios where credit spreads decrease.
