



1 June 2012

Mr Neil Grummitt  
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Email: [REDACTED]

Dear Neil

### **Submission on Proposals – “Illiquidity Premium”**

Thank you for the opportunity to comment on APRA's proposals in respect of illiquidity premium, as set out in its letter to all CEOs and Appointed Actuaries of life insurers, dated 30 March 2012.

The Actuaries Institute is the sole professional body for actuaries in Australia, providing expert and ethical comment on public policy issues wherever there is uncertainty of future financial outcomes. It represents the interests of over 3,800 members, including more than 2,000 actuaries.

Some of the principles that guide the Institute's input into public policy are:

- » Acceptance of public sector involvement where the market does not meet societal needs,
- » The need to take a long term policy view, with appropriate transitional arrangements,
- » Ensuring that consequences of risk taking behaviour are borne by the risk taker,
- » Issues of intergenerational equity, and
- » Clear and reliable information available for decision-making.

### **Background**

In December 2011, APRA released a number of draft standards as part of its Life and General Insurance Capital (LAGIC) project.

Draft Prudential Standards *LPS112 Capital Adequacy: Measurement of Capital* contemplated the inclusion of an illiquidity premium in the discount rate used to calculate the RFBEL for certain types of policies. In a letter dated 30 March 2012 to all CEOs (or equivalent) and Appointed Actuaries of life insurers, APRA set out its proposed methodology (APRA method) and rationale for the calculation of illiquidity premium.

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The Actuaries Institute has previously provided a paper to APRA, dated 17 November 2011 (Illiquidity Premium Paper), which provided information on methods of determining the illiquidity premium for use in regulatory capital calculation. Further, the Illiquidity Premium Paper provided a simplified proxy formula for determining the illiquidity premium (Actuaries Institute proxy).

For the purposes of the Illiquidity Premium Paper, we considered:

1. APRA's requirements for illiquidity premiums, as set out in the response to submissions to the capital discussion paper<sup>1</sup>, including:
  - » A satisfactory method must have reasonable assurance of giving appropriate results in both normal and stressed conditions;
  - » The amount of insurer/actuary discretion involved in determining the illiquidity premium should be small, so that all insurers use approximately the same illiquidity premium at the same point in time; and
2. Further discussions with APRA which indicated a preference for a formula-based approach which referenced one or more observable market parameters, with the parameters being calibrated using a range of market-based methodologies.

In addition to discussing methods for estimating an illiquidity premium, we also considered the potential impact that any future change in the illiquidity premium might have on a life insurer. If an illiquidity premium is used by a life insurer, then under APRA's proposed capital principles the risk that such illiquidity premiums adversely change should be captured in determining that life insurer's capital requirements.

The Actuaries Institute has also previously submitted that the method should be responsive to changes in market conditions. Asset values include an illiquidity premium for illiquid assets, and this illiquidity premium will change over time. The life company's liabilities should also change over time with market conditions to provide matching between movements in assets and liabilities.

The Illiquidity Premium Paper set out an approach which aimed to meet APRA's stated criteria. We did not consider the appropriateness of applying an illiquidity premium to specific product structures, although the Actuaries Institute has previously submitted that APRA should articulate a clear set of principles for qualifying products.

## Discussion

The Actuaries Institute welcomes APRA's response to industry feedback that the illiquidity premium is an important aspect of the valuation of certain life insurance liabilities, and hence should be allowed for in valuing those liabilities.

We also recognise that measures of illiquidity premium represent estimates only and therefore support APRA's view that a level of conservatism is appropriate in incorporating illiquidity premium in regulatory prudential capital calculations.

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<sup>1</sup> "Response to Submissions: Review of Capital Standards for General Insurers and Life Insurers", APRA, March 2011 p.30 [http://www.apra.gov.au/CrossIndustry/Documents/GLI\\_RS\\_RCSGLI\\_032011\\_ex\\_r11.pdf](http://www.apra.gov.au/CrossIndustry/Documents/GLI_RS_RCSGLI_032011_ex_r11.pdf)



We note that APRA has set out that it has adopted a level of conservatism 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.

In summary we support the following features of APRA's proposal:

- 1. For the first 10 years, the APRA method does represent a formula-based, market-sensitive approach which references one or more observable market parameters.**

The parameters referenced are readily available in a timely manner, and are consistent with those used in the Actuaries Institute's proxy formula.

- 2. The APRA method includes an upward shock to illiquidity premium as part of the credit spreads risk charge component of the asset risk charge, subject to a minimum credit spreads risk charge.**

We consider it a positive development to include the shock to illiquidity premium within the credit spread risk charge as it recognises that a component of the movement in credit spreads is actually a movement in illiquidity premium.

In the Illiquidity Premium Paper we proposed applying the credit spread shock to the illiquidity formula and applying both upward and downward shocks to credit spreads. The APRA method therefore represents a simpler approach but does not address the situation where credit spreads and illiquidity premiums contract. This scenario may adversely impact the capital base of a fund with illiquid liabilities and assets with very strong credit ratings.

Notwithstanding the above points, we believe APRA's proposals for the illiquidity premium, and the overall resulting discount rate, are overly conservative based on the following observations:

- 1. For the first 10 years the APRA method produces an illiquidity premium of approximately half of the value produced by the Actuaries Institute proxy. We note for example, that in benign markets, such as prior to the GFC, it can result in discount rates significantly below swap.**

This means that the overall discount rate is lower than the current discount rate for regulatory prudential capital requirements for life insurers which is capped at the maximum of swap rates.

We also note that in Europe for QIS5 for Solvency II a formula of 50% of (Spread -0.4%) was adopted (with spread based on the spread of a corporate bond index to swap). Using this formula to estimate discount rates for Australia at 31 December 2011 gives significantly higher discount rates than those derived using APRA's proposed formula.

- 2. As noted in the Illiquidity Premium Paper, the instruments which were used to derive the Actuaries Institute proxy are generally more liquid than the life insurance policy values for which APRA intends to permit the application of an illiquidity premium. The Actuaries Institute proxy therefore already includes a level of inherent conservatism because it will tend to underestimate the illiquidity premium appropriate to life insurance liabilities.**

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

- 3. 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.

- 4. The APRA method is subject to a cap of 150 basis points whereas the Actuaries Institute proxy has no cap.**

The cap is not based on market based methodologies and acts to reduce the market sensitivity of the illiquidity premium. We note that the cap would not have impacted the APRA illiquidity premium formula in recent years, although it may do so in future.

- 5. The APRA method beyond 10 years is a fixed 20 basis points, whereas the Actuaries Institute proxy uses a formula based on market indices.**

The use of a flat 20 basis points is both low by historic standards and further acts to reduce the market sensitivity of the illiquidity premium.

Overall, these adjustments made by APRA result in multiple layers of conservatism and reduce the market-sensitivity of the approach.

We recommend that the parameters of the APRA method be reviewed so that they are:

- 1. At a level which is representative of market based illiquidity premiums;**
- 2. More market sensitive, especially beyond 10 years; and**
- 3. Not subject to caps.**

We recommend that APRA reviews the parameters periodically in line with new developments and market experience.

Thank you for the opportunity to make this submission. If required, we would be happy to discuss our views on this matter with you further. Please do not hesitate to contact Rob Desoisa, Convenor of the Liquidity Premium Working Group on [REDACTED] or Melinda Howes, CEO on [REDACTED]

Yours sincerely

David Goodsall  
President

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