Prudential Standard GPS 118

Capital Adequacy: Operational Risk Charge

Objectives 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 operational 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 Operational Risk Charge is the minimum amount of capital required to be held against operational risks. The Operational Risk Charge relates to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

This Prudential Standard sets out the method for calculating the Operational 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.

Operational Risk Charge

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

6. The Operational Risk Charge is the minimum amount of capital a regulated institution must hold against the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Calculation of the Operational Risk Charge

7. The Operational Risk Charge for a regulated institution is calculated as the sum of:

   (a) the Operational Risk Charge for inwards reinsurance business (ORCI) defined in paragraph 9; and

   (b) the Operational Risk Charge for business that is not inwards reinsurance business (ORCNI) defined in paragraph 10.

   The Operational Risk Charge for a Level 2 insurance group is calculated after consolidation of intra-group exposures.

8. For the purposes of paragraphs 9 and 10:

   (a) GP_1 is written premium revenue (gross of reinsurance) for the 12 months ending on the **reporting date**;

   (b) GP_0 is written premium revenue (gross of reinsurance) for the 12 months ending on the date 12 months prior to the reporting date;

   (c) Written premium revenue is the amount charged in relation to accepting risk from the insured. For the purposes of the Operational Risk Charge calculation, this includes ~~fire services levy, other~~ levies imposed by state and territory governments, and revenue relating to portfolio transfers and unclosed business;

   (d) NL is the central estimate of insurance liabilities (net of reinsurance) determined in accordance with Prudential Standard GPS 340 Insurance Liability Valuation (GPS 340), at the reporting date[1]; and

   (e) $|GP_1 - GP_0|$ is the absolute value of the difference between GP_1 and GP_0.

~~All of the values determined under this paragraph should correspond to the value in the regulated institution's **statutory accounts**.~~ All transfers of **insurance business** made in accordance with the Act must be recognised in line with the corresponding requirements under *Australian Accounting Standards.* ~~*AASB 1023 General Insurance Contracts.*~~

9. The ORCI is calculated as follows:

$$ORCI = 2\% \times \{\text{maximum}(GP_1, NL) + \text{maximum}(0, |GP_1 - GP_0| - 0.2 \times GP_0)\}$$

10. The ORCNI is calculated as follows:

$$ORCNI = 3\% \times \{\text{maximum}(GP_1, NL) + \text{maximum}(0, |GP_1 - GP_0| - 0.2 \times GP_0)\}$$

Adjustments and exclusions

11. 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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1 Under *Prudential Standard GPS 340 Insurance Liability Valuation,* a Level 2 insurance group may use accounting entries to determine its premiums liabilities, after allowing for necessary adjustments made under GPS 340. Where accounting entries have been used to determine net premiums liabilities, the Level 2 insurance group must use the accounting equivalent of net premiums liabilities instead of the net central estimate for the purposes of the Operational Risk Charge.