31 May 2012

Ian Laughlin
Member
Australian Prudential Regulation Authority
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SYDNEY NSW 2001

Email: Insurance.Capital@apra.gov.au

Dear Mr Laughlin,

ILLIQUIDITY PREMIUM

CommInsure welcomes the opportunity to respond to your letter from 30 March 2012 outlining APRA's illiquidity premium proposals for life insurers. CommInsure represents the insurance business of the Commonwealth Bank of Australia (CBA), encompassing the life insurance business (The Colonial Mutual Life Assurance Society) and general insurance business (Commonwealth Insurance Limited). CMLA is one of the largest life insurance companies in Australia with over 4.3 million policyholders.

We strongly support APRA's proposed guiding principles and formula underpinning their illiquidity premium framework. In particular we endorse APRA's implementation of a simple formula and consistent approach across the industry.

We have identified some minor practical issues that, while we believe are not material in the current environment, APRA should monitor the continued suitability of the parameters if the credit environment changes substantially. These practical issues are outlined below.

1. Proposed illiquidity premium beyond 10 years: APRA proposes that the illiquidity premium applied on forward rates beyond 10 years is a constant 20 basis points. We note that the application of a constant illiquidity premium may result in an increase in profit and loss volatility. This appears to be an unintended consequence and should be monitored during the implementation of APRA's framework.
2. 10 year cut-off point: While the term of corporate bonds issued in Australia is relatively short, international markets tend to have bonds issued for considerably longer maturities. Given their longer maturity, overseas bonds are becoming an increasingly popular investment to back the liabilities of Australian life insurance companies. However we are concerned that the proposed cut off point of 10 years between the formula-driven illiquidity premium and the proposed long-term rate of 20 basis points is too abrupt and does not recognise the growth of life insurers investing in overseas based securities. We believe APRA's framework should have regard to the growing prevalence of overseas bond investment and consider the development of a phased approach at the 10 year point.
3. Application to specific products: We acknowledge APRA's overriding objective to develop clear and unambiguous capital standards. However, we remain concerned that prescribing specific products to which the illiquidity premium applies may create market distortions and become a potential impediment to providing specific products.

4. Illiquidity premium cap: APRA propose a cap to the illiquidity premium due to uncertainty about whether the proxy formula would remain appropriate in extremely stressed circumstances. We submit that the application of a cap appears to be inconsistent with the treatment of assets which should continue to be valued at those spreads which are viewed as unreliable for valuing the liabilities.

As noted above, we believe periodic post-implementation reviews of APRA's framework are necessary. We envisage these reviews would be conducted in consultation with industry every two to three years. Importantly, this process provides scope for APRA to review the application and appropriateness of the formula's parameters. This also allows for further consideration of the issues identified above and we welcome the opportunity to work with APRA as part of this process.

We appreciate APRA's consultative approach during the development of this framework and welcome the opportunity to provide further information as required. Should you have any questions, please contact me or Heather Navid (Capital Management Actuary) on [redacted] or at [redacted].

Yours sincerely,

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