



Discussion Paper

Prudential supervision of corporate groups involving authorised general insurers

Including related issues affecting all authorised general insurers

16 May 2005

Preamble

Following the Government's financial sector reforms arising out of the Financial System Inquiry (FSI) in 1997, prudential regulation of the Australian financial system became the responsibility of the Australian Prudential Regulation Authority (APRA).

The FSI recognised that corporate groups were a dominant feature of Australia's financial system and envisaged their continued evolution as 'one-stop financial shops' in the provision of financial services in Australia. The FSI therefore recommended that APRA have the necessary powers to regulate corporate groups that include APRA-regulated institutions as well as non-operating holding companies (NOHCs) heading these groups, and that APRA should establish standards covering these structures and their operations.

In the years following APRA's formation, there has been extensive policy development and public consultation in respect of a framework of prudential supervision for conglomerates involving authorised deposit-taking institutions (ADIs). In April 2000, APRA released a policy framework for the supervision of conglomerate groups involving ADIs, with issues relating to the measurement of group-wide capital adequacy and large exposures (both intra-group and external) finalised in October 2001.

While developing the ADI conglomerates framework, APRA was mindful of the application of this framework to other APRA-regulated industries and indicated that corporate groups involving authorised general insurers (insurers) would be its next focus.

On 1 July 2002, a new prudential regulatory framework for the supervision of insurers became effective. The new framework substantially strengthened and modernised the prudential requirements applying to insurers in Australia. The framework also makes provision for the regulation of corporate groups (including NOHCs).¹ However, APRA has not yet introduced a prudential regime for the supervision of corporate groups involving insurers. APRA's primary focus has been on bedding down the new framework, with the intention that a second stage of reforms would include a component of consolidated supervision.

In April 2003, Justice Owen, Commissioner of the HIH Royal Commission, handed down his findings and recommendations on the failure of HIH Insurance. In September 2003, the Government announced its final response to these findings. The Government supported the recommendations that fell within the responsibility of APRA and referred them to APRA for consideration. Recommendations 38 and 39 relate to the regulation of corporate groups.

As foreshadowed in APRA's discussion paper on *Prudential Supervision of General Insurance – Stage 2 Reforms* (the 2003 discussion paper) issued in November 2003, this paper examines issues associated with the operations of corporate groups involving insurers and outlines APRA's initial policy proposals for a consolidated approach to the supervision of such groups. These proposals inter-relate with proposals in the 2003 discussion paper, and may be modified to harmonise with developments in those proposals.

While this paper focuses on the development of a framework of prudential supervision for corporate groups that include one or more Australian insurers, some of the policy proposals set out in this paper will also apply to all insurers on a stand-alone basis, including Australian branches of foreign insurance companies. These include proposed capital deduction requirements, revised treatment of asset concentrations and requirements in relation to management of reinsurance concentrations. In addition, Australian branches of foreign insurance companies would be subject to proposed requirements in relation to the management of group inter-relationships (e.g. branding and distribution of financial products and sharing of group infrastructure) in respect of the branch's dealings and associations with other group companies operating in Australia.

APRA welcomes comments on the policy proposals outlined in this paper, which should be submitted in writing by 14 October 2005 to:

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¹ Although the framework allows APRA to make prudential standards for insurers, authorised NOHCs and subsidiaries of these entities, APRA will further assess the framework to ensure it is fully effective for implementing a consolidated supervision regime for insurers.

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Glossary

ADI	Authorised deposit-taking institution
APRA	Australian Prudential Regulation Authority
APS	ADI Prudential Standard
ELE	Extended Licensed Entity
EU	European Union
FCR	Financial Condition Report
Foreign-owned insurer	Foreign-owned, locally incorporated insurer
FSSA	<i>Financial Sector (Shareholdings) Act 1998</i>
FSI	Financial System Inquiry
GGN	General Insurance Guidance Note
GPS	General Insurance Prudential Standard
GRF	General Insurance Reporting Form
Insurance Act	<i>Insurance Act 1973</i>
Insurer	A general insurer authorised under the Insurance Act
IAIS	International Association of Insurance Supervisors
Large exposures	Large credit risk exposures arising from asset concentrations
MCR	Minimum Capital Requirement
NOHC	Non-operating holding company
REMS	Reinsurance Management Strategy
Reinsurance exposures	Credit risk exposures to another insurer or reinsurer arising from reinsurance arrangements
RMS	Risk Management Strategy

Chapter 1

Introduction

Most authorised general insurers (insurers) in Australia operate as part of a corporate group and some have operations in overseas jurisdictions. The current prudential regime for general insurance, however, focuses largely on regulating and supervising individual authorised entities, without explicit regard to linkages to, or activities conducted by, the wider corporate group to which they belong. Nor does the regime have explicit regard to general insurance activities conducted in separately incorporated entities in overseas jurisdictions. Accordingly, there remains a considerable risk that adverse developments in activities conducted by other group members could impact on the soundness of the Australian insurer (or insurers) in the group. As foreshadowed in its submission to the HIH Royal Commission, the Australian Prudential Regulation Authority (APRA) intends to include a component of consolidated

supervision in the current stage 2 reforms for the prudential supervision of general insurance to address this potential gap.

The prudential policy proposals outlined in this paper represent APRA's initial view on adopting a consolidated approach to the supervision of corporate groups that include one or more Australian insurers. Comments are sought on this approach, together with suggestions for alternatives where issues are raised. Subject to the outcome of the consultation process, APRA intends that new prudential standards as well as new reporting standards and forms reflecting the proposed policy approach will commence in 2007. Where necessary, APRA would agree transitional arrangements with affected insurers to allow sufficient time for adjustments to be made to their business operations (including capital restructuring) to fully comply with the new standards.

Chapter 2

The need for consolidated supervision

Insurers that operate as part of a corporate group generally have various inter-relationships with other members (regulated and unregulated) in the group. These range from a simple ownership linkage to other group entities, to complex intra-group arrangements for financial support, including funding and reinsurance, as well as common governance and risk management systems and controls.

Associations and dealings with other members of its corporate group may expose an insurer to contagion risk – the risk that adverse developments in a group entity may compromise the financial and operational position of the insurer. Contagion risk can arise simply from the reputational impact of having a tainted, poorly performing or failing member in the group, from implied moral obligations to support ailing affiliates, or directly from large intra-group exposures (arising from debt, equity, reinsurance, other support arrangements or provision of operational services).

In order to protect the interests of policyholders, there is a need for APRA to ensure that other activities within a corporate group do not lead to financial instability in an insurer in the group. This protection can be achieved in at least two ways. APRA could adopt an approach of strictly ‘ring-fencing’ the insurer, i.e. prohibiting any dealings (including financial and operational service linkages) between the insurer and other members in the same group. In this way, APRA could limit the possibility of any financial or operational instability in other parts of the group being transmitted to the insurer. In an extreme event, the objective would be that failure by the rest of the group need not hamper the ongoing viability of the insurer, which could continue (perhaps under new ownership) as a stand-alone entity.

The cost of such complete ‘ring-fencing’ could be quite high. In particular, it would restrict the ability of companies and groups to utilise integrated and often efficient business structures. However, for groups with mixed general insurance and commercial businesses this approach would limit the need for APRA to intervene in the affairs of the group’s non-financial business operations.

An alternative is for APRA to apply regulatory oversight to the wider corporate group on a consolidated basis, and to extend some or all of the prudential standards imposed on the insurer to the group as a whole, to ensure that the overall group remains financially sound. Undoubtedly, this approach allows corporate groups more freedom to organise their activities as they see fit. It also accepts that legal structures exist for many reasons (e.g. regulatory, tax, historical) and APRA needs to look beyond the pure legal entities to ensure that the interests of policyholders are protected. However, for groups with mixed general insurance and commercial businesses, this would imply greater involvement by APRA in businesses outside its usual regulatory sphere. This would also pose legislative and supervisory challenges to APRA to apply prudential requirements covering all activities of such groups.

To enable APRA to adequately supervise insurers and their corporate groups (including their overseas operations), this model requires a prudential framework that applies to each of the insurers in the group and to the group as a whole. The objective of the framework would be to ensure that the overall group is financially sound and that group activities and inter-relationships do not unduly impinge on the financial soundness of an insurer in the group. Prudential supervision of the group would not substitute for prudential supervision of the individual insurer. Rather, it would be an adjunct to it.

For most corporate groups involving insurers, APRA believes that a consolidated approach to supervision will achieve a reasonable balance between achieving its prudential objectives and not unduly constraining commercial business practices, and APRA proposes to adopt this approach. However, where an insurer is a subsidiary of a commercial business, APRA does not propose to include the commercial parent in this group-wide supervision. For such groups, APRA proposes to apply consolidated supervision only to the general insurance sub-group. In this case, however, APRA may also apply additional or more stringent prudential requirements to an insurer in the general insurance sub-group, or to the general insurance sub-group as a whole, or both, in respect of dealings with the commercial company parent and other group members outside the general insurance sub-group. The objective

would be to ensure that the general insurance subgroup is adequately protected from the impact of any adverse developments in the rest of the group, while minimising APRA's involvement in businesses outside its usual regulatory purview.

The consolidated supervision framework for insurers proposed in this paper has been developed in line with recommendations 38 and 39 of the HIH Royal Commission.² It also reflects the insurance 'core principle' of group-wide supervision (ICP 17) issued by the International Association of Insurance Supervisors (IAIS) which requires supervisory authorities to supervise insurers on both a stand-alone and group-wide basis, and Principle 2 of the IAIS Insurance Concordat in relation to the supervision of insurers' cross-border business operations.³ These emphasise the need for group-wide supervision focusing on the additional risks created by the existence of a group, and including supervisory oversight of group management and ownership structures, capital adequacy (including the potential for double-gearing of capital), reinsurance and risk concentrations, intra-group transactions and exposures, and internal control and risk management processes (including reporting lines and fit and proper requirements).

The proposed consolidated approach builds on APRA's existing framework for the supervision of conglomerate groups involving authorised deposit-taking institutions (ADIs),⁴ as well as on the existing

and proposed prudential frameworks for insurers. The proposed consolidated supervision framework outlined in this paper covers policy proposals on the following areas:

- permissible corporate structures to facilitate prudential supervision of insurers and other members of their corporate group on a consolidated basis;
- approaches to the measurement of capital adequacy for groups and parent insurers;
- an insurer's dealings with related entities;
- risk concentrations at both the authorised entity and group levels;
- governance requirements at group level;
- group risk management;
- management of group-wide reinsurance arrangements (both intra-group and those with third party insurers/reinsurers);
- appointment of an approved actuary (or actuaries) for the group; and
- management of group relationships.

In addition, it proposes alternative arrangements which may allow non-financial sector businesses to continue to operate subsidiary general insurance businesses without undue intervention by APRA in the commercial business operations.

² These recommendations relate to the establishment of a system of prudential regulation allowing APRA to monitor the financial condition of corporate groups involving insurers (including their overseas operations) and the application of a group-wide Minimum Capital Requirement (MCR).

³ These two documents are available on the IAIS web site (www.iaisweb.org).

⁴ Details of the ADI conglomerates policy framework were set out in the April 2000 policy information paper and the October 2001 discussion paper, and reflected in the revised ADI prudential standards *APS 110 Capital Adequacy*, *APS 111 Capital Adequacy: Measurement of Capital*, *APS 221 Large Exposures* and *APS 222 Associations with Related Entities* (2003 and 2007 versions). These papers and standards (including associated guidance notes) are available on the APRA web site (www.apra.gov.au).

Chapter 3

International practice on group-wide supervision of general insurers

Practices on the supervision of insurers that operate within a larger corporate group vary from country to country.⁵ To date, most general insurance supervision has operated on the basis of regulating and supervising each individual insurer in a corporate group. This assumes that by ensuring each insurer in the group is adequately managed and financially sound, an insurer can be 'ring-fenced' from problems elsewhere in the group.

A more comprehensive approach to dealing with contagion of financial problems in a corporate group containing insurers has been implemented in the European Union (EU) under its *Insurance Groups Directive* (98/78/EC).⁶ The approach applies an additional layer of supervision at the consolidated group level to ensure that the group as a whole as well as the individual insurers within it, are financially sound. Specifically, this Directive allows for group supervision of insurers up to the highest 'mainly insurance' parent worldwide, including insurance and reinsurance firms

and holding companies. It provides for adjustments to the solvency margin test to eliminate double or multiple gearing (i.e. the use of the same capital to support two or more businesses through investments in related undertakings); a parent undertaking solvency calculation (i.e. the top entity solvency); and supervision of intra-group transactions.

Within the EU, a major recent development has been the *Financial Groups Directive* (2002/87/EC).⁷ This Directive combines the sectoral approaches to consolidated supervision of banking and general insurance groups for financial conglomerates where there is significant cross-sector activity within the group. It provides for an overall oversight of a financial conglomerate which involves supervisory oversight of group systems, controls and management, risk concentrations and intra-group transactions, and group capital adequacy and solvency. Under this Directive, regulated entities will use one of the three Joint Forum methods⁸ (all of which address double-gearing and down-streaming) or a combination of these methods for considering the adequacy of group capital.

⁵ Attachment 1 provides an outline of the supervision approach adopted in the United Kingdom and Canada.

⁶ This Directive can be found at http://europa.eu.int/scad_en.htm.

⁷ This Directive can be found at <http://www.fsa.gov.uk>.

⁸ The relevant Joint Forum paper can be found at <http://www.bis.org>.

Chapter 4

Corporate structures

To allow APRA to adequately assess and address contagion risk posed to an Australian insurer in a corporate group from group activities and inter-relationships, the structure of a corporate group that includes an Australian insurer needs to be sufficiently transparent for APRA to be able to ascertain:

- where the various business lines are conducted;
- the risk profile of the group and its individual parts;
- the way in which internal risk management is organised and conducted; and
- what corporate, financial and other linkages exist between group members.

This is important both where the group undertakes other financial (e.g. banking, life insurance and funds management) and/or non-financial (i.e. commercial) activities, in which case the risk profile of the group differs significantly from a pure general insurance group. In the case of mixed conglomerates (combining financial and commercial businesses), APRA's concern is to make sure that such conglomerate groups are not structured in a way which would require APRA to have to supervise commercial entities that head the groups in order to effectively supervise an insurer and other members in the group on a consolidated basis.

As a general rule, APRA will expect the structure of corporate groups involving Australian insurers to enable it to effectively exercise prudential oversight of the group as a whole, using the regulatory framework set out under the *Insurance Act 1973* (Insurance Act) and the *Financial Sector (Shareholdings) Act 1998* (FSSA). This can be most readily achieved where corporate groups that include one or more Australian insurers (including foreign-owned groups) are headed by:

- an Australian insurer; or
- a NOHC authorised by APRA under the Insurance Act (or under the *Banking Act 1959* where the group contains significant banking business, or both in the case of financial conglomerates containing substantial banking and general insurance business); or
- certain other APRA-regulated entities.

These group structures facilitate APRA supervision of the overall group through the APRA-regulated head company within the framework of its legislative powers (including prudential standard-making, investigative and enforcement powers).⁹ This framework would include regulatory access to relevant group information and would allow APRA to assess the capital structures, risks, and control and governance arrangements entailed in the business of the group, and to impose prudential requirements on a group basis.

However, APRA would consider exceptions to these preferred group structures on a case-by-case basis, as is current practice. For example, it would still be possible for locally incorporated commercial entities heading a corporate group to include subsidiary general insurance operations within the group. Where it is envisaged that group-wide supervision is not practically viable in these circumstances, alternative arrangements (as proposed below) would need to be put in place to ensure that the general insurance operations are effectively 'ring-fenced' from the rest of the group to limit contagion risk.

Groups with existing corporate structures that differ from the APRA-preferred model would need to liaise with APRA whether they will change to one of the permissible corporate structures over an agreed transition period or whether an alternative ring-fencing approach would be applied to the general insurance operations.

Potential permissible group structures are outlined at 4.1 to 4.5.

4.1 Headed by an Australian insurer

Under this corporate structure, the locally incorporated insurer heading the group and its subsidiaries (including their overseas operations) would form a consolidated group for prudential supervision purposes.¹⁰ The proposed consolidated supervision framework would apply to each of the Australian insurers in the group and to the group as a whole.

In the case of a joint venture insurer that is equally controlled by two or more parties, this insurer (and

⁹ Refer footnote 1.

¹⁰ For the purpose of this paper, subsidiaries have the meaning within section 46 of the *Corporations Act 2001*.

its subsidiaries) would not be treated as part of its parents' corporate groups for consolidated supervision purposes. Where the joint venture insurer has one or more subsidiaries, this insurer and its subsidiaries would form a separate consolidated group for prudential supervision purposes. The proposed consolidated supervision framework would apply to the joint venture insurer and to this insurer and its subsidiaries as a whole. However, additional prudential requirements would apply to govern this insurer's dealings with parents and other members of the parents' corporate groups, to ensure that this insurer is effectively 'ring-fenced' from contagion risk posed by the activities of its parents and the parents' corporate groups (see sections 5.2 and 5.7 for details).

4.2 Headed by an authorised NOHC

In this case, the authorised NOHC heading the group and its subsidiaries (including their overseas operations) would form a consolidated group for prudential supervision purposes. The proposed consolidated supervision framework would apply to each individual Australian insurer in the group and to the consolidated group.

Consistent with the conglomerates framework applying to ADIs, authorised NOHCs would be restricted to activities necessary to support the functioning of the group. To this end, the activities of authorised NOHCs would be limited to:

- providing executive leadership across the group;
- holding investments in subsidiaries;
- holding properties used by group members;
- raising funds to invest in, or to provide support to, subsidiaries;
- raising funds to conduct its own limited activities;
- investing funds (e.g. surplus capital) on behalf of the group;
- conducting the financial activities required for its own limited functions; and

- providing administrative (e.g. back office), risk management and financial services to support the efficient operation of the group (subject to any statutory or prudential limitations placed on such activities).

Authorised NOHCs would not be permitted to:

- trade in financial instruments (other than for hedging purposes for itself and the group, and managing its cost of capital and funding);
- engage in general insurance or reinsurance activities;
- guarantee the obligations of its subsidiaries without the approval of APRA;¹¹
- utilise its investments in subsidiaries as security without the approval of APRA; or
- conduct any other business not ancillary to its core role as holding company for investments in group companies.

4.3 Owned by a foreign insurance company or other foreign entity (approved under the FSSA)

For foreign insurance companies establishing a local general insurance group in Australia, the foreign-owned, locally incorporated insurer (foreign-owned insurer) and its subsidiaries (including any overseas operations) would form a consolidated group for APRA prudential supervision purposes. Alternatively, where the foreign-owned insurer has a locally incorporated NOHC parent that heads the Australian group, the consolidated group would comprise the Australian NOHC parent and its subsidiaries. The insurer's foreign parent(s) (including any Australian branch of the foreign insurance parent), the foreign parent's overseas-based subsidiaries (other than those owned through the Australian NOHC or insurance subsidiaries) and their other directly owned subsidiaries operating in Australia would be excluded from the Australian consolidated group and would not be subject to APRA's consolidated

¹¹ Consistent with the proposed requirements to be applied to insurers in relation to dealings with related entities (see section 5.2.2), as a general rule authorised NOHCs of insurers would not be permitted to have unlimited exposures to related entities either in aggregate or at an individual entity level (e.g. a general guarantee of the obligations of a related entity).

supervision. Accordingly, the proposed consolidated supervision framework would apply to each Australian insurer in the Australian group and to the Australian consolidated group (including any foreign operations of that group). This includes supervision of their business relationships with other related parties (see sections 5.2 and 5.7).

It is not necessary for a foreign-owned insurer to be the holding company for all of a foreign conglomerate group's operations in Australia.¹² However, the foreign conglomerate group containing an Australian insurer will need to satisfy APRA that it is subject to regulatory oversight broadly consistent with that applied by APRA to conglomerate groups involving insurers and, should the need arise, to provide APRA with information concerning activities of the overall group and/or its individual entities outside the Australian consolidated group. Where the home country regulator does not apply group-wide supervision on a basis that is broadly consistent with that applied by APRA, additional or more stringent ring-fencing arrangements apart from those proposed under the consolidated supervision framework (see sections 5.2 and 5.7) may be required to effectively limit contagion risk posed to the Australian general insurance operations from other parts of the foreign conglomerate group.

4.4 Headed by other APRA-regulated entities

Where an Australian insurer forms part of a corporate group that includes one or more other APRA-regulated entities, a group involving any ADIs must be headed by either a locally incorporated ADI or an authorised NOHC as per the existing conglomerates regime applying to ADIs. In other cases, the group may be headed by a registered life company.¹³ Under this corporate structure, the APRA-regulated entity heading the group and its subsidiaries (including their overseas operations) would form a consolidated group for prudential supervision purposes. The proposed consolidated supervision framework would apply to

each individual insurer in the group and to the overall group.¹⁴ Structures which lead to double-gearing within the group will not be permitted.

4.5 Headed by a commercial entity

As is current policy, mixed conglomerates comprising commercial and general insurance businesses could be headed by commercial entities. Under this group structure, APRA would be able to apply supervisory oversight to the overall group through the commercial company parent heading the group, either via conditions on its FSSA approval or a formal and irrevocable (without APRA's agreement) undertaking (which might be in the form of a deed) from the commercial parent. However, as noted earlier, applying a group-wide supervision approach to such a mixed conglomerate would generally not be practically viable.

APRA therefore proposes to adopt a pragmatic approach to the supervision of an Australian insurer that operates in such a group. Under this approach, consolidated supervision would only apply to the subsidiary general insurance group. For this purpose, a general insurance sub-group would include the Australian insurer(s) in the group, any locally incorporated NOHC that directly holds the general insurance sub-group (which would need to be an authorised NOHC) and subsidiaries of these entities (including any overseas operations of the general insurance sub-group). Where these groups contain more than one insurer, APRA will expect these to be owned either through one of the Australian insurers or by a single authorised NOHC. Accordingly, the proposed consolidated supervision framework would apply to each individual insurer in the general insurance sub-group and to the general insurance sub-group on a consolidated basis. The insurer's commercial parent heading the overall group and the parent's subsidiaries (other than those that form part of the general insurance sub-group) would not be subject to APRA's consolidated supervision.

¹² A foreign conglomerate group refers to any group of companies which is headed by an approved foreign entity and has an Australian insurer in its group.

¹³ The life insurer heading the group must own the general insurance subsidiary out of its shareholders fund.

¹⁴ APRA intends to extend the conglomerate policy frameworks for ADIs and insurers to the life insurance industry. The prudential framework for the supervision of corporate groups involving life insurers will be further developed at a later date.

In this case, however, the proposed application of ring-fencing arrangements to an Australian insurer and authorised NOHC in respect of either entity's dealings with group entities would also capture dealings with the commercial company parent and other group entities outside the general insurance sub-group (see sections 5.2 and 5.7 for details). These include the requirement that dealings with these entities must be on an arm's-length basis and requirements relating to management of group relationships with these entities (such as intra-group outsourcing, group branding and sharing of infrastructure and service arrangements).

As noted earlier, APRA may impose additional or more stringent ring-fencing requirements on each Australian insurer in the general insurance sub-group (including, where applicable, the authorised NOHC heading the general insurance sub-group), or on the general insurance sub-group as a whole, or both, in respect of associations and dealings with other parts of the

wider corporate group. For example, APRA may prohibit the authorised NOHC and the insurer(s) from providing any funding or financial support to the commercial parent or other subsidiaries of the commercial parent outside the general insurance sub-group. APRA may also apply tighter asset exposure limits in respect of the general insurance sub-group's aggregate exposures to these entities.

APRA would also require a formal undertaking from the commercial parent (via conditions on its FSSA approval) to demonstrate its financial soundness and ability to provide material support to the general insurance sub-group from time to time. The commercial parent would also be required to notify APRA as soon as practicable where there is a material change in its financial capacity (including whether this will have a material impact on its ability to support the subsidiary general insurance operations).

Chapter 5

Consolidated supervision framework

The proposed framework would apply to an Australian insurer that operates in a corporate group as follows:

- in the case of a corporate group headed by an APRA-regulated entity, the proposed prudential requirements would apply to each individual insurer in the group and to the head company and its subsidiaries on a consolidated basis; and
- in the case of a corporate group with mixed commercial and general insurance businesses that is headed by an Australian commercial entity (or by another non-APRA regulated Australian entity), the proposed prudential requirements would apply to each individual insurer in the group and to the general insurance sub-group on a consolidated basis (this would comprise all Australian insurers in the group, any authorised NOHC for holding the general insurance sub-group and subsidiaries of these entities).

The proposed framework discussed in this paper focuses on prudential requirements to be applied to an Australian insurer that operates within a corporate group and to the wider corporate group on a consolidated basis. However, the new capital deduction requirements and revised asset concentration thresholds (including requirements in relation to management of reinsurance concentrations) proposed to apply to an Australian insurer at the stand-alone level (see particularly sections 5.1.1, and 5.2) will apply to all insurers, including Australian branches of foreign insurance companies. Proposed prudential requirements in relation to management of group inter-relationships, such as branding and distribution of financial products and sharing of group infrastructure (see section 5.7), would also apply to Australian branches of foreign insurance companies in respect of the branch's dealings and associations with other group entities in Australia.

5.1 Approach to consolidated capital adequacy

Currently, insurers are required to maintain an appropriate level of capital¹⁵ commensurate with the level and extent of risks to which they are exposed from their activities. For Australian insurers that operate as part of a corporate group, the board of the insurer, in determining stand-alone capital adequacy, should also have regard to group risks posed to the insurer by other members in the group, and obligations (direct or indirect) arising from associations with group entities which might give rise to a call on the capital of the insurer.

Apart from maintaining adequate capital on a stand-alone basis, under the proposed consolidated supervision framework Australian insurers (or their APRA-regulated parent companies) that head a corporate group will also need to satisfy APRA that the group as a whole is financially sound and has sufficient capital consistent with the group's risk profile.¹⁶ To this end, the board of the Australian insurer (or other APRA-regulated entity) heading a corporate group involving Australian insurers must:

- establish policies on group capital adequacy (which should have regard to the type and distribution of capital resources held by the group) and, as part of the group's risk management framework, implement a strategy for group capital management that is consistent with the group's business plan and ensure that the group is adequately capitalised to cover the risks faced by the group and meet regulatory, market and strategic needs;¹⁷
- ensure that appropriate and adequate systems and procedures are in place to identify, assess, measure and monitor group risks on a continuous basis; and
- ensure that the group has sufficient capital freely available to meet unexpected losses and adverse shocks impacting on the group.

¹⁵ For the purpose of this paper, capital has the meaning within *GPS 110 Capital Adequacy for General Insurers* and *GGN 110.1 Measurement of Capital Base* (including any changes in the definition of capital contained in subsequent revised prudential standards and guidance notes).

¹⁶ Where a corporate group involving Australian insurers is headed by an Australian commercial entity, the proposed requirements set out in this section would only apply to the authorised NOHC or insurer heading the general insurance sub-group and to the general insurance sub-group.

¹⁷ The proposed requirement for group capital management is consistent with the proposals set out in APRA's draft *GPS 220 Risk Management* (including related guidance notes) released in May 2005. These are available on the APRA web site (www.apra.gov.au).

In determining capital levels for the overall group, the board of the head company should have regard to:

- the potential for risk to compound across the group (as well as any proven benefits of risk diversification);
- concentration of capital and risk within individual entities in the group;
- the capital needs of individual entities in the group;
- the nature of capital held by the group, including its maturity, servicing costs and any double counting or upgrading of capital within the group;
- the ability to readily transfer surplus or free capital within the group and the type of capital which would be available to individual entities from other group members if required (this would involve consideration of the impact of taxation, regulatory requirements and other factors impinging on the ability to transfer surplus capital among individual entities); and
- the integration of business within the group and the ability of the group to readily realise capital through the sale of business lines and/or individual member entities without adversely impacting the viability of the group's on-going operations.

The head company would also be required to provide APRA with a description of its policies on group capital adequacy (including the methodology used to measure capital adequacy of the overall group) and approach to group capital management.

Consistent with the existing capital adequacy framework applying to a conglomerate group involving ADIs (which may also include Australian insurers in the group), APRA proposes to assess the capital adequacy of an Australian insurer that operates as part of a corporate group at three levels (see illustrative diagram in Attachment 2):

Level 1 – This level would apply to: (1) each Australian insurer in the group on a stand-alone basis; or (2) where applicable, each Australian insurer's Extended Licensed Entity (ELE) comprising the insurer itself and any APRA-approved ELE-eligible entities assessed as a single 'stand-alone' entity as per the existing regime.¹⁸

Level 2 – This level would apply to the consolidated general insurance group, comprising: (1) in the case of a corporate group headed by an APRA-regulated entity, the ultimate Australian insurer in the group, its immediate locally incorporated NOHC (if any)¹⁹ and their subsidiaries (other than non-consolidated subsidiaries²⁰) assessed as a consolidated group; and (2) in the case of a corporate group headed by an Australian commercial entity, the ultimate Australian insurer in the general insurance sub-group, any authorised NOHC holding the general insurance sub-group and subsidiaries (other than non-consolidated subsidiaries) of these entities.

Level 3 – This level would only apply to a corporate group involving Australian insurers where prescribed by APRA (other than a corporate group headed by an Australian commercial entity or by another non-APRA regulated Australian entity where consolidated supervision would only apply to the general insurance sub-group). This level would cover the entire corporate group headed by an APRA-regulated entity at the widest level.

Under this approach, all overseas general insurance subsidiaries would be consolidated and subject to APRA's capital adequacy requirements at group level (although these subsidiaries would also still be subject to the capital adequacy requirements set by the host supervisor on a stand-alone basis).

¹⁸ See GGN 110.4 *Investment Risk Capital Charge* for the requirements applying to ELE-eligible entities.

¹⁹ The inclusion of immediate NOHC is consistent with Basel II proposals for banks.

²⁰ See section 5.1.2.

Given the diversity of corporate structures that exist, institutions should advise APRA of particular issues that may create difficulties in applying the proposed three-level approach to their situation.

In addition to capital adequacy reporting at the authorised entity level, insurers subject to Level 2 and Level 3 capital adequacy assessments would also be required to report to APRA on a regular basis (quarterly or more frequently if required by APRA) in respect of the Level 2 and Level 3 group's capital positions.

With respect to Australian insurers that are part of a group owned by a foreign entity, or which include foreign subsidiaries, APRA would expect to enter into arrangements with their foreign regulator to ensure that APRA is kept adequately informed of the capital position of the entire group. APRA may also request information directly from the entities as necessary.

5.1.1 Level 1 capital requirements²¹

Level 1 capital adequacy is fundamental for assessing the financial soundness of a regulated entity on a stand-alone basis and will continue to apply to all insurers.

As a general principle, APRA believes that capital invested by a regulated entity in another entity within the group should not be regarded as also being available to support the activities of the regulated entity for purposes of assessing its stand-alone capital adequacy. It is proposed that any intangible component of investments in subsidiaries regulated by APRA or by a foreign equivalent (i.e. the excess of the investment value over the net tangible assets of the subsidiary) made by an Australian insurer or the ELE (as appropriate) be deducted from Tier 1 capital, with the remainder subject to investment risk capital charges as an equity investment. All equity investments in other subsidiaries (other than APRA-approved ELE-eligible entities) and related entities as well as joint

ventures, would also be required to be deducted from Level 1 capital, with the intangible component of the investments deducted from Tier 1 capital and the remainder deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital.²² Credit support of a capital nature provided to other entities, such as guarantees provided in lieu of capital, or in support of capital instruments issued by related companies, or other first loss facilities such as those associated with securitisation schemes,²³ would need to be deducted from Tier 1 and Tier 2 capital on a 50:50 basis. This is similar to the approach proposed for ADIs (see *APS 111 Capital Adequacy: Measurement of Capital* (2007 version for ADIs)) and reflects the prudential need to avoid double leveraging of capital.

All such investments and exposures deducted from the insurer's or ELE's capital (as appropriate) would be excluded from the investment risk capital charge required under *GPS 110 Capital Adequacy*.

5.1.2 Level 2 capital requirements

Level 2 capital adequacy assessment aims to measure the capital available to support the group's general insurance activities. Accordingly, prudentially regulated non-general insurance subsidiaries, subsidiaries acting as manager, responsible entity, trustee or similar role in relation to funds management or the securitisation of assets, and commercial entities not directly related to the insurer's business²⁴ would all be treated as non-consolidated subsidiaries for Level 2 capital adequacy purposes. Depending on an insurer's corporate structure, APRA recognises that there could be more than one ultimate Australian insurer in a group or more than one Level 2 consolidated group within a conglomerate.²⁵

For the purposes of determining capital adequacy of the consolidated general insurance group, APRA proposes to extend the risk-based capital adequacy framework (including the valuation principles) that

²¹ Where relevant, the proposed requirements set out in this section would also apply to Australian insurers that operate as stand-alone entities and to the Australian branch of a foreign insurance company when calculating their prudential capital requirements.

²² In cases where Tier 2 capital is not sufficient to absorb the required deduction, the shortfall would be deducted from Tier 1 capital.

²³ For this purpose, this does not include conventional lenders mortgage insurance which is otherwise included in the insurer's capital calculation.

²⁴ Note that subsidiary service companies would be consolidated.

²⁵ For example, in the illustrative diagram at Attachment 2 there are two ultimate Australian insurers within the same corporate group (namely GI₁ and GI₂). Accordingly, the two insurers (including their immediate locally incorporated NOHC) and all relevant subsidiaries would be subject to separate Level 2 capital adequacy assessment under the proposed framework.

currently applies to Australian insurers on a stand-alone basis²⁶ to the consolidated general insurance group at Level 2. As is the case for determining an insurer's Minimum Capital Requirement (MCR) at Level 1, this could include the use of an APRA-approved internal model developed by an insurer (subject to satisfying a range of similar criteria applied to the insurer at Level 1) to determine the MCR of the consolidated general insurance group. APRA would retain the ability to adjust the Level 2 group's MCR where it believes that the amount determined under the Internal Model-Based Method or the Prescribed Method, or a combination of these methods, does not adequately reflect the risk profile of the consolidated general insurance group.

As noted above, overseas general insurance subsidiaries would be consolidated and subject to APRA's capital adequacy requirements at group level. However, APRA would adopt a pragmatic approach when applying the Australian capital adequacy requirements to overseas general insurance operations at Level 2. APRA does not expect individual overseas general insurance subsidiaries to calculate their insurance liabilities from the ground up in accordance with APRA's requirements for the purposes of determining Level 2 capital adequacy (i.e. the Australian capital adequacy requirements would not apply to overseas general insurance subsidiaries on a stand-alone basis). Rather, it would be the responsibility of the group actuary (or actuaries) to determine the comparability of overseas capital standards (including valuation principles for insurance liabilities) and make necessary adjustments accordingly at the consolidated group level.

Similar to the capital deduction rules proposed for Level 1, all equity investments in non-consolidated subsidiaries, joint ventures (which are not subsidiaries) and other related entities which are not part of the Level 2 group, as well as credit support of a capital nature provided to other entities, would need to be deducted from the group's Level 2 capital (in line with the deduction approach proposed for Level 1). All such investments and exposures deducted from the group's capital would be excluded from any associated investment risk capital charge required at Level 2.

5.1.3 Level 3 capital requirements

Only Australian insurers prescribed by APRA would be subject to Level 3 capital adequacy assessment. APRA will identify corporate groups for which Level 2 assessment is deemed insufficient for measuring an Australian insurer's capital adequacy on a group-wide basis. For example, these could be financial conglomerates containing substantial banking and general insurance activity, mixed conglomerates containing significant financial and non-financial activity, or general insurance groups with corporate structures which are not readily amenable to comprehensive Level 2 assessment.

Insurers subject to Level 3 assessment would need to have an APRA-approved, group-wide capital calculation that corresponds to their corporate structure. Essentially, the capital calculation should have regard to all group members (whether ADIs, insurers (life or general), approved trustees or entities not regulated by APRA) and the capacity for any surplus capital to be moved around the group according to need. The capital calculation might be based on the methodologies of the Joint Forum²⁷ or a combination of those methodologies.

It might also be possible for prescribed Level 3 groups to extend the risk-based capital adequacy framework at Level 2 to their Level 3 capital calculation. This might occur, for example, where the group is predominantly general insurance-based.

Alternatively, where they have been sufficiently developed, the capital adequacy requirement at Level 3 might be based on the group's own internal capital estimation and allocation models. The Australian insurer would need to satisfy APRA that the corporate group of which it is a part has sufficient capital (defined according to the standard Tier 1 and Tier 2 definitions) for the risk profile of the group as a whole.

APRA would expect any methodology for measuring group-wide capital adequacy to apply capital deductions at Level 3 similar to those above for Level 2, in respect of equity investments in group entities and other related entities (including any credit support of a capital nature provided to other entities)

²⁶ See *GPS 110 Capital Adequacy for General Insurers* and associated guidance notes for details.

²⁷ The relevant Joint Forum paper can be found at <http://www.bis.org>.

and to address any double counting or upgrading of capital within the group, to the extent that they are not eliminated within a conglomerate model.

Prescribed Level 3 groups would need to provide to APRA details of their own benchmarks on minimum group-wide capital adequacy. Subject to APRA being satisfied with the methodology for group-wide capital adequacy calculation, minimum group-wide capital adequacy benchmarks would be agreed with the prescribed Level 3 group. The Level 3 group must meet the agreed minimum benchmarks and would need to provide to APRA details of the extent to which these are exceeded by the group, on an ongoing basis. It is expected that a minimum benchmark would be that all regulatory capital requirements within the group should be ultimately financed by eligible capital at group level (after elimination of requirements generated by intra-group transactions). Allowance would need to be made in this calculation for business in jurisdictions where regulatory requirements are demonstrably less stringent than Australian requirements.

In instances where APRA is not satisfied with the group-wide capital adequacy assessment – for example, because the group’s internal benchmarks are deemed insufficiently prudent or because APRA is not satisfied with the assumptions made (e.g. for diversification or in relation to capital mobility) – APRA may impose additional or higher capital requirements on the Australian insurer(s) in the group or the overall group (relative to the group’s own benchmarks).

5.2 Risk concentrations and intra-group transactions

5.2.1 Large exposures

Both insurers and their corporate group may face asset concentration risk. This may arise from excessive holdings of a particular investment asset (such as real estate, debt and equity securities issued by a particular counterparty or deposits with an ADI) or excessive credit risk exposure to another insurer or reinsurer arising from reinsurance recoveries (referred to as ‘reinsurance exposures’ hereafter), at the authorised entity or group level or both. Insurers may also be exposed to asset concentration risk arising from excessive intra-group lending to a particular group member or through intra-group reinsurance arrangements.

As with capital requirements, APRA proposes a tiered approach to deal with asset concentration risk (also referred to as ‘large exposures’ in this paper) associated with corporate groups involving Australian insurers. Under this approach, asset exposures in relation to Australian insurers that operate within a corporate group would be assessed at three levels (as defined in section 5.1) as follows:²⁸

Level 1 – As is current practice, this would capture exposures of an insurer (including any entities approved as part of its ELE) to a particular asset or counterparty (or group of related counterparties). This would include exposures to related entities²⁹ and external counterparties.³⁰

²⁸ The proposed three-level asset concentration assessment also aligns with the large exposures framework applying to conglomerate groups involving ADIs, although some of the proposed methodologies differ.

²⁹ For large exposure purposes, all entities controlled (whether directly or indirectly) by an Australian insurer (other than APRA-approved ELE-eligible entities) or by the ultimate APRA-regulated parent of an Australian insurer (including the parent itself) represent a ‘related entity’ of an Australian insurer. Where appropriate, APRA may deem that other entities (and their subsidiaries) represent a ‘related entity’ of an Australian insurer for this purpose.

³⁰ This includes all entities other than related entities. For large exposure purposes, the following entities would also be treated as external counterparties:

- (i) in the case of an Australian insurer that operates in a corporate group that is headed by an Australian commercial entity – the insurer’s commercial company parent heading the group and the parent’s subsidiaries (other than those that form part of the general insurance sub-group and non-consolidated subsidiaries of the general insurance sub-group) would be treated as a group of related external counterparties;
- (ii) in the case of a joint venture insurer that is equally controlled by two or more parties – each of the insurer’s parents (and their respective corporate groups) would be treated as a separate group of related external counterparties. Likewise, where an Australian insurer and other parties equally control a joint venture insurer, the joint venture insurer and its subsidiaries would be treated as a group of related external counterparties of the parent insurer for large exposure purposes; and
- (iii) in the case of a foreign-owned insurer – the insurer’s foreign parent(s) (including any Australian branch of the foreign insurance parent), the foreign parent’s overseas based subsidiaries (other than those owned through the Australian NOHC or general insurance subsidiaries), and their other directly owned subsidiaries operating in Australia would be treated as a group of related external counterparties.

Level 1 – Level 1 assessment will continue to apply to (cont.) insurers that operate as stand-alone entities and to the Australian branch of a foreign insurance company as is current practice.³¹ However, this would be measured against revised asset concentration thresholds set out in section 5.2.3.

Level 2 – This would capture asset exposures of the consolidated general insurance group to an external counterparty or group of related external counterparties,³² including exposures to holdings of a particular asset.

Level 3 – Corporate groups involving Australian insurers prescribed by APRA to meet Level 3 capital requirements would also be subject to Level 3 asset concentration assessment. This would capture exposures of the overall group to holdings of a particular asset or individual external counterparties (or a group of related external counterparties).³³

Under this framework, asset exposures at Levels 1, 2 and 3 would be measured as a percentage of capital base of the respective level, and against prescribed prudential thresholds (see section 5.2.3 for proposed thresholds to be applied at Levels 1 and 2) for the purposes of applying asset concentration charges under the proposed three-level capital adequacy framework.³⁴ Until APRA agrees with individual prescribed insurers on a Level 3 capital calculation, Level 3 asset concentration would initially be dealt with solely under the Level 3 group's Risk Management Strategy (RMS) agreed with APRA. Any large exposure limits to be applied to a Level 3 group would be agreed on a bilateral basis.

As is currently required under *GPS 220 Risk Management for General Insurers*, insurers must have policies, systems and controls in place to identify, monitor, manage and report their large exposures to particular assets or individual counterparties (or groups of related counterparties) and these must be documented in their RMS.³⁵ This includes limits and other requirements relating to large exposures arising from intra-group or related entity transactions (see section 5.2.2 for proposed requirements in relation to an Australian insurer's dealings with related entities). To adequately address potential asset concentration risk at a group level, this requirement would be extended to cover large exposures at Level 2 and Level 3 as part of the insurer's Group RMS (see section 5.4 for proposed requirements in relation to group risk management).

In addition to current requirements on large exposures reporting at the authorised entity level, Australian insurers would also be required to report to APRA on a regular basis (quarterly or more frequently if required by APRA) asset exposures of the consolidated insurance group exceeding 10 per cent of the Level 2 capital base. Likewise, large exposure reporting requirements, to be agreed with APRA on a bilateral basis, would apply to prescribed Level 3 groups.

5.2.2 Dealings with related entities³⁶

Intra-group or related entity transactions may expose insurers to excessive risk. It is critical that the board of an insurer establishes, and monitors compliance with, policies governing all dealings with related entities (such as borrowing and lending, equity underwriting, use of and payment for services, reinsurance and other

³¹ For foreign insurers operating through branches in Australia, the insurer's head office, other foreign branches, subsidiaries, parent(s), and the parent's subsidiaries would all be treated as a group of related counterparties for large exposure purposes.

³² For large exposure purposes, entities identified in footnote 30 as external counterparties of an Australian insurer at Level 1 would also be treated as external counterparties of the consolidated insurance group at Level 2. Any non-consolidated subsidiaries of the group (as identified in section 5.1.2) would also be treated as a group of related external counterparties.

³³ In respect of asset exposures to a joint venture insurer that is equally controlled by two or more parties, of which one of these parties is an Australian insurer included in the Level 3 group, the joint venture insurer and its subsidiaries would be treated as a group of related external counterparties of the Level 3 group for large exposure purposes.

³⁴ For foreign insurers operating through branches in Australia, asset exposures of the Australian branch will be measured against the branch's adjusted net assets in Australia (as reported in *GRF 110.0 Minimum Capital Requirement*) for large exposure purposes.

³⁵ Refer APRA's draft *GPS 220 Risk Management* (including related guidance notes) released in May 2005, which is available on the APRA web site (www.apra.gov.au).

³⁶ The proposed requirements set out in this section are based on the prudential measures currently applying to insurers in respect of their dealings with external counterparties, and would apply to each of the groups set out in footnotes 29, 30, and 31.

types of transactions), and these must be documented in the insurer's RMS. The board must also ensure that adequate systems and controls are in place for identifying, monitoring, managing and reporting exposures arising from dealings with related entities. APRA may require an insurer to put in place additional internal controls, a more robust reporting mechanism and/or be subject to a higher minimum capital requirement if it is not satisfied with the adequacy of the insurer's systems and controls.

As a general rule, board policies on related entity dealings must include a requirement that any such dealings be conducted on an arm's-length basis to ensure that there is no implicit or explicit suggestion that the resources of the insurer can be inappropriately used to support the activities of associates.³⁷ For example, intra-group loans generally must not be extended on more favourable terms (i.e. for credit assessment, interest rates, repayment tenor, requirement for security) than corresponding loans to non-related counterparties and must be properly documented and approved. Similar principles also apply to intra-group insurance or reinsurance dealings.

The board must also establish prudent limits on exposures to related entities at both an individual and aggregate level. In determining these exposure limits, the board should have regard to the level of exposures which would be approved for non-related entities of broadly equivalent credit status, and the impact on the insurer's stand-alone capital and liquidity positions as well as its ability to continue operating, in the event of a failure of any related entity to which the insurer is exposed.

As a general rule, insurers would not be permitted to have unlimited exposures to related entities, whether in aggregate or at an individual entity level (such as providing general guarantees over the operations of related entities).³⁸ Nor would an insurer be permitted to enter into cross-default clauses whereby a default by a related entity on an obligation (whether financial

or otherwise) is deemed to trigger a default by the insurer on its obligations.³⁹ The group should not be managed in a manner that relies on support from the insurer.

5.2.3 Asset concentration thresholds

Currently, insurers are required to hold additional capital (in the form of an investment concentration charge) where their holdings of an asset or exposures to a particular counterparty (or group of related counterparties) exceed certain prescribed thresholds set out in *GGN 110.4 Investment Risk Capital Charge*. This includes asset exposures to both related entities (other than APRA-approved ELE-eligible related entities) and external counterparties.

However, these thresholds are set at high levels, and neither concentration limits nor additional capital charges apply to an exposure where the counterparty's credit rating is above certain prescribed levels. APRA is concerned that the current requirements are not robust enough to adequately address the issue of asset concentration risk of an insurer, either at an authorised entity level or at a group level (if this approach were extended to apply to asset exposures at Level 2).

APRA proposes to retain the existing large exposures framework whereby asset exposures over certain credit ratings-based thresholds attract a 100 per cent capital charge (in respect of the excess portion). However, a separate set of thresholds would apply to reinsurance exposures (i.e. credit exposures to another insurer or reinsurer arising from reinsurance arrangements) and non-reinsurance exposures. In addition, the framework would be extended to apply to asset exposures at Level 2. Adjustments would also be made to the framework to improve its robustness. Essentially, APRA would reduce the credit ratings-based thresholds currently applying and enhance the application of the framework to address the issue of aggregating asset exposures to a group of related counterparties with different credit ratings.

³⁷ A corresponding requirement would also apply to an authorised NOHC of an insurer in respect of its dealings with related entities.

³⁸ This would exclude any unlimited exposures arising from the statutorily defined coverage of an insurance contract.

³⁹ Corresponding requirements to those set out in this paragraph would also apply to authorised NOHCs of insurers.

Proposed new thresholds are set out in Table 1. These thresholds would apply to asset exposures (both reinsurance and non-reinsurance) to a counterparty or group of related counterparties (including exposures to holdings of a particular asset) at Level 1 and Level 2 (as defined in section 5.2.1) and would be measured against the capital base of the respective level.⁴⁰ As with intra-group exposures, as a general rule APRA expects that neither insurers nor authorised NOHCs of insurers will have unlimited exposures to any individual external counterparty.⁴¹

The proposed non-reinsurance thresholds would capture aggregate non-reinsurance exposure to a counterparty (or group of related counterparties). This would include all on-balance sheet claims on the counterparty (such as loans to and deposits with the counterparty and holdings of debt and/or equity securities issued by the counterparty) and off-balance sheet contingent exposures to the counterparty (such as those arising from direct credit substitutes issued by the insurer and derivative contracts). The thresholds, however, would apply net of non-reinsurance exposures that have already been deducted from capital or are secured by eligible collateral or guarantees (as currently defined in *GGN 110.4 Investment Risk Capital*

Charge). The portion of the exposure collateralised or guaranteed would be treated as an exposure to the collateralised asset or guarantor respectively. The proposed thresholds would also apply to holdings of a particular asset such as real estate and units in a trust. Aggregate non-reinsurance exposure to a counterparty (or group of related counterparties) or particular asset in excess of the proposed thresholds applying to the respective level would be subject to a 100 per cent capital charge (in respect of the excess portion).

For reinsurance exposures to a counterparty (or group of related counterparties) at Level 1 and Level 2, the proposed thresholds would capture all on-balance sheet reinsurance recoveries from the counterparty (i.e. potential recoveries against both outstanding claims and premiums liabilities), net of eligible collateral and guarantees (as currently defined in *GGN 110.4 Investment Risk Capital Charge*). The portion of the exposure collateralised or guaranteed would be treated as an exposure to the collateralised asset or guarantor respectively. Aggregate reinsurance exposure to a counterparty (or group of related counterparties) in excess of the proposed thresholds of the respective level would be subject to a 100 per cent capital charge (in respect of the excess portion).⁴²

Counterparty rating	Current threshold (aggregate reinsurance and non-reinsurance exposures)	Proposed threshold (non-reinsurance exposures)	Proposed threshold (reinsurance exposures)	Proposed threshold (aggregate reinsurance and non-reinsurance exposures)
Grade 1 (AAA rated)	no limit	50%*	100%	100%
Grade 2 (AA rated)	no limit	50%*	100%	100%
Grade 3 (A rated)	no limit	25%	50%	50%
Grade 4 (BBB rated or unrated)	50%	25%	25%	25%
Grade 5 (BB rated or below)	25%	10%	10%	10%

* No limit would apply to non-reinsurance exposures to governments and central banks with a credit rating of AA or above.

⁴⁰ As noted above, the proposed thresholds would also apply to Australian insurers that operate as stand-alone entities and to the Australian branch of a foreign insurance company, and would be measured against the insurer's capital base and the branch's adjusted net assets in Australia (as reported in *GRF 110.0 Minimum Capital Requirement*) respectively.

⁴¹ This would exclude any unlimited exposures arising from the statutorily defined coverage of an insurance contract.

⁴² For foreign insurers operating through branches in Australia, any reinsurance exposures arising from head office's global reinsurance program would be treated as reinsurance exposures to third party reinsurers for large exposure purposes where the Australian branch could make a direct claim on the reinsurers.

Some insurers organise their reinsurance through group arrangements which pool risk within captive reinsurers, which then reinsure into the market place. APRA recognises that this can be a legitimate technique which may bring benefits to the group and need not involve any increase in material risk (even though it may indirectly expose insurers to contagion from other insurers in the group). With this in mind, APRA proposes to exempt an insurer's reinsurance exposures to a related insurer within the same group from any investment risk and investment concentration capital charges where that related insurer is a pure captive reinsurer which only reinsures other insurers in the group and has no other general insurance business of its own.⁴³

The proposed aggregate thresholds for reinsurance and non-reinsurance exposures (last column of Table 1) would capture all reinsurance and non-reinsurance exposures to a counterparty (or group of related counterparties). Aggregate reinsurance and non-reinsurance exposure in excess of the proposed aggregate thresholds (excluding any exposures already subject to a 100 per cent capital charge) would be subject to a 100 per cent capital charge (in respect of the excess portion).

In respect of exposures to a group of related counterparties that have different ratings, aggregate exposure to those counterparties of the same grade would be measured against the specified threshold applying to that grade. In addition, exposures to particular counterparties within a group of related

counterparties would be aggregated upwards through the rating grades, with the threshold for each grade applying to aggregate exposures summed for that grade and all lower quality grades. Exposures in excess of the relevant specified thresholds at each grade would attract a 100 per cent capital charge. Amounts to which the 100 per cent capital charge is applied would then be excluded from the aggregation at the next highest level.

Data submitted on *GRF 150.0 Asset Concentration and Risk Charge* indicate that most insurers have non-reinsurance exposures to AAA or AA-rated counterparties (other than governments and central banks) below 50 per cent of their capital base, while some insurers have exposures to these counterparties which might be regarded as excessively large (e.g. over 100 per cent of capital). The data also indicate that few insurers have non-reinsurance exposures to other counterparties which exceed or even approach the current thresholds. As a result, the proposed adjustment of the thresholds more closely matches the prudent thresholds already in place for most of the industry, and will constrain future behavior that might involve excessive risk. This also reflects the need to diversify credit risks even to currently well-rated counterparties to guard against possible future deterioration.⁴⁴

The proposed thresholds for reinsurance exposures are lower than reinsurance exposures that some insurers report at the present time, both to related and unrelated insurers or reinsurers. However, they reflect the highest exposures that APRA believes are prudent.⁴⁵

⁴³ Existing exemptions granted by APRA to certain insurers in respect of investment risk and investment concentration capital charges for intra-group reinsurance exposures would cease to apply where those intra-group reinsurance arrangements fail to meet the proposed requirement. Where necessary, APRA would agree transitional arrangements with affected insurers to allow for capital adjustments and/or restructuring of intra-group reinsurance processes to take place in an orderly manner.

⁴⁴ Currently, overseas insurance regulators apply different prudential limits (expressed as a percentage of assets or insurance liabilities) to contain an insurer's non-reinsurance asset exposures to related entities and external counterparties (including aggregate holding of a particular asset). As a result, no particularly relevant references could be drawn from overseas regulatory practice. In some cases, related party transactions are prohibited except where these are nominal or immaterial value transactions, or are fully secured by prescribed government securities.

⁴⁵ Overseas regulatory practice on addressing an insurer's potential exposure to excessive credit risk arising from reinsurance concentrations also varies from country to country.

The UK regulator applies 'soft' limits to contain reinsurance concentrations. Under current requirements, an insurer's reinsurance exposures (net of acceptable collateral and guarantees) to a reinsurer or group of related reinsurers should not exceed 100 per cent of the insurer's capital. Acceptable collateral and guarantees include cash (such as withheld funds or deposits), bank guarantees and credit derivatives (the guaranteed portion of the exposure is treated as an exposure to the guarantor or derivative counterparty accordingly). In addition, premiums paid to a single reinsurer (or the aggregate premiums paid to a group of related reinsurers) relative to the insurer's gross earned premiums in the financial year should not exceed the higher of 20 per cent of the insurer's projected gross earned premiums for that year or £4 million. An insurer is required to notify the regulator immediately where it has exceeded, or anticipates exceeding, these limits. The insurer concerned is required to demonstrate that prudent provision has been made for the reinsurance exposure in excess of the 100 per cent limit, or explain why in the insurer's opinion no provision is required, and explain how the reinsurance exposure is being safely managed.

Overseas reinsurers writing business in the US are required to post collateral equal to 100 per cent of their liabilities for reinsurance to be credited on US cedants' balance sheets. They must fund the collateral with letters of credit, trust funds and cash. The collateral requirements also apply to US reinsurers that are not authorised in the cedant's state.

Where necessary, APRA would agree transitional arrangements with affected insurers to allow for capital adjustments to conform with these new thresholds in an orderly manner.

5.2.4 Reinsurance exposures⁴⁶

The approach proposed in this paper seeks to tackle reinsurance concentrations both prospectively at purchase and continuously while an exposure exists. Insurers are required to avoid exceeding the proposed reinsurance thresholds through means such as diversification of reinsurers, minimum ratings requirements, cash collateral or guarantee requirements, and contractual provisions to enable a replacement of reinsurers in the event that the reinsurance contract is voidable by the insurer (e.g. following a ratings downgrade of the reinsurer).

In approving an insurer's Reinsurance Management Strategy (REMS),⁴⁷ APRA would look for a reasonable spread of reinsurance counterparties. As a guide, in respect of an insurer's reinsurance exposures to reinsurers,⁴⁸ APRA expects that:

- there should be more than one reinsurance counterparty; and
- no premiums paid to a single reinsurer (or its related group) should exceed the higher of 20 per cent of the insurer's total premium revenue reported for the current financial year or \$5 million, with the insurer expected to provide strong justification for any more limited diversification.

In respect of intra-group reinsurance exposures, APRA would also take into account the REMS of the related entity in determining the adequacy of diversification of the ceding insurer's reinsurance exposures.

APRA wishes to monitor the potential for reinsurance exposures to move over time if insured risks eventuate, and intends that such potential (off-balance sheet) exposures should also be included in large exposures reporting. Since some potential exposures (e.g. in relation to statutory classes of business) may be unlimited, APRA is considering measuring this at the point of probable maximum loss for each class of business. APRA invites comments on the feasibility of this and on alternatives for measuring this potential exposure.

5.3 Governance⁴⁹

As a general principle, APRA expects that conglomerate groups will be managed so as to minimise any adverse impact on regulated entities from group activities. The board of the APRA-regulated entity heading a corporate group involving insurers needs to take responsibility for the prudent management of the overall group.⁵⁰ With this in mind, it is proposed that in broad terms the governance and risk management requirements applying to insurers would also be applied at group level. With respect to governance arrangements generally, APRA released a range of proposals relating to board composition and functioning in the *Prudential Supervision of General Insurance – Stage 2 Reforms* (the 2003 discussion paper). In May 2005, APRA will release a second discussion paper (including draft prudential standards) on governance which sets out further proposals in relation to insurers and other APRA-regulated industries. APRA is looking to apply these proposals in a consistent fashion at both the insurer and group levels.

In March 2004, APRA released a discussion paper and draft prudential standards in relation to fit and proper requirements for directors, senior managers

⁴⁶ The proposed requirements set out in this section would also apply to Australian insurers that operate as stand-alone entities and to the Australian branch of a foreign insurance company.

⁴⁷ In May 2005, APRA released draft *GPS 230 Reinsurance Management* and related guidance notes for public consultation. The draft prudential standard and related guidance notes are available on the APRA web site (www.apra.gov.au).

⁴⁸ In the case of a joint venture insurer that is equally controlled by two or more parties of which one or more of these parties is an Australian insurer, this would include the joint venture insurer's reinsurance exposures to the insurer parent and the insurer parent's reinsurance exposures to the joint venture insurer. In the case of a foreign-owned insurer, this would include the insurer's reinsurance exposures to the foreign insurance parent (including any Australian branch of the foreign insurance parent). In the case of the Australian branch of a foreign insurance company, this would include the branch's reinsurance exposures to any general insurance subsidiaries of the institution, insurer parent(s), and the parent's general insurance subsidiaries.

⁴⁹ The papers referred to in this section are (and will be) available on the APRA web site (www.apra.gov.au).

⁵⁰ Where a corporate group involving Australian insurers is headed by an Australian commercial entity, the proposed requirements set out in this section would only apply to the authorised NOHC or insurer heading the general insurance sub-group and to the general insurance sub-group.

and other responsible persons of authorised NOHCs, insurers and other APRA-regulated entities. These draft prudential standards did not deal with fit and proper requirements for general insurance groups. The consultation period on these proposals ended in May 2004, and APRA expects to release revised proposals in the coming months. It is intended that comparable standards will be introduced for general insurance groups as part of the proposed consolidated supervision arrangements. An implication of the proposed consolidation framework is that an actuary (or actuaries) would need to be appointed to advise on the valuation of insurance liabilities at the group level. It is envisaged that the fit and proper requirements would extend to this role (see section 5.6).

5.4 Group risk management⁵¹

A corporate group may face risk concentrations with a potential to adversely impact on the financial strength and reputation of the group and its constituent members. Although diversity of a corporate group's operations can reduce its overall risk profile, common risk factors across a group can also interact in an adverse manner. An example might be insurance and lending or investment exposures to common clients or to counterparties in the one geographical region. Complex group structures and intra-group arrangements could also increase risk at group level.

The board of the APRA-regulated entity heading a group of which one or more insurers is a member, is responsible for ensuring that comprehensive policies and procedures are in place to measure, manage, monitor and report overall risk at a group level. To ensure that these policies and controls remain adequate and appropriate, the board or a board committee should review them at least annually to take account of changing risk profiles of group entities.

A group RMS endorsed by the board of the head company would need to be submitted to APRA annually. The document must detail group risks⁵²

and approaches to managing them (and could include in the same document details of risk management by each individual insurer in the group on a stand-alone basis).

The requirement that insurers must provide APRA with an annual Board Declaration in relation to their risk management systems (and other matters) would also be extended to apply to the head company of the group, with the head company being required to provide a declaration covering the group as a whole. Similar to the group RMS, the declaration could encompass both the position of the overall group and the position of individual insurers in the group on a stand-alone basis.

In addition, the board of the head company should ensure that adequate policies, systems and controls are in place to monitor compliance with APRA's regulatory requirements on a group-wide basis. The head company should notify APRA immediately it becomes aware of any circumstances within the group that might reasonably be seen as having a material impact and potentially adverse consequences for an insurer in the group or for the overall group. The head company should also advise APRA of any proposed changes to the composition or operations of the group which have potential to materially alter the group's overall risk profile, and obtain APRA's prior approval for the establishment or acquisition of a regulated presence domestically or overseas and the takeover or acquisition of other entities.

As is the case with insurers currently, APRA would also seek an annual report from the auditor of the group. This would report on:

- the effectiveness of group systems and controls to ensure compliance with APRA's prudential requirements on a group basis;
- any non-compliance with APRA's regulatory requirements applied to the group;
- compliance with the group's RMS and REMS (see section 5.5 for details);

⁵¹ See footnote 50.

⁵² At a minimum, APRA would expect that the document will cover balance sheet and market risk, credit risk, operational risk, insurance risk, reinsurance risk and concentration risk at group level.

- the effectiveness of group systems and controls to ensure the reliability of group statistical and financial data provided to APRA; and
- whether there are any matters in the group that have come to the attention of the group auditor which might prejudice the interests of policyholders of an insurer in the group.

In April 2005, APRA released *GPS 222 Business Continuity Management* (and a related guidance note). In May 2005, APRA also released draft *GPS 221 Outsourcing* (including a related guidance note) for public consultation.⁵³ It is envisaged that these would also be applied at group level in due course.

5.5 Group-wide reinsurance management⁵⁴

Where there are a number of insurers within a corporate group, it is not uncommon for each to reinsure with their general insurance parent, other general insurance group entities or a specialist reinsurer in the group before any risk is passed from the group to third party reinsurers. The group should develop and maintain a REMS which sets out the reinsurance strategy of the group. The group REMS could also include details of the reinsurance strategy of each individual insurer in the group. While it is envisaged that this document would cover the broad range of information as required for insurers on a stand-alone basis, the focus would be on how reinsurance arrangements are calibrated and managed at group level. The annual Board Declaration provided by the head company of the group to APRA would also need to cover reinsurance management at group level.

Among other things, the group REMS would need to deal with the management of credit exposures to other insurers and reinsurers in the group and to third party reinsurers at group level arising from reinsurance arrangements, as discussed earlier in this paper. This would need to include limits on these exposures to ensure that the insurer's and the group's solvency are not affected by excessive reinsurance exposure to a particular related entity or external party. Mechanisms used to reduce reinsurance exposures to external

counterparties such as collateralisation or guarantees, and arrangements to deal with downgrade of the credit rating of the reinsurer, should also be outlined.

When determining an acceptable limit for credit exposures resulting from reinsurance with a related entity or third party at group level, the board of the head company should have regard to the impact on the financial position of individual general insurance entities in the group if the related entity or external party to which they are exposed were to fail. The head company must also be able to demonstrate that it has adequate systems and controls in place for identifying, monitoring, managing and reporting exposures arising from reinsurance contracts with related entities and external counterparties at the group-wide level.

5.6 Role of the actuary⁵⁵

In order to fulfil the consolidation requirements in respect of group capital adequacy proposed in section 5.1, it is envisaged that the group would need to appoint an actuary (or actuaries) to provide advice on the valuation of insurance liabilities at group level. It is envisaged that this would include the preparation of an insurance liability valuation report at group level, which would be submitted to the insurer or authorised NOHC heading the group and to APRA. The person or persons fulfilling this role would be expected to be 'fit and proper' persons, meeting at least minimum criteria provided in the prudential standards for an Approved Actuary.

As outlined in the discussion paper *Prudential Supervision of General Insurance Stage 2 Reforms: Risk and Financial Management* released by APRA in May 2005, the 2003 discussion paper proposed that the role of the Approved Actuary for an insurer should be expanded to include provision of a Financial Condition Report (FCR). Although APRA believes that such a report would also be valuable at a group level and believes that insurers may wish to prepare a FCR for the group under certain circumstances, this is not proposed at this time. APRA intends to review this in light of progress with development of FCR reporting for insurers.

⁵³ These are available on the APRA web site (www.apra.gov.au).

⁵⁴ See footnote 50.

⁵⁵ See footnote 50.

5.7 Intra-group associations and infrastructure

An Australian insurer that operates as part of a corporate group must address risks arising from membership of the group and associations with other related entities beyond those arising from direct financial dealings with group members and other related entities.⁵⁶ These range from reputational risk to operational risk and legal risk evolving from the use of common badging, common services or cross-selling of products respectively, and to the risks arising from the potential confusion over the implicit support provided by the insurer to group members and other related entities and vice-versa.

The insurer and other members of its corporate group (as well as other related entities of the insurer) may use a common brand name (group badging) provided the roles and responsibilities of the different group members (or related entities) involved are clearly disclosed, to minimise any impression that a non-general insurance member of the group (or a non-general insurance related entity) is an insurer, or that (contrary to the legal position) a group member (or related entity) is guaranteed or supported by the insurer in the group. Likewise, to enable counterparties to clearly distinguish dealings with an insurer and those with other non-general insurance group entities (or other non-general

insurance related entities), the insurer should ensure that financial transactions between unregulated group members (or other unregulated related entities) and external counterparties are accompanied by clear, comprehensive and prominent disclosures.

Where the insurer in the group distributes the financial products of other group members or related entities (or vice versa), appropriate disclosures must clearly outline the respective roles and responsibilities of the product distributor and the product provider.

The insurer may also participate in group operations (such as share premises with other group members or related entities, centralise back-office functions and outsource services to other group members or related entities and vice versa) provided these dealings are appropriately documented in written agreements, do not create confusion in the minds of consumers, do not impinge on the safety and soundness of the insurer as a stand-alone entity and APRA is able to obtain information required for the supervision of the insurer or the group as a whole.⁵⁷ Prior board approval should be given where an insurer participates in corporate group operations.

These arrangements would be modelled on those applying to ADIs (see *APS 222 Associations with Related Entities for ADIs*). The outsourcing requirements mentioned earlier would also be relevant.

⁵⁶ 'Group members' means any entity that forms part of an Australian insurer's consolidated group as defined in section 4 for consolidated supervision purposes. For the avoidance of doubt, the proposed requirements set out in this section would also apply to an Australian insurer's dealings and associations with APRA-approved ELE-eligible entities.

In addition, the proposed requirements set out in this section would also apply to an Australian insurer's dealings and associations with the following entities:

- (i) in the case of an Australian insurer that operates in a corporate group that is headed by an Australian commercial entity – the insurer's commercial company parent heading the group and the parent's other subsidiaries (i.e. subsidiaries outside the general insurance sub-group);
- (ii) in the case of a joint venture insurer that is equally controlled by two or more parties – the insurer's parents and members of the parents' corporate groups. Likewise, where an Australian insurer and other parties equally control a joint venture insurer, the insurer parent's dealings and associations with the joint venture insurer (and its subsidiaries) would also be subject to the proposed requirements; and
- (iii) in the case of a foreign-owned insurer – any Australian branch of the foreign insurance parent and other subsidiaries of the insurer's foreign parent(s) operating in Australia (i.e. subsidiaries outside the Australian consolidated group).

The proposed requirements would apply to the maximum extent possible to the Australian branch of a foreign insurance company in respect of the branch's dealings and associations with any subsidiary of the foreign insurance parent in Australia. Where appropriate, APRA may deem that other entities (and their subsidiaries) represent a 'related entity' of an Australian insurer for the purpose of this section.

⁵⁷ Where the insurer is a member of a corporate group headed by an Australian commercial entity (or by another non-APRA regulated Australian entity), the reference to 'the group as a whole' means the general insurance sub-group on a consolidated basis.

Attachment 1

Overseas practice on prudential supervision of general insurers operating within a wider corporate group

United Kingdom

Supervision of insurance groups is conducted in line with *Insurance Groups Directive (98/78/EC)*.

A group capital adequacy test (i.e. group capital resources should be greater than or at least equal to group capital resources requirement) is applied to insurance groups at the highest EEA and worldwide parent levels. While insurance groups are required to report the results of the group capital adequacy test at these two levels, it is not a regulatory requirement to pass these tests.⁵⁸

Asset exposure limits are applied to an insurer's aggregate holding of an asset or aggregate exposure to a counterparty or group of connected counterparties (including exposures of the insurer's subsidiaries to the same asset or counterparty). These limits also apply to an insurer's exposures to subsidiaries and other related parties. No asset concentration limits apply at holding company level.

Canada

In general, supervision of federally regulated Canadian property and casualty (P&C) insurance companies is conducted on a consolidated basis, using information from other regulators as appropriate. It includes an assessment of all material related entities (subsidiaries, branches or joint ventures) both in Canada and internationally.

A risk-based minimum capital test (a capital available to capital required test) is applied to federally regulated Canadian P&C insurance companies on an unconsolidated basis, with the regulator retaining the discretion to require consolidated testing as appropriate.⁵⁹

An investment concentration limit is applied to all federally regulated P&C insurance companies (including Canadian branches of foreign insurers), restricting their aggregate investments in an entity or group of related entities (including investments made by the Canadian P&C insurer's subsidiary companies in the same entity).

Transactions with related parties (whether directly or indirectly) are prohibited, except as provided in the *Insurance Companies Act* (one of these being 'nominal or immaterial value transactions').

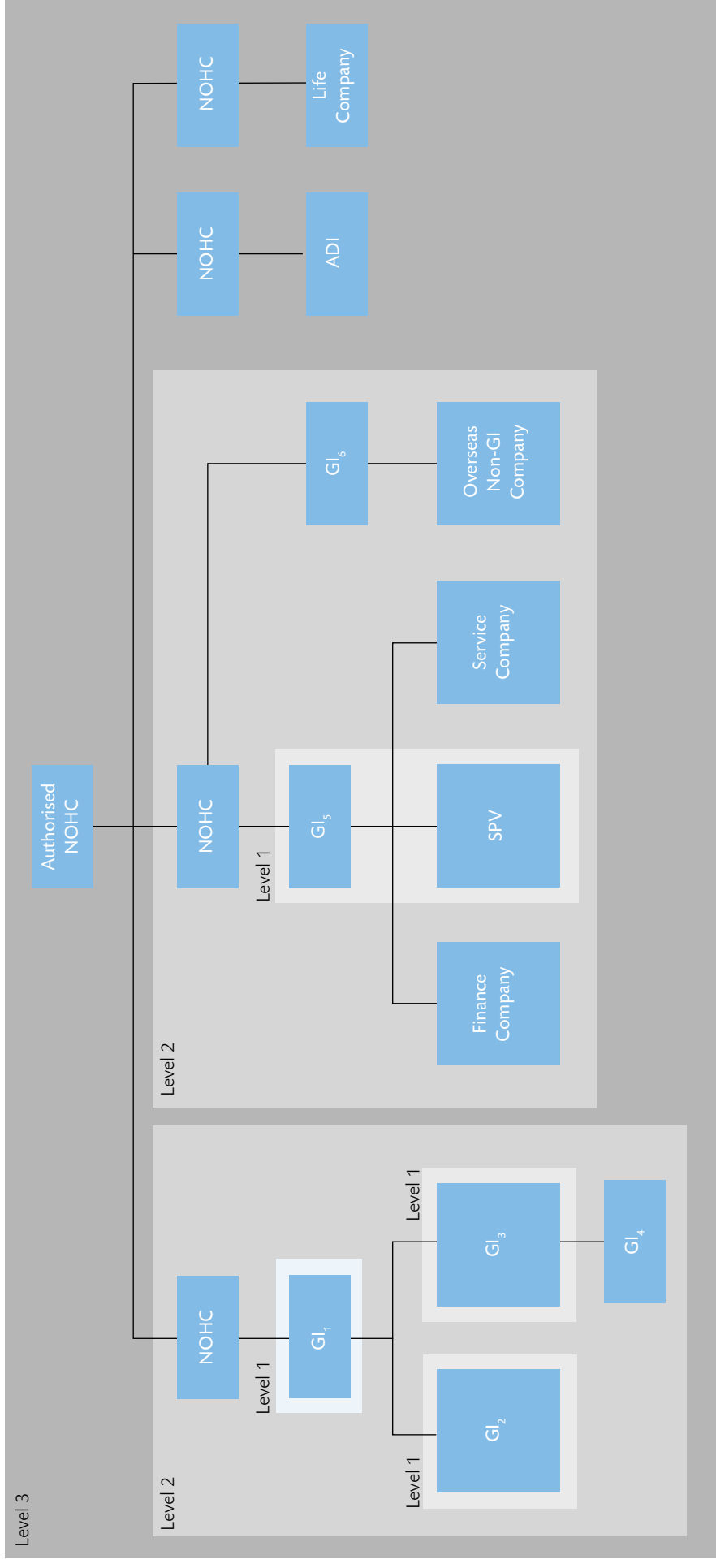
⁵⁸ Insurance groups are required to meet the group capital adequacy test at the EEA parent level from end 2006.

⁵⁹ Historically, very few Canadian P&C insurers have had subsidiaries and, as a result, the industry has been subject to unconsolidated capital requirements.

Attachment 2

Application of a three-level capital adequacy framework to an Australian insurer operating in a corporate group

- Level 1 – The insurer assessed on a stand-alone basis or the Extended Licensed Entity (ELE) comprising the insurer and its APRA-approved ELE-eligible entities assessed as a ‘stand-alone’ entity, as appropriate.
- Level 2 – The ultimate insurer, its immediate locally incorporated NOHC and all their subsidiaries (other than non-consolidated subsidiaries) assessed as a consolidated general insurance group.
- Level 3 – Entire group assessed.



Legend

- 1, 2, 3 and 5 = Company licensed as an insurer in Australia
- 4 and 6 = Company not incorporated in Australia. Conducting general insurance business overseas.



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