Australian Prudential Regulation Authority

400 George Street (Level 26)
Sydney NSW 2000

GPO Box 9836
Sydney NSW 2001

T 02 9210 3000
F 02 9210 3411
W www.apra.gov.au

14 January 2014

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

Illiquidity premium

Background

From 1 December 2013, the Reserve Bank of Australia (RBA) ceased publishing the information required by life insurers to calculate the illiquidity premium as 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.

Interim method

In accordance with LPS 112, APRA approves the following alternative method to be used for reporting dates from 1 December 2013 until APRA advises a permanent method.

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

Illiquidity premium = 33 per cent x 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 illiquidity premium in paragraph 7 are 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.

Rationale for interim method

APRA has specified an alternative method for calculating the illiquidity premium that:

- gives approximately the same result as the existing formula at 29 November 2013 - the last effective date that Table F3 was published in its previous format;
- gives broadly similar results as the existing formula over the period from January 2006 to November 2013.

As discussed in APRA's letter to insurers dated 30 March 2012, the RBA statistical Table F3 has been chosen as the data source because it is publicly available and it results in all life insurers using the same illiquidity premium at the same point in time.

Example

At 31 December 2013, the 'A spread 3 year' was 98.9 basis points. The resulting illiquidity premium to be added to risk-free forward rates would therefore be 33 basis points for the first 10 years and 20 basis points thereafter.

Consultation on proposed permanent alternative method

APRA also proposes that the interim alternative method outlined above be used for calculating the illiquidity premium on a permanent basis in place of the formula currently specified in paragraph 7 of Attachment H to LPS 112. APRA welcomes submissions from industry on the suitability of this method. Submissions should be sent to Insurance.Policy@apra.gov.au by 28 February 2014. APRA expects to advise life insurers of the permanent method during the second quarter of 2014.

Any queries in relation to this letter should be directed to Andrew Patterson (andrew.patterson@apra.gov.au).

Yours sincerely

Neil Grummitt
General Manager
Policy Development

Important Disclosure Notice - Publication of Submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity which is not in the public domain and which is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and therefore will ordinarily be exempt from production under the FOIA.