

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

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

Re: APRA Response Paper: Adjustments to the 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 response paper *Adjustments to the capital settings for longevity products* issued on 29 October 2025 (**Response Paper**) and accompanying draft standards (**Draft Standards**), following our 25 July 2025 submission in response to the consultation paper *Capital settings for longevity products* issued on 12 June 2025 (**Consultation Paper, 25 July Submission**).

Challenger welcomes the proposed changes outlined in the Response Paper and Draft Standards, and the move towards a more risk-sensitive and less pro-cyclical capital regime for annuity products, with improved alignment to peer jurisdictions.

Based on our analysis, we believe there are several refinements to the proposed capital framework that would further enhance APRA's objectives to incentivise market supply of annuity offerings, whilst maintaining insurer financial resilience.

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]
[REDACTED]
[REDACTED]
[REDACTED]

Sydney Level 2, 5 Martin Place, Sydney NSW 2000 Australia, GPO Box 3698 Sydney NSW 2001, Telephone 02 9994 7000
Melbourne Level 19, 31 Queen Street PO Box 297, Flinders Lane, Melbourne VIC 3000 Telephone 02 9994 7000
Brisbane Level 6, 215 Adelaide Street GPO Box 3234, Brisbane QLD 4000 Telephone 07 3136 5400
Perth Level 26, 140 St Georges Terrace, Perth WA 6000 Telephone 08 6466 9613
Adelaide Level 7, Suite 714, 147 Pirie Street, Adelaide SA 5000 Telephone 08 8427 9511

Executive Summary

We strongly believe that the changes outlined in the Draft Standards 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.

We are strongly supportive of APRA's proposal for an advanced illiquidity premium (**Advanced ILP**) based on current spreads on a reference portfolio, with a risk allowance framed in terms of long-term average spreads (**LTAS**). However, we consider that the proposed risk allowance of 45% of LTAS is overly conservative, both when considered in the context of alignment with overseas jurisdictions, and on a "fundamentals basis", also noting the strong risk controls proposed under the Draft Standards.

Similarly, we are supportive of the increased allowance within the credit spread stress (**CSP**) charge for changes in the illiquidity premium in a stressed scenario. However, we consider that for consistency with the calculation of the adjusted policy liability, the entire Advanced ILP should flow through to the CSP calculation.

We are supportive of using private ratings within the capital calculation on the same basis as public ratings from the same agency. However, we consider that given the conditions proposed by APRA for this inclusion, their acceptance should be extended to securitised exposures and that the provision for the use of internal ratings where an insurer is able to demonstrate appropriately sophisticated credit risk management capabilities would also bring significant benefit.

Responses to Response Paper Questions

Section 1: Proposed changes to the illiquidity premium

Feedback on the advanced illiquidity premium approach

As set out in our 25 July Submission, we consider that the risk allowance should be set as a percentage of LTAS, and we are very supportive of structuring the Advanced ILP as 100% of the spread on a reference index less a risk allowance set in proportion to LTAS.

APRA proposes to adopt a floor of 45% of LTAS for the risk allowance, and in the Response Paper, APRA notes that “peer regulators implement a 35% floor of the LTAS to the risk allowance. However, given the potential for misestimation risk and basis risk arising from the mismatch between actual assets and the reference portfolio (as discussed in section 1.2.2), APRA proposes to impose a floor higher than 35% (‘risk allowance floor’)”. We note that Solvency II adopts a floor of 35% of LTAS for the fundamental spread (**FS**) used when calculating policy liabilities under the “matching adjustment” approach. As noted in our 25 July Submission, we consider that the Bloomberg US Corporate Investment Grade Bond Index (Bloomberg code: LUACSTAT), an index that represents the US investment grade corporate bond market, is an appropriate reference portfolio for an annuity liability book, given its long duration and deep diversification. Our analysis indicates that a risk allowance of 20% of LTAS for LUACSTAT is appropriately prudent, reflecting worst observed defaults over a period of over 40 years plus a further margin for conservatism. In this context, we consider the Solvency II FS already includes a material margin for regulator conservatism, and any further impost would act against APRA’s aim of improving alignment with peer jurisdictions.

The Response Paper also sets out limitations in the amount of the increase in the Advanced ILP to flow through to the credit spread stress (**CSP**) charge in *Prudential Standard LPS 114 Capital Adequacy: Asset Risk (LPS114)*. In the Response Paper, APRA indicates this is “to allow for misestimation of the illiquidity premium, including potential higher defaults in a stressed scenario”. APRA also notes that “the introduction of this adjustment is in line with peer jurisdictions”.

We note that the Insurance Capital Standard (**ICS**) set out by the International Association of Insurance Supervisors (**IAIS**) sets out that in the calculation of the non-default spread risk (**NDSR**) “all liabilities sensitive to changes in spreads are taken into account in the calculation of the NDSR charge”, and in “the determination of the stressed insurance liabilities, the same stresses (as for the assets) are applied to the input values (for $t > 0$) used to derive the spread adjustments to the relevant base yield curve”. This in effect allows the entire change in spread to be considered in the calculation of stressed liability values. We consider therefore that it is appropriate, and consistent with the calculation of the adjusted policy liability, for APRA to allow the entire Advanced ILP to flow through to the CSP.

Feedback on the proposed cashflow matching test, particularly the impact of the proposed maximum accumulated shortfall on the illiquidity premium cut-off point

We consider that the proposed cashflow matching test is an appropriate risk control and its linkage to the Advanced ILP cut-off point is an appropriate component of the overarching risk management framework. However, as noted in our 25 July Submission, it is important that risk controls are consistent with the level of risk-sensitivity in the overall capital framework. In this context, we have set out below a number of areas where we consider that the proposed capital requirements are overly conservative, given the controls inherent in the cashflow matching test.

Feedback on the proposed approach that the advanced illiquidity premium used for prudential purposes must not exceed the corresponding illiquidity premium determined under the accounting standard, ensuring consistency and reasonableness across insurers

We note that Australian Accounting Standard AASB 17 Insurance Contracts sets out that “the discount rates applied to the estimates of the future cash flows ..shall .. reflect the liquidity characteristics of the insurance contracts” and “be consistent with observable current market prices (if any) for financial instruments with cash

flows whose characteristics are consistent with those of the insurance contracts, in terms of, for example, timing, currency and liquidity.” Consequently, the liability values under both the accounting standard and prudential standards both contemplate an ILP, and it is reasonable that these ILPs should be consistent. While we consider that there is no particular imperative to link the ILP for capital reporting purposes to that for accounting purposes, at this stage we do not expect this to cause any material issues.

Section 2: Risk controls

Feedback on the introduction of the proposed risk controls

We are supportive of the proposed risk controls and consider that they will support policyholder security while allowing the annuity market to develop. As noted above, we consider the effectiveness of these risk controls in improving policyholder security enables APRA to further refine other aspects of the Draft Standards, including the quantification of the risk allowance, the CSP offset for movements in policy liability, and the treatment of private and unrated debt.

Section 3: Impact

What impact will the proposed changes to the illiquidity premium have on your measurement of capital (i.e. capital base before versus after the proposed reforms)?

The changes can be considered under two separate headings, using a construct of framing the ILP as a credit spread less a risk allowance.

- The Advanced ILP starts with 100% of the current spread on a reference index and the existing approach starts with 100% of the current spread on the RBA Index. We expect that the adopted reference index will have a higher spread than the RBA Index, and this aspect of the changes will therefore **increase** the capital base.
- The Advanced ILP includes a risk allowance set at a floor of 45% of LTAS on the reference index; whereas the existing approach effectively includes a risk allowance of 67% of the current spread on the RBA Index. Current spreads are materially lower than LTAS at the moment, hence this aspect of the changes will **decrease** the capital base.

At the time of writing this response, these two impacts are broadly offsetting, hence the impact on capital base at transition is likely to be small. However, this is a function of current market spreads. If the Advanced ILP were to be implemented when spreads were at more normal levels, the impact would be to increase the capital base.

What impact will the proposed changes to the illiquidity premium have on your capital requirements (i.e. PCA and Target Capital before versus after the proposed reforms)?

The proposed capital updates will lead to a reduction in PCA as a result of the changes in the calculation of the CSP component of the Asset Risk Charge. In addition to this, the new capital framework means that the capital position will be materially more resilient to market shocks than it is under the existing framework. This in turn presents an opportunity to review both asset allocation and target surplus settings. We have commenced this work, and will progress it further as we prepare for implementation of the new standards.

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?

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.

What impact will the change in the illiquidity premium have on your entity's asset allocation?

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, including alternative (unrated) assets and / or privately rated assets.

What are the estimated incremental costs you expect to incur in implementing and complying with the proposed changes to the longevity capital framework?

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.

Section 4: Scope of products eligible for the illiquidity premium

Feedback on the proposed product eligibility approach for the advanced illiquidity premium?

We consider the proposed approach to be appropriately principles based, and that it moves the Australian regime closer to peer overseas jurisdictions. However, we consider that other illiquid liabilities, such as single premium whole of life business or disabled lives reserves for disability income products, should also be considered eligible to adopt the Advanced ILP, subject to satisfying the relevant requirements in terms of risk controls.

Section 5: Other issues

Feedback on the proposed treatment of alternative (unrated) assets and / or privately rated assets used to back longevity products

Challenger is supportive of the move to allow a component of the portfolio to utilise private ratings from a recognised rating agency subject to meeting a range of conditions set out in Attachment C of the draft version of *Prudential Standard CPS 001 Defined Terms (CPS001)*, including that the rating is "based on a same standard of information, rigour, analysis, approval process and reporting as that applied in generating a public external rating".

CPS001 also sets out that private ratings cannot be used for securitisation exposures. However, given the conditions being applied, we consider that private ratings from a recognised rating agency should also be used

for securitisation exposures. APRA already recognises public ratings against securitisation exposures, and applies a higher capital requirement than for non-securitised exposures of the same rating. APRA's recognised rating agencies have robust methodologies and a long track record in respect of the rating of securitisation exposures. The additional conditions in CPS001 mean that the provision and monitoring of the private rating are in all material respects identical to that of a public rating. The requirement to have the internal ability and expertise to perform appropriate due diligence on the rating provides additional risk mitigation and is an important control in the use of all ratings, both public and private. We consider that longer duration lending against diversified asset backed exposures is an attractive investment option to back both long and short duration liabilities, and that there is no compelling rationale to exclude private ratings of securitised exposures.

We further note that in the Response Paper, APRA aligns the limits on private assets to the valuation and credit risks associated with these asset types. We believe that these risks must be considered first and foremost in the context of the insurer's ability to meet policyholder benefit payments, and are therefore already appropriately captured within the broader risk management framework, as evidenced in the Advanced ILP declaration. Any further limitation applied on investment in these asset types may therefore lead to unintended consequences, such as increasing the levels of reinvestment risk within a portfolio, as these asset types can offer longer duration investment exposures. We also consider that these limitations will have the effect of reducing alignment with overseas jurisdictions, where the list of approved ratings agencies is less restrictive than within the APRA framework.

Examples of sophisticated risk management approaches in managing assets and longevity products for consideration of higher limits for alternative (unrated) assets and / or privately rated assets

APRA has set out in the Response Paper the additional risks it perceives to be associated with these asset types, being valuation and credit risk, as a rationale for the proposed capital treatment and thresholds. Challenger considers five important factors in being able to appropriately manage these risks with higher allocations to private credit:

- private credit investment capability;
- credit risk management;
- valuation methodology;
- sophisticated asset-liability management; and
- scenario and stress testing.

Private credit investment capability

Whether investment origination is conducted internally or outsourced, it is essential to maintain robust first-line investment capabilities that operate under strong governance. This ensures that all private credit investments are managed appropriately, with clear accountability and alignment to the firm's risk appetite and strategic objectives.

Credit risk management

A well-resourced and independent credit function is fundamental to a sophisticated annuity investment strategy. This function must be supported by robust systems and processes to identify, assess, manage and monitor credit risk effectively. Key responsibilities should include the following.

- **Internal credit rating process:** The ability to identify, assess and monitor credit risks of debt investments that are higher risk, privately rated or non-externally rated is critical. The function should have the ability to assign internal counterparty ratings aligned to rating agency methodologies. This process should be underpinned by well documented procedures and governance that is applied to all private credit – and extended to parts of the portfolio that carry external ratings where the credit function believes this to be appropriate, for example higher risk lending or those assets with private ratings.
- **Limit setting and monitoring:** Exposures to higher risk investments should be managed within risk appetite by the setting of appropriate approval delegations, portfolio and individual investment limits to manage concentration risks, counterparty exposure and credit risk within the portfolio.
- **Platform and external manager assessments:** Where financing is being provided in securitised form, thorough platform assessment processes should be in place to ensure an understanding of aggregate issuer risks and underlying collateral, including detailed external manager assessment and development of an understanding of the risks within externally managed investment portfolios.

- **Lifecycle management:** This refers to oversight and monitoring of credit quality throughout the life of each investment. This includes maintaining up-to-date internal ratings, managing a credit watchlist, conducting regular portfolio and sector-level reviews to identify existing and emerging risks that ensures continued alignment with the firm’s risk appetite, and having appropriate procedures to manage underperforming and distressed investments.

Valuation methodology

We note that the proposed Advanced ILP declaration includes the statement that “*the insurer is expected to meet benefit payments as they fall due without resorting to selling illiquid assets backing longevity liability cashflows in a market downturn*”. We consider therefore that impact of any risks associated with the valuation of private debt assets will be contained.

To the extent that the sale of private credit assets may be required to fund liquidity requirements in stress scenarios, a sophisticated valuation process is required. This would include well documented processes for valuation of these assets, with management oversight of the resultant valuation outcomes, in addition to external audit. Valuations should take into account the specific credit position of the credit, other external factors in particular prevailing credit spreads, which together will mitigate the risk of valuation becoming ‘stale’. In order to properly value stressed credit in particular, an insurer must have access to capabilities to properly assess potential recovery values.

Asset liability management (ALM)

A sophisticated ALM function has the people, processes and technology to effectively manage the cashflow matching requirements of the fund. This would typically be a dedicated ALM function that manages the cashflow matching, pricing, liquidity, interest rate and other basis risks of the fund, with understanding of the key characteristics of the liabilities, and the assets backing these liabilities.

Scenario and stress testing

The Internal Capital Adequacy Assessment Process (**ICAAP**) must be suitably developed for the specific risks attached to cashflow matching relevant liabilities with private assets. In particular, stress testing and scenario analysis must be adapted to the specific scenarios and risks that the insurer is exposed to, for example, being able to run a wide range of stress scenarios to test at a granular level reinvestment risk, cashflow mismatch risk and liquidity risks. As it relates to the elevated use of private credit, the insurer would be expected to run a range of granular stress scenarios that would impact cashflow profiles of both assets and liabilities to ensure cashflow matching can be maintained without resorting to the sale of illiquid assets under stressed conditions.

Which types of additional credit ratings — such as private ratings from APRA-recognised rating agencies, ratings from non-APRA-recognised rating agencies, or insurers’ internal ratings — would have the greatest impact in supporting life insurers in investing assets backing longevity products? Please respond in the order of impact

- 1) **Use of internal ratings:** The current approach to non-externally rated investments, whereby capital is defaulted to a BB level, effectively disincentivises investment into lower risk (i.e. investment grade) exposures. These represent a large part of the investable universe and are far more appropriate for very long duration investments that could form the basis of a strong cashflow match for lifetime income streams. As such, we consider the ability to utilise internal insurer ratings subject to an insurer demonstrating to APRA sufficiently sophisticated internal credit capabilities, would have the largest impact to support optimal investment objectives.
- 2) **Private ratings of securitisations:** As set out above, Challenger proposes permitting the use of private ratings of securitisations (subject to the requirements laid out in CPS001). Domestic issuers utilise private placements and unrated warehouses as a complement to their public debt capital markets activities. They allow issuers to strategically manage their funding requirements without having to publicly disclose the same level of information to competitors that they have to with public market transactions. Given their attractive cashflow characteristics, Challenger believes private securitisations could have a meaningful role in an insurer’s investment strategies, and therefore customer outcomes, while maintaining policyholder security.
- 3) **Approved rating agencies:** Lastly, extending the list of recognised rating agencies to include Kroll and DBRS, subject to appropriate due diligence and oversight, would also increase the investable universe given

their increasing presence in debt market transactions, however, with less immediate impact than either internal ratings or private ratings of securitisations.

Wording clarifications

Paragraph 7 of Attachment F to LPS112 sets out that the Advanced ILP can be used in the calculation of the adjusted policy liability for immediate term certain annuities. The Advanced ILP declaration within the FCR then sets out a number of conditions that must be satisfied, which are framed in the context of “*assets backing longevity liability cashflows*”, as defined in CPS001. We consider that this may cause some confusion, given that term certain annuities are not exposed to longevity risk. We instead suggest that the wording be changed to reference “*assets backing illiquid liability cashflows*” which will better reflect the broader intent of the updated standards.