Prudential Standard GPS 115

Capital Adequacy: Insurance Risk Charge

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a general insurer or Level 2 insurance group to maintain adequate capital against the insurance risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a general insurer or Level 2 insurance group rests with its Board of directors. The Board must ensure that the general insurer or Level 2 insurance group maintains an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile, such that it is able to meet its obligations under a wide range of circumstances.

The Insurance Risk Charge is the minimum amount of capital required to be held against insurance risks. The Insurance Risk Charge relates to the risk that the value of the net insurance liabilities is greater than the value determined by the Appointed Actuary or Group Actuary.

This Prudential Standard sets out the method for calculating the Insurance Risk Charge. This charge is one of the components of the Standard Method for calculating the prescribed capital amount for general insurers and Level 2 insurance groups.

Authority

1. This Prudential Standard is made under section 32 of the *Insurance Act 1973* (the Act).

Application

2. This Prudential Standard applies to each:

   (a) **general insurer** authorised under the Act (**insurer**); and

   (b) **Level 2 insurance group** as defined in *Prudential Standard GPS 001 Definitions* (GPS 001).

   Where a requirement is made in respect of a Level 2 insurance group, the requirement is imposed on the **parent entity** of the Level 2 insurance group.

3. This Prudential Standard applies to insurers and Level 2 insurance groups (**regulated institutions**) from 1 July ~~2019~~2023.

Interpretation

4. Terms that are defined in GPS 001 appear in bold the first time they are used in this Prudential Standard.

5. For the purposes of this Prudential Standard the term 'Actuary' is a reference to either the **Appointed Actuary** for an insurer or the **Group Actuary** for a Level 2 insurance group (as appropriate).

Insurance Risk Charge

6. This Prudential Standard sets out the method for calculating the **Insurance Risk Charge** for a regulated institution using the **Standard Method** to determine its **prescribed capital amount**.

7. The Insurance Risk Charge relates to the risk that the value of net insurance liabilities is greater than the value determined in accordance with *Prudential Standard GPS 340 Insurance Liability Valuation* (GPS 340). It has two components:

   (a) a risk charge in respect of Outstanding Claims Risk; and

   (b) a risk charge in respect of Premiums Liability Risk.

   The total Insurance Risk Charge is the sum of the risk charge for each of the two components.

Outstanding Claims Risk

8. The risk charge for Outstanding Claims Risk relates to the risk that the value of the net outstanding claims liabilities will be greater than the value determined in accordance with GPS 340.

9. For the purposes of the Standard Method, the risk charge for each **class of business** is calculated by multiplying the net outstanding claims liabilities for that class (as determined in accordance with GPS 340) by the relevant Outstanding Claims Risk Capital Factor in Attachment A. The total risk charge for outstanding claims risk is the sum of the risk charges for each class of business.

Premiums Liability Risk

10. The risk charge for Premiums Liability Risk relates to the risk that the value of the net premiums liabilities will be greater than the value determined in accordance with GPS 340. It also relates to the risk that 'material net written premium', as defined in paragraph 17, will be insufficient to fund the liabilities arising from that business.

11. For the purposes of the Standard Method, the risk charge for each class of business is calculated by multiplying the sum of:

    (a) net premiums liabilities as determined in accordance with GPS 340; and

    (b) material net written premiums

    by the relevant Premiums Liability Risk Capital Factor in Attachment A. The total risk charge for Premiums Liability Risk is the sum of the risk charges for Premiums Liability Risk for each class of business.

Classes of business

12. For the purposes of the Outstanding Claims Risk Capital Factor and Premiums Liability Risk Capital Factor, all but the '**other**' **direct class of business**[1] and **'**other' **reinsurance class of business** have been classified into different categories in Attachment A (Table 1 and Table 2 respectively). The 'other' class of business must be allocated to a category by the Actuary, in accordance with paragraphs 13 and 14.

13. For the purpose of calculating the Insurance Risk Charge in respect of any 'other' business (whether it is direct business or reinsurance), the Actuary is required to determine the most appropriate category (i.e. category A, B or C) in Table 1 and Table 2 of Attachment A. The choice must be based on the underlying risk characteristics of the business being written. The regulated institution must then apply the corresponding Outstanding Claims Risk Capital Factor and Premiums Liability Risk Capital Factor listed in Attachment A in determining the Insurance Risk Charge.

14. If the 'other' class of business includes multiple risks with differing risk profiles, the Actuary may subdivide the net outstanding claims liabilities, net premiums liabilities and material net written premiums into more than one category.

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1 The other class of business is as defined in paragraph 1(k) of Attachment B of GPS 001.

15. The reasons for selecting the specific risk category or categories to which the 'other' class of business is assigned must be documented in the **Actuarial Valuation Report**.

Business covering multiple classes

16. Where a regulated institution underwrites an inwards reinsurance contract which spans multiple classes, the contract must be allocated by using an appropriate method (provided the same method is used for all contracts and all subsequent periods). Appropriate methods include:

    (a) allocating the contract on a pro rata basis to each of the relevant categories; or

    (b) allocating the contract to the category which represents the greatest exposure; or

    (c) allocating the contract to the category representing the greatest premium income.

    The regulated institution may use an alternative method from those listed above for allocating inwards reinsurance business that spans multiple classes. The regulated institution must be able to demonstrate that the chosen method is appropriate and is used for all contracts and all subsequent periods.

Material net written premium

17. With respect to direct business and reinsurance business where policies incept in the following reporting period and where these policies would have a material impact on capital adequacy, net written premium for exposure that has not been included in the calculation of the premiums liabilities is to be subject to the premiums liabilities risk charge.[2] This premium amount is defined as 'material net written premium'. The materiality of the business that incepts in the next reporting period should be determined in accordance with the Australian accounting and auditing standards subject to APRA's discretion.

[2] This requirement is based on the principle that an insurer should be able to meet its insurance obligations at all times, not just at the quarterly **reporting date**. With regards to written contracts for which insurers are not on risk in the current **reporting period**, APRA has not defined how far into the subsequent reporting period the capital requirement applies. APRA expects that at the reporting date, insurers will hold sufficient capital for all general insurance contracts for which the general insurer is committed, regardless of when the contract incepts.

18. For inwards proportional reinsurance contracts, the value of material net written premium calculated in paragraph 17 must reflect the full premium revenue expected for the full term[3] of the reinsurance contract, where revenue has not yet been recognised, subject to the appropriate subsection below:

    (a) where the remaining term of the contract is five years or less, the value of material net written premium should not exceed the net premium revenue forecast for 18 months from the end of the current reporting period; or

    (b) where the remaining term exceeds five years, an insurer may approach APRA to determine alternate treatment.

~~18. The value of material net written premium calculated in paragraph 17 must also reflect the full premium revenue for inwards proportional reinsurance for:~~

~~(a) the full term of the current reinsurance contract where that reinsurance contract runs for up to five years and where the treaty extends beyond the end of the current reporting period but the revenue has not yet been recognised.~~[4]

~~(b) 18 months from the end of the current reporting period for whole of account quota share reinsurance arrangements, where treaties extend for over five years beyond the end of the reporting period and there is 18 or more months remaining in the Initial Term or the Total Term (as applicable) of the reinsurance contract; or~~

~~(c) the remaining term, where treaties extend for over five years beyond the initial reporting period and there is less than 18 months remaining in the Initial Term or Total Term (as applicable) of the reinsurance contract.~~

Securitisation

19. If a regulated institution securitises insurance liabilities, the net insurance liabilities may reduce. The regulated institution must apply to APRA for approval to include the securitisation transaction in the Insurance Risk Charge.

Adjustments and exclusions

20. APRA may, by notice in writing to a regulated institution, adjust or exclude a specific requirement in this Prudential Standard in relation to that regulated institution.

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[3] For reinsurance contracts that are continuous but cancellable at regular intervals or on specified dates, the term of the contract can be measured to the earliest cancellation date that is not less than 12 months from the previous cancellable date.

~~[4] For the avoidance of doubt, the reinsurance revenue for inwards reinsurance business should be recognised for the full term of current reinsurance contracts, usually 12 months from the inception of the contract, and not any shorter period. For reinsurance contracts that are continuous but cancellable at regular intervals or on specified dates, the term of the contract can be measured to the earliest cancellation date that is not less than 12 months from the previous cancellable date.~~

Determinations made under previous prudential standards

21. ~~An exercise of APRA's discretion under the previous version of this Prudential Standard continues to have effect under this Prudential Standard. For the purposes of this paragraph, 'the previous version of this Prudential Standard' means *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge* (GPS 115) made on_7 December 2012.~~An exercise of APRA's discretion (such as an approval, waiver or direction) under a previous version of this Prudential Standard continues to have effect as though exercised pursuant to a corresponding power (if any) exercisable by APRA under this Prudential Standard.

Attachment A

Table 1: Direct insurance business

Category	Class of business	Outstanding Claims Risk Capital Factor (%)	Premiums Liability Risk Capital Factor (%)
A	Householders Commercial Motor Domestic Motor	9.0	13.5
B	Travel Fire and ISR Marine and Aviation Consumer Credit Other Accident	11.0	16.5
C	Mortgage CTP Public and Product Liability Professional Indemnity Directors and Officers Employers' Liability Cyber	14.0	21.0

Table 2: Inwards reinsurance business

Category	Class of business	Reinsurance type	Outstanding Claims Risk Capital Factor (%)	Premiums Liability Risk Capital Factor (%)
A	Householders Commercial Motor Domestic Motor	Proportional	10.0	15.0
		Non-proportional	12.0	18.0
B	Travel Fire and ISR Marine and Aviation Consumer Credit Other Accident	Proportional	12.0	18.0
		Non-proportional	14.0	21.0
C	Mortgage CTP Public and Product Liability Professional Indemnity Directors and Officers Employers' Liability Cyber	Proportional	15.0	22.5
		Non-proportional	17.0	25.5