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Mr Neil Grummitt
General Manager, Policy Development
Australian Prudential Regulation Authority
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By e-mail: InsuranceCapital@apra.gov.au

Dear Neil

Submission on Proposals – "Illiquidity premium" dated 30 March 2012

Thank you for the opportunity to comment on APRA's proposals in respect of illiquidity premium, as part of the Life and General Insurance Capital project (LAGIC).

This submission, which is made on behalf of Challenger Life Company Limited, is set out in Attachment 1 and includes submissions on the proposals set out in APRA's letter to all CEOs and Appointed Actuaries of life insurers, dated 30 March 2012.

Challenger has made several prior submissions relating to LAGIC, including submissions dated 4 August 2011, 3 November 2011 and 24 February 2012. These submissions included important comments which we believe need to be addressed by APRA. While some matters have been addressed in APRA's response and draft standards, there are many areas which we believe still need to be addressed to achieve the required outcomes. Please refer to these prior submissions for further details on these issues.

If you have any questions, please do not hesitate to contact me.

Yours sincerely

Tony Bofinger
CFO and Appointed Actuary
Challenger Life Company Limited

Attachments:

1. Challenger submissions

Attachment 1: Challenger submissions

Challenger strongly supports the use of an illiquidity premium for the valuation of certain life insurance liabilities. It is essential that the method:

- is responsive to changes in market conditions;
- is set at an appropriate level; and
- results in a consistent treatment of assets and liabilities in a shock scenario.

Challenger has previously submitted that we support the implementation of the methodology for illiquidity premium as set out in the Actuaries Institute submission of 17 November 2011 (Actuaries Institute method). The Actuaries Institute method represents a market-based, robust and conservative approach to the determination of illiquidity premium. We have previously submitted that there is no justification for the Actuaries Institute method to be made more conservative through caps or changes to parameters, and indeed such adjustments would materially reduce the effectiveness of the formula.

We reiterate our submissions that the Actuaries Institute method should be implemented without adjustment.

In considering the Actuaries Institute method, it should be noted that:

- the Actuaries Institute submission notes that the method is for use in regulatory prudential capital calculations;
- the Actuaries Institute method provides a simple proxy based on readily available public information. It therefore satisfies APRA's requirement that the amount of insurer/actuary discretion should be small;
- the Actuaries Institute notes that the instruments which have been used to derive the method are generally more liquid than the life insurance policy values for which APRA intends to permit the application of an illiquidity premium. In our view, this means that the proposed formula already includes a level of inherent conservatism because it will tend to underestimate the illiquidity premium appropriate to life insurance liabilities;
- the curves which have been fit to the data produce high correlation results to the base data (96% and 91% respectively for the shorter and longer term formulae); and
- in constructing the term structure for the method, the Actuaries Institute used an approach whereby the illiquidity premium is level for a period of time and then reverts to a long term level. This is despite the fact that illiquidity premium should, in theory, be upward sloping with time, and reflects the possibility that a life company may not be able to capture the longer term illiquidity premium. As such, the term structure includes another level of conservatism.

In reviewing the method proposed by APRA (APRA method) and comparing it against the criteria for an appropriate methodology, we are pleased that the APRA method:

- is market-sensitive, at least for the first 10 years; and

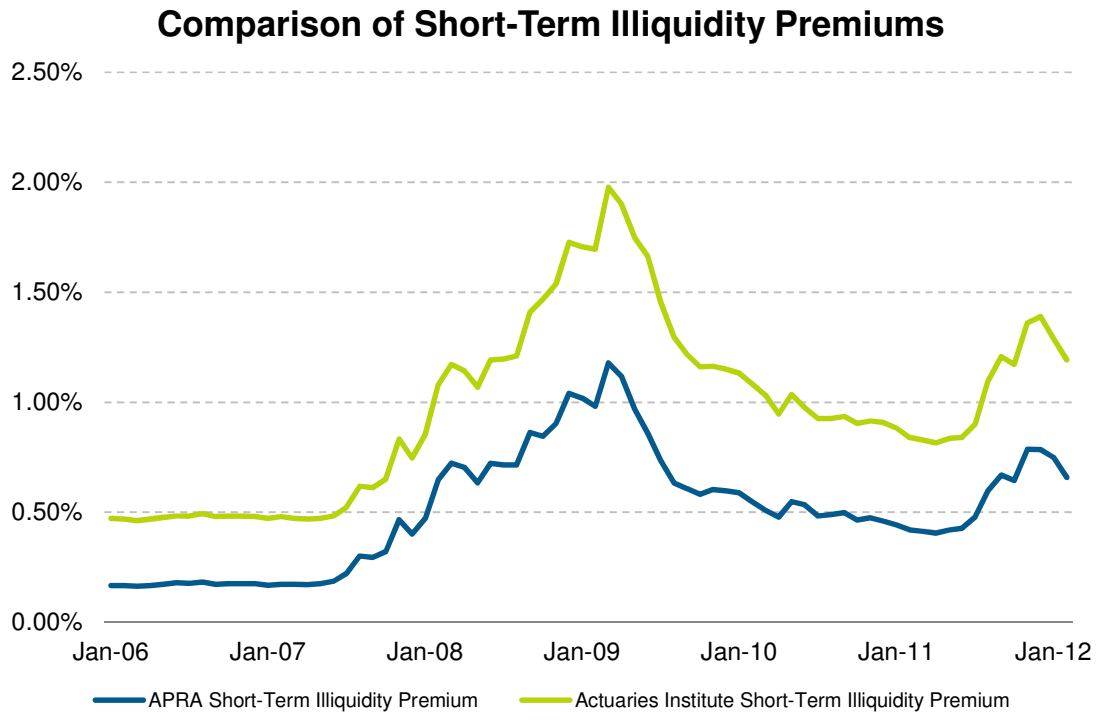
- allows for a “shock” to be applied to the illiquidity premium as part of the credit spread risk charge component of the asset risk charge.

In our view, this represents an improvement on the initial proposals under which the illiquidity premium was a level margin to the CGS curve.

There are, however, several areas of the APRA method which we believe should be addressed to ensure an appropriate outcome:

- For the first 10 years, the APRA method is generally about half of the value of the Actuaries Institute method. Further, in benign markets, for example prior to the GFC, it can result in discount rates significantly below swap. This results in a lower discount rate on liabilities, and therefore higher capital impost for life companies. This level of conservatism is unnecessary and results in the value of illiquid liabilities for life companies being overstated.

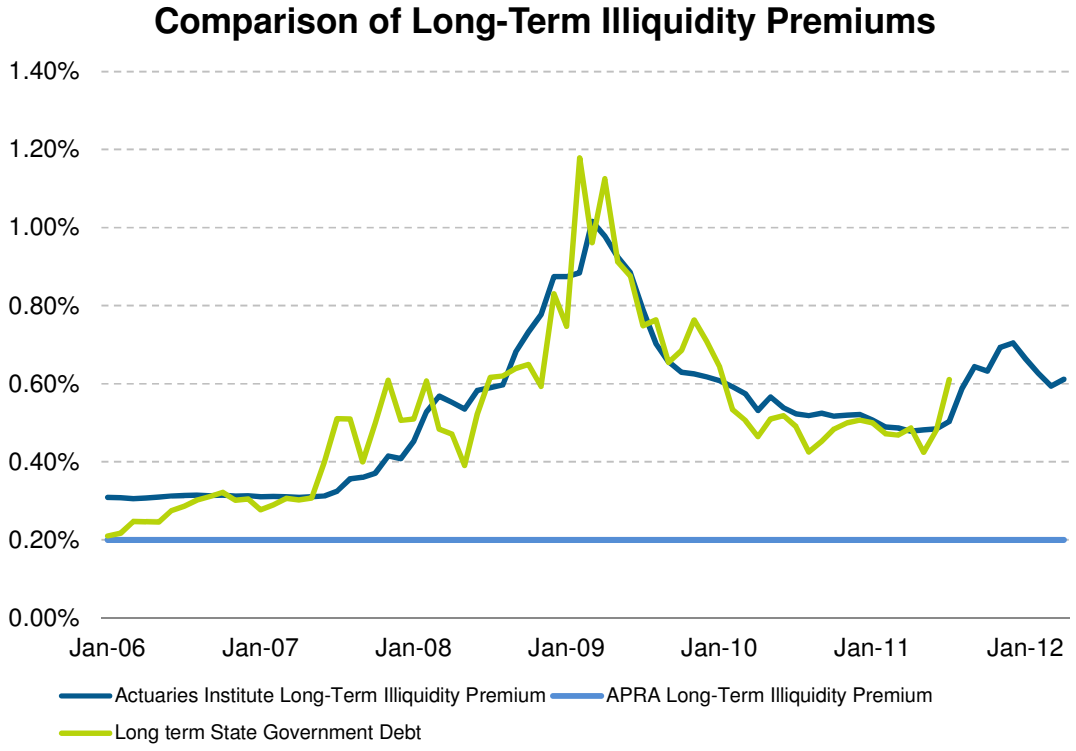
  The following chart shows a comparison of the APRA method and the Actuaries Institute method.



- The APRA method is subject to a cap of 150bps whereas the Actuaries Institute method has no cap. The cap is an arbitrary figure that acts to reduce the market sensitivity of the illiquidity premium. We note that the cap would not have impacted the illiquidity premium in recent years, although in March 2009 it came within a few basis points of applying (when the 30bps credit spread shock is included).

- The APRA method beyond 10 years is a fixed 20bps whereas the Actuaries Institute method uses a formula based on market indices. The use of a flat 20bps is both low by historic standards and further acts to reduce the market sensitivity of the illiquidity premium.

  The chart below compares the APRA method and Actuaries Institute method with returns on long term state government debt as a proxy risk-free asset. The Actuaries Institute method shows a close fit to the state government debt and is market sensitive, whereas the APRA method is significantly lower and is not market sensitive.



Overall, these adjustments made by APRA result in multiple layers of conservatism and reduce the efficacy of the proposals.

We note that APRA has argued that this conservatism is justified because:

- there is limited relevant historical data;
- a conservative approach limits the risk that the proxy formula overstates illiquidity premium in the future;
- it is difficult for the life company to capture longer term illiquidity premiums; and
- there is uncertainty about whether the proxy formula will remain appropriate in extremely stressed circumstances.

However as set out above, the Actuaries Institute notes that the instruments which have been used to derive the Actuaries Institute method are generally more liquid than the life insurance policy values for which APRA intends to permit the application of an illiquidity premium. In our view, this means that the Actuaries Institute method already includes a level of inherent conservatism because it will tend to underestimate the illiquidity premium appropriate to life insurance liabilities.

This means that, while APRA considers that there is a risk that a proxy formula may overstate the illiquidity premium *inherent in corporate or state government bonds* in the future, it is less likely that it will overstate the illiquidity premium *appropriate for life insurance policy values*.

As an illustration of the illiquid nature of life insurance policy values, Prudential Standard LPS4.02 Minimum Surrender Values and Paid-up Values (LPS4.02) sets out a Gross Rate for Fixed Term/Rate and Income Stream Business of 4% over CGS (or the gross pricing yield, if greater). Section 6 of LPS4.02 sets out that:

> "It is in the nature of this business, generally, that the investment strategy of the life company is to match the investment risks of the assets supporting the liabilities with those liabilities. A policy owner terminating the policy during the contracted term defeats the investment strategy of the life company which could adversely impact the future investment returns."

In effect, the 4% margin represents the illiquidity premium that the life company charges the policy owner for terminating the policy. It is therefore indicative of the level of illiquidity of life insurance policy values. This margin applies across all durations in respect of this type of business.

Further, under accounting standards life companies are required to mark their assets to fair value. Movements in the fair value of assets can be impacted by changes in the risk-free discount rate, credit risk premiums and illiquidity premium. An example of the importance of the illiquidity premium as a component of the fair value is the experience during the GFC where a large part of the blow out in spreads on debt securities was driven by illiquidity constraints rather than a deterioration in the outlook for credit. This means that any yield shocks to debt securities actually represent a combination of a shock to illiquidity premium and credit spread.

In order to ensure an appropriate matching of movements in assets and liabilities, the life company's liabilities should also change over time in line with market conditions. This must include movements in risk-free discount rates and illiquidity premiums that are reflective of those market conditions: to apply a conservative approach to the determination of these factors will lead to an inappropriate mismatch between the valuation of assets and liabilities resulting in unnecessarily pro-cyclical outcomes.

It should also be noted that the overall resulting discount rate (i.e. the combined CGB yield base rate plus illiquidity premium adjustment) results in inconsistency with banking regulation – ADIs do not value their liabilities at "risk free". There is no requirement to value term deposits, swap or other derivative book exposures, or loan liabilities, using this definition of "risk free" so as to generate large capital charges on these liabilities.

The addition of the illiquidity premium goes some way to addressing this for certain products; however, we believe the overall resulting discount rate remains overly conservative.

This is unnecessary and will place a burden on the life insurance industry in its attempt to meet consumer and public policy demands to provide competitive income stream and longevity products.