



27 March 2014

**To: All CEOs and Appointed Actuaries of life insurers (including friendly societies)**

**Approved alternative method to calculate the illiquidity premium**

### **Background**

From 1 December 2013, the Reserve Bank of Australia (RBA) ceased publishing the information required by life companies to calculate the illiquidity premium specified in paragraph 7 of Attachment H to *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112). As a result, the formula specified in LPS 112 can no longer be applied and an alternative method, approved by APRA under LPS 112, is required to calculate the illiquidity premium.

### **Approved alternative method**

On 14 January 2014, APRA issued a consultation letter<sup>1</sup> inviting feedback on an alternative method for calculating the illiquidity premium. No submissions were received in response to the consultation letter.

Therefore, in accordance with LPS 112, APRA approves the following alternative method to be used on a permanent basis for the calculation of the illiquidity premium, in place of the formula currently specified in paragraph 7 of Attachment H to LPS 112. The alternative method applies to reporting dates from 1 December 2013.

The illiquidity premium (in basis points) added to the risk-free forward rates for the first 10 years after the reporting date is:

$$\text{Illiquidity premium} = 33 \text{ per cent} \times \text{A spread 3 year}$$

The spread must be obtained from 'Statistical Table F3 - Aggregate Measures of Australian Corporate Bond Spreads and Yields' published by the RBA on its website. 'A spread 3 year' is the spread to Australian Commonwealth Government Securities (CGS) for non-financial corporate bonds with broad credit rating (as determined by Standard and Poor's) of A and target tenor of 3 years.

The other conditions applying to the calculation of the illiquidity premium under LPS 112 remain unchanged:

- the maximum illiquidity premium is 150 basis points and the minimum is zero;
- the illiquidity premium added to risk-free forward rates more than 10 years after the reporting date is 20 basis points; and
- the same illiquidity premium applies to both Australian and overseas liabilities.

<sup>1</sup> <http://www.apra.gov.au/lifs/Pages/other-information-for-life-insurance.aspx>

Amendments to LPS 112 to explicitly incorporate the revised method set out in this letter will be included within the scope of the next full review of the standard.

Any queries in relation to this letter should be directed to Peter Kohlhausen ([Peter.Kohlhausen@apra.gov.au](mailto:Peter.Kohlhausen@apra.gov.au)).

Yours sincerely

A handwritten signature in black ink, appearing to read 'N. Grummitt', is written on a light blue grid background.

Neil Grummitt  
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Policy Development