



Draft Prudential Practice Guide

3PG 110 Capital Adequacy

August 2014


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About this guide

Prudential practice guides (PPGs) provide guidance on APRA's view of sound practice in particular areas. PPGs frequently discuss legal requirements from legislation, regulations or APRA's prudential standards, but do not themselves create enforceable requirements.

Prudential Standard 3PS 110 Capital Adequacy (3PS 110) aims to ensure that a Level 3 group maintains a level and quality of capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from the group, including its non-APRA-regulated institutions. This PPG aims to assist Level 3 Heads in complying with the requirements of 3PS 110 and, more generally, to outline prudent practices in relation to capital adequacy.

This PPG also aims to assist Level 3 Heads in calculating the Level 3 prescribed capital amount.

This PPG is designed to be read together with 3PS 110 but does not address all prudential requirements in relation that prudential standard.

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Introduction

1. Under 3PS 110, APRA may determine an APRA-regulated institution to be the Level 3 Head of a Level 3 group. 3PS 110 aims to ensure that a Level 3 group maintains a level and quality of capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from the group, including its non-APRA-regulated institutions. To this end it requires, amongst other things, a Level 3 Head to ensure that:
 - (a) the Level 3 group, at all times, maintains Level 3 Eligible Capital (Level 3 EC) in excess of its Level 3 Prudential Capital Requirement (Level 3 PCR); and
 - (b) where a non-APRA-regulated institution in the Level 3 group has insufficient Level 3 EC to cover its contribution to the Level 3 PCR, the group has sufficient capital available in the group to cover this shortfall.¹
3. In accordance with 3PS 110, APRA will determine an APRA-regulated institution to be a Level 3 Head by notice in writing. APRA expects to discuss its intent to make such a determination with the institution beforehand.
4. As a Level 3 Head may not be in a position to meet the Level 3 requirements as soon as it is determined to be a Level 3 Head, APRA will consider requests for transitional relief on a case-by-case basis. Before transitional relief can be provided, APRA expects the Level 3 Head to provide detailed reasons as to which specific requirements of the framework it would not be able to comply with and why, along with a timeframe within which it believes it will be able to meet the requirements.

Scope of the Level 3 group

Determining a Level 3 Head

2. The Level 3 framework is designed to complement APRA's existing industry-based Level 1 and Level 2 frameworks. As such, APRA will decide on a case-by-case basis which groups will be subject to Level 3 supervision, based on the following principle:

If a group, containing one or more APRA-regulated institutions, performs material activities across more than one APRA-regulated industry and/or contains non-APRA-regulated institutions that perform material activities in one or more non-APRA-regulated industries, it may be supervised at Level 3 where APRA considers that supervision at Level 1 and/or Level 2 does not adequately capture the risks associated with the group's activities or provide an adequate view of the overall financial and operational soundness of the group.
5. 3PS 001 defines a Level 3 group as a group of entities of which a Level 3 Head is the parent entity. APRA may adjust the group for prudential purposes by including or excluding entities.
6. Where the Level 3 Head is the ultimate parent of the group, the Level 3 group would ordinarily comprise all institutions that are included in the scope of consolidation for the purposes of the group's annual financial statements.
7. APRA would include an entity that is not part of the Level 3 group's annual consolidated financial statements, for example, where it considers that a group has been deliberately structured so that material risks to APRA beneficiaries would not be automatically captured by the definition of a Level 3 group.

¹ Another important requirement in 3PS 110 is that a Level 3 Head must ensure that the Level 3 group has an Internal Capital Adequacy Assessment Process (ICAAP). The separate, cross-industry Prudential Practice Guide CPG 110 *Internal Capital Adequacy Assessment Process and Supervisory Review* (CPG 110) assists APRA-regulated institutions, including Level 3 Heads, in developing their ICAAP.

8. The Level 3 Head may not be the ultimate parent of a consolidated group. In these cases, the group of which the Level 3 group forms a part is referred to as the wider conglomerate group. APRA expects this situation to occur, for example, where the members of the Level 3 group are subsidiaries of a member of a foreign controlled group or a commercial (non-financial) Australian group. Members of the wider conglomerate group, other than Level 3 institutions, are regarded as third parties to the Level 3 group for the purposes of the Level 3 Prudential Standards.

Equivalent overseas regulated institutions

9. 3PS 110 requires a Level 3 group to include its equivalent overseas deposit-taking institutions, general insurers and life companies on a stand-alone basis in the ADI, GI and LI blocks², respectively, and to include the capital required in the host jurisdiction in a consistent manner in the relevant industry block's required capital (RC) calculation. Where an equivalent overseas institution is part of a Level 2 group, the relevant industry block's RC figure must instead be based on Level 2 inputs.
10. APRA acknowledges that overseas jurisdictions may have requirements that differ significantly from APRA's requirements. As the Level 3 framework is a Common Equity Tier 1 (CET1) framework, when determining the relevant block's RC APRA would expect a Level 3 group to use, as a starting point, the CET1-equivalent capital requirements in the host jurisdiction. Where the equivalent overseas institution is subject to multiple requirements, APRA expects the extent to which CET1-equivalent capital is constrained to be taken into account in a manner similar to the one described in paragraph 14 of the Attachment. The Level 3 framework adjusts for intra-group transactions and exposures (ITEs). APRA expects a Level 3 group to adjust the equivalent overseas institution's requirement for ITEs prior to including it in the relevant block's RC calculation.
11. In accordance with 3PS 110, in determining an equivalent overseas regulated institution's contribution to the relevant block's RC figure, APRA may direct a Level 3 Head to apply a proxy based on the relevant industry-specific APRA requirements.

Significant effort when determining ITEs

12. Where significant effort would be required to accurately determine a specific ITE adjustment, 3PS 110 allows a Level 3 Head, subject to APRA's written agreement, to:
- (a) use a conservative approximation for the impact on the Level 3 PCR of the ITE adjustment; or
 - (b) choose not to take the adjustment into account, where adjusting for the ITE would lead to a net reduction in the Level 3 PCR.
13. In assessing whether a specific ITE adjustment requires significant effort, APRA expects the Level 3 Head to consider:
- (a) the ITE's expected impact on the Level 3 PCR;
 - (b) the costs associated with accurately measuring the ITE; and
 - (c) the costs and benefits (in terms of appropriateness and relative accuracy) of a conservative approximation.
14. APRA expects that Level 3 groups will strive to accurately determine all material ITE adjustments so that the exemption would ordinarily be limited to immaterial adjustments. There may be rare circumstances in which adjusting for a material ITE would lead to a net increase in the Level 3 PCR; in such circumstances APRA would not ordinarily approve the use of approximations.

² The industry blocks are defined in 3PS 110.

Internal capital allocation (ICA)

Determining an ICA

15. 3PS 110 requires an ICA to reflect all material risks to APRA beneficiaries arising from each industry block. *Prudential Standard CPS 220 Risk Management* considers material risks to 'have a material impact, both financial and non-financial, on the institution or on the interests of depositors and/or policyholders'. APRA expects that Level 3 groups will apply a definition similar to this one, although appropriately extended to reflect the interests of all APRA beneficiaries, including superannuation members.
16. As the Level 3 PCR is an equity-equivalent requirement, APRA expects an ICA to also be based on equity-equivalent principles.
17. For the funds management (FM) block, APRA expects 0.15 per cent of the external funds to be an appropriate benchmark for the ICA. APRA notes two exceptions:
 - (a) operational separation or separability reduces the risks to APRA beneficiaries and could therefore lead to a lower expectation for the ICA; and
 - (b) there could potentially be a difference in risk profile between funds under management (FUM) and funds under administration (FUA), both of which may be performed by funds management institutions in the FM block. A Level 3 group could take these differences into account when setting the ICA figure for the FM block. However, if assets were to enter the group as FUA and are then passed through to another funds management institution in the group as FUM or to a life company in the group as investment-linked policies, the risk profile of those assets has increased. In that case, APRA would expect the group to take this increased risk profile into account when determining the appropriate ICA for these assets.
18. In determining the appropriateness of a Level 3 group's ICA for the OA block, APRA will consider, at a minimum, market benchmarks and industry ratios for the relevant commercial industries. The purpose of this consideration is to identify where creditors allow non-APRA-regulated institutions to operate with less equity than they would accept of a similar institution that is not part of a Level 3 group. This may occur where creditors expect the Level 3 group to provide a back-stop to any potential losses in those non-APRA-regulated institutions. The comparison with market benchmarks and industry ratios will assist APRA in identifying any situations where such a potential undercapitalisation at the legal entity level may occur. In assessing the appropriateness of the ICA for the OA block, APRA will also consider its own equity-equivalent requirements for materially similar APRA-regulated activities.
19. As is the case for the FM block, operational separation or separability reduces the risks to APRA beneficiaries and could, therefore, lead to a lower expectation for the ICA of the OA block.
20. For both the FM and OA blocks, 3PS 110 requires a Level 3 group to incorporate a minimum ICA based on any non-APRA equity-equivalent capital requirements that are applicable to Level 3 institutions in the block. An equity-equivalent capital requirement means any minimum required amount of CET1 Capital, ordinary shares and/or retained earnings, or common equity.
21. APRA expects Level 3 groups not to include any offsets in the ICA for deductions included in Level 3 EC, including for operationally separated or separable institutions. For example, APRA would not expect it to be appropriate for a Level 3 group to claim a reduction in the ICA for the FM block in relation to goodwill in operationally separated or separable institutions.

22. 3PS 110 requires funds management institutions conducting non-funds management activities to allocate these activities to the OA block, and dual regulated entities to allocate their RSEs to the Super block, their other funds management activities to the FM block and their non-funds management activities to the OA block. Material risks associated with these activities must be captured by the RC calculation for the relevant block. For example, APRA would expect a funds management institution that engages in proprietary trading alongside its third-party clients to reflect the risks associated with this proprietary trading in the OA block rather than the FM block.
23. A Level 3 group is responsible for the determination of the ICA for the FM and OA blocks. Where APRA considers that the ICA determined by a Level 3 Head does not adequately cover all material risks, instead of amending the ICA outcome, APRA is likely to impose a Level 3 supervisory adjustment in accordance with 3PS 110. APRA expects the adjustment to remain in place until its concerns have been adequately addressed.

Documentation and governance

24. 3PS 110 requires a Level 3 group to document the rationale, design and operational details of its ICA. The group must have documented policies and procedures for the regular review of the ICA processes and outcomes. APRA expects that this documentation would broadly evidence the group's compliance with the minimum standards of 3PS 110 and typically address topics such as the ICA's:
- (a) consistency with the Board's risk appetite;
 - (b) process for identification of material risks;
 - (c) calibration process;
 - (d) material assumptions underpinning its design and operational details;
 - (e) incorporation of relevant non-APRA equity-equivalent requirements, if any;
 - (f) review process, including its frequency; and
 - (g) oversight by Board and management.
25. The ICA to be used in determining RC for the FM and/or OA block could differ from the outcome of the economic capital model (ECM) that the group uses for internal capital management purposes. This could be because the ICA reflects the risks associated with an industry block while, for example, the ECM could be determined on the basis of business lines. Further, the ECM could reflect hurdle rates or a specific credit rating while the ICA reflects regulatory requirements. APRA would expect the group to be able to identify and explain any material differences between the ICA and the ECM.

Operational separation and operational separability

26. 3PS 110 states that a Level 3 group (which does not contain a systemically important ADI) may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of the Level 3 institution(s) in the FM or OA block, thereby potentially reducing the relevant block's RC figure. It adds that APRA will determine whether it agrees that the group has credibly reduced the risk to APRA beneficiaries based on a list of considerations.
27. In determining the ICA, APRA expects a Level 3 group to clearly outline how the operational separation or separability of a Level 3 institution has reduced risk to APRA beneficiaries. As a general rule, the more indicators that a Level 3 group meets, the more credible the separation and the lower the risk posed to APRA beneficiaries. However, it would be highly unlikely that operational separation or separability can reduce the risk to APRA beneficiaries to zero.
28. APRA expects that the risk to APRA beneficiaries from operationally separated or separable institutions would be reduced where, for example, the group clearly, publicly and credibly indicates that its APRA-regulated institutions will not support operationally separated or separable institutions if they were to experience severe financial difficulties.

Capital shortfall assessment

29. The purpose of the capital shortfall assessment detailed in 3PS 110 is to ensure that there are no undercapitalised subsidiaries (on a stand-alone basis) within a Level 3 group that lack access to sufficient additional funding from within the group to cover that shortfall.
30. The capital shortfall assessment evaluates capitalisation on a stand-alone basis as obligations are ultimately borne by legal entities. This assessment requires stand-alone amounts for required capital and eligible capital to be determined for each non-APRA-regulated institution (including, where applicable, the Level 3 NOHC). Although there is no requirement in 3PS 110 for the group's ICA to be determined on a legal entity basis, APRA expects that a Level 3 group would generally be able to allocate the ICA result across the relevant Level 3 institutions in the industry block(s).
31. APRA considers that the highest quality of capital for a subsidiary is freely available funding held upstream in the Level 3 group in an ownership sense. Freely available funding would not trigger relevant legal or regulatory restrictions, including in stressed conditions. APRA would expect the capital shortfall assessment to include consideration of liquidity constraints.

Public disclosure

32. 3PS 110 does not proscribe a Level 3 group from publishing information relating to its Level 3 capital adequacy. However, existing rules proscribing disclosure of Level 1 and Level 2 PCRs and APRA supervisory adjustments remain in place. A published Level 3 prescribed capital amount does not disclose any Level 1 or Level 2 PCRs and APRA supervisory adjustments if it is recalculated so that:
 - (a) the RC figure for the ADI block uses as inputs the 4.5, 6.0 and 8.0 per cent minimum PCRs rather than the actual PCRs for the relevant ADIs as determined by APRA; and
 - (b) the RC figures for the GI and LI blocks use as inputs the prescribed capital amounts rather than the PCRs for the relevant insurers as determined by APRA.
33. APRA expects a Level 3 Head to provide APRA with an opportunity to review the Level 3 group's approach to any public disclosures prior to their first release and whenever there are material changes to that approach.

Attachment – Calculating the Level 3 prescribed capital amount

Introduction

1. 3PS 110 requires a Level 3 Head to ensure that the Level 3 group, at all times, maintains Level 3 EC in excess of the Level 3 PCR. The Level 3 PCR is equal to the sum of the Level 3 prescribed capital amount and any Level 3 supervisory adjustment.
2. This Attachment provides guidance on calculating the Level 3 prescribed capital amount in accordance with the requirements in 3PS 110. Where this Attachment refers to an obligation of the Level 3 Head or to a right or power that may be exercised by APRA, that reference is to an obligation, right or power that arises under 3PS 110, unless indicated otherwise.

Level 3 PCR

3. The Level 3 prescribed capital amount, Level 3 PCR and Level 3 EC are dollar amounts.
4. The Level 3 prescribed capital amount is calculated by summing the required capital for six industry blocks:
 - (a) ADI block;
 - (b) GI block;
 - (c) LI block;
 - (d) Super block;
 - (e) FM block; and
 - (f) OA block.

The allocation of Level 3 institutions to the industry blocks is set out in 3PS 110.

5. 3PS 110 states that APRA may determine a Level 3 supervisory adjustment to be included in the Level 3 PCR of the Level 3 group, and may vary the this supervisory adjustment at any time. CPG 110 provides a non-exhaustive list of circumstances in which APRA may consider the application of a Level 3 supervisory adjustment.
6. APRA may also impose supervisory adjustments on APRA-regulated institutions at Level 1 or Level 2. These adjustments are incorporated in the inputs used to calculate the industry block RC figures and, unlike the Level 3 supervisory adjustment, do not need to be added to the Level 3 prescribed capital amount as a separate step.

Allocation of Level 3 institutions to industry blocks

7. Level 3 institutions must be allocated to the six industry blocks in accordance with the requirements in 3PS 110. The activities of dual regulated entities and certain funds management institutions may be required to be allocated to more than one block; refer to paragraph 22 of this PPG.
8. Example (1): as part of its business model, a funds management institution in a Level 3 group invests in the same assets as its third-party clients. These proprietary trades are not covered by the 3PS 110 definition of funds management activities. In accordance with 3PS 110, the risks associated with non-funds management activities must be allocated to the OA block.
9. 3PS 110 requires the ADI and GI block RC calculations to be determined on a Level 2 basis where possible, and otherwise on a Level 1 basis. The LI and Super block calculations must be determined on a Level 1 basis. For statutory reporting purposes, the FM block's ICA output must be determined separately for the aggregate of funds management institutions that are operationally separated or separable (as determined by APRA in accordance with 3PS 110); and the aggregate of funds management institutions in the FM block that are not operationally separated or separable. Similarly, the OA block's ICA output must be determined separately for the aggregate of Level 3 institutions and activities in the OA block that are operationally separated or separable (as determined by APRA in accordance with 3PS 110); and the aggregate of Level 3 institutions and activities in the OA block that are not operationally separated or separable.

10. In accordance with 3PS 110, institutions that are not included in the scope of consolidation of the Level 3 group are not Level 3 institutions and must not be assigned to any industry block. Exposures to such institutions are to be treated as exposures to third parties and treated accordingly.
11. Example (2): A Level 3 group owns a minority stake in a funds management institution that is not included in the group's scope of consolidation. The minority stake must be treated in accordance with the requirements applicable to the investor; if, for example, the investor is an intermediate holding company that is included in the OA block, the investment must be deducted as per *Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital* (3PS 111). The funds management institution is not included in the FM block as it is not part of the Level 3 group.
14. 3PS 110 requires a Level 3 Head to exclude from the ADI, GI and LI block RC calculations, any Additional Tier 1 Capital and Tier 2 Capital held by other Level 3 institutions in the group. The purpose of this is to prevent an inappropriate increase in Level 3 surplus as a result of internal capital cross-holdings, as these do not enhance the financial strength of the group. However, capital instruments held by the Level 3 group on behalf of third parties, such as superannuation fund members or investment-linked policyholders, are still eligible to be included in the Level 3 RC block calculations.
15. Example (1): a life company issues Additional Tier 1 Capital to the Level 3 Head, which funds this with senior debt. Without an adjustment, this could reduce the LI block's RC and thereby increase the Level 3 group's surplus through capital upgrading.

ADI, GI and LI blocks

12. The ADI, GI and LI block RC formulae take the greater of three inputs³:
 - (a) CET1 PCR⁴;
 - (b) Tier 1 PCR⁵ minus Additional Tier 1 Capital; and
 - (c) Total Capital PCR minus Additional Tier 1 Capital and Tier 2 Capital.
13. These formulae ensure that where part or all of the difference between the CET1 PCR and the Tier 1 and/or Total Capital PCR must be met with CET1 Capital, this amount is added to the relevant Level 3 block's RC figure.
16. Example (2): a life company issues Additional Tier 1 Capital to the Level 3 Head, which funds this by issuing ordinary shares. Without an adjustment, this would increase the group's Level 3 EC and simultaneously reduce the LI block's RC as the capital is effectively double-counted.
17. Where the instruments are funded through a materially similar instrument issued to third parties, APRA may exclude capital instruments from the adjustment set out in paragraph 14 of this Attachment.
18. Example (3): a life company issues Additional Tier 1 Capital to the Level 3 Head, which funds this by issuing a capital instrument to third parties. Where APRA determines that the instrument issued to third parties shares the material features of the life company's Additional Tier 1 Capital instrument, the Level 3 group would exclude that instrument it from the adjustment. The capital instrument is subtracted from the life company's Tier 1 PCR and Total Capital PCR in the formula set out in paragraph 12 of this Attachment.

³ For ADIs the PCRs are multiplied by total risk-weighted assets to arrive at a dollar amount.

⁴ For general insurers and life companies, the 'CET1 PCR' should be understood as 60 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

⁵ For general insurers and life companies, the 'Tier 1 PCR' should be understood as 80 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

Intra-group transactions and exposures

19. The Level 3 prescribed capital amount is calculated using a bottom-up method by aggregating RC figures for the various industry blocks. The inputs to the RC calculations for the ADI, GI and LI blocks are determined on a stand-alone basis (or Level 2 basis where applicable). These stand-alone or Level 2 inputs may reflect ITEs relating to other Level 3 institutions in the Level 3 group. In accordance with 3PS 110, where a Level 3 institution has ITEs to other institutions in the Level 3 group against which capital is required to be held at Level 1 (including, where applicable, by equivalent overseas institutions on a stand-alone basis) or at Level 2, these ITEs must be eliminated at Level 3 and the applicable capital requirement reversed in the calculation of RC for the relevant industry block(s).
20. Example: a loan provided by an ADI to a general insurer in the Level 3 group increases the ADI's Level 1 risk-weighted assets. However, from the Level 3 group's perspective, this intra-group exposure does not create any additional credit risk to the group's APRA beneficiaries. The RC figure for the ADI block must therefore be adjusted to reverse the capital requirement associated with this loan. The RC figure for the GI block does not require any adjustment.
21. It is possible, though expected to be rare, that through the adjustment for ITEs, the RC figures are increased rather than decreased. This could occur, for example, where diversification effects associated with the ITEs disappear upon elimination of the ITEs. APRA expects Level 3 Heads to take all risks, including risks that may increase upon adjustment for ITEs, into account when assessing capital adequacy.
22. APRA emphasises that the ITEs calculated for determining the Level 3 prescribed capital amount are of a more limited scope than the internal ITE reports required under *Prudential Standard 3PS 222 Intra-group Transactions and Exposures* (3PS 222). ITEs in the former case are specifically limited to changes in a block's RC, whereas ITEs for the purposes of 3PS 222 reflect all material exposures of a Level 3 institution to another institution within the same Level 3 group.

Exceptions

23. 3PS 110 details exceptions to the general rule that ITEs must be adjusted. These exceptions relate to:
 - (a) market risk hedges, guarantees and credit derivatives;
 - (b) insurance risk charges;
 - (c) funds management activities;
 - (d) ITEs with Level 3 institutions that are operationally separated or separable; and
 - (e) ITEs that would require significant effort to be accurately determined.
24. The following sections provide APRA's rationale for these exceptions and examples of how they are intended to operate. Additional adjustments may be necessary for tax effects relating to general insurers and life companies, and for securitisation; these are covered in subsequent sections of this Attachment.

Market risk hedges, guarantees and credit derivatives

25. 3PS 110 defines a market risk hedge as 'an investment risk exposure by a Level 3 institution that is hedged with another institution in the Level 3 group so that the latter institution effectively bears the risk'. Where Level 3 institutions within a Level 3 group engage in market risk hedges with one another, these hedges are not eliminated. Similarly, where a Level 3 institution provides a guarantee or a credit derivative to another institution in the Level 3 group, these ITEs are not adjusted for the purposes of calculating the Level 3 prescribed capital amount.
26. The exception for market risk hedges is based on the consideration that the Level 3 PCR should reflect all risks to which the group's APRA beneficiaries are exposed but that, in principle, it is not relevant where in the industry block structure these risks are addressed. If one Level 3 institution hedges its market risks with another Level 3 institution in the Level 3 group, the latter institution bears the risks and these should be reflected in its RC. If this hedge were required to

be reversed, the former institution would reflect the risks in its RC and the latter institution would adjust its RC to exclude the risks. From a Level 3 group perspective, it should not matter whether the risks are reflected in the former or in the latter institution's RC – the Level 3 prescribed capital amount will remain the same. (There may be some impact if the institutions have different approaches to calculating their RC for the associated risks. It is assumed that such differences are not material.) Therefore, to simplify the calculation of the Level 3 prescribed capital amount, market risk hedges are excluded from the ITE adjustments.

27. Example (1): a general insurer has a foreign currency exposure to a third party, which it hedges through a transaction with an ADI in the Level 3 group. At Level 1, the ADI has included this foreign currency exposure in its risk-weighted assets, and the general insurer has reduced its asset risk charge due to the benefits of having a currency hedge in place. At Level 3, no adjustments are necessary to the ADI and GI block's RC figures as the risks associated with the foreign currency exposure are already reflected in the Level 3 prescribed capital amount.
28. Where Level 3 institutions engage in a market risk hedge to close-out positions with third parties, not eliminating market risk hedges may avoid an increase in the Level 3 prescribed capital amount.
29. Example (2): assume that the general insurer and ADI from the previous example have equal and opposite currency positions with parties external to the Level 3 group and perform a currency swap to close these positions. As the positions are equal and opposite, the net exposure of the Level 3 group is zero. If the market risk hedges were reversed, the currency swap would be adjusted for the purposes of calculating the Level 3 prescribed capital amount and both the ADI and GI block's RC would be increased. By not adjusting for the internal currency swap, the Level 3 prescribed capital amount recognises that there is no net open currency position and is, therefore, not increased.

30. Where a Level 3 institution provides a guarantee or credit derivative to another institution in the Level 3 group, the former institution is now exposed to the external risk in place of the latter. Similar to market risk hedges, the guarantee or credit derivative must be excluded from the ITE adjustments in accordance with 3PS 110.

31. 3PS 110 notes that counterparty credit risk (CCR) and/or credit risk charges related to market risk hedges, guarantees and credit derivatives must be eliminated like other ITEs. If a Level 3 institution hedges risk with another Level 3 institution in the Level 3 group, it may be subject to a CCR and/or credit risk charge at Level 1. From a Level 3 perspective, CCR and/or credit risk exposures between Level 3 institutions are not relevant and are to be adjusted.
32. Example (3): at Level 1, the general insurer from the first example is subject to a default risk charge on its hedge with the ADI. At Level 3, the GI block's RC figure must exclude this risk charge.

Insurance risk charges

33. If a Level 3 group contains a general insurer or life company that provides insurance cover for another Level 3 institution in the group, RC is not adjusted for the associated ITEs as the insured risk is external to the group. Reversing such an exposure would mean that the institution purchasing cover would need to apply an appropriate adjustment to its RC to reflect the risk; this insurance risk is, however, best captured by the general and life insurance regulatory frameworks at Levels 1 and 2.
34. Example (1): an ADI purchases professional indemnity insurance from a general insurer in the Level 3 group. The RCs for the ADI and GI blocks do not need to be adjusted for this ITE. RC for the general insurer retains the charge for the risks associated with professional indemnity insurance cover, and the ADI block excludes this risk.

35. Example (2): an ADI purchases lenders mortgage insurance from a lenders mortgage insurer in the Level 3 group. The RCs for the ADI and GI blocks do not need to be adjusted for this ITE. RC for the GI block retains the insurance risk charge for the risks associated with lenders mortgage insurance, and RC for the ADI block retains the risk-weighted assets that incorporate the impact of lenders mortgage insurance.

Funds management activities

External funds

36. For the purposes of determining RC in relation to funds management activities, 3PS 110 requires the Level 3 group to use only external funds as an input. Pass through funds, being ITEs, must be eliminated.
37. 3PS 110 applies a 'net approach' to funds management activities: funds entering the Level 3 group from external sources are included in the relevant block's RC figure, but internal pass-through funds are exempt, and any applicable capital requirements at Level 1 or Level 2 relating to these funds must be eliminated.
38. Example (1): a life company in a Level 3 group has investment-linked policies that are owned by third parties and passes the funds through to a funds management institution in the group. RC for the LI block includes the operational risk charge related to the investment-linked policies and RC for the FM block excludes these funds. Were the situation reversed, RC for the FM block would include these funds but RC for the LI block would exclude the operational risk charge related to the investment-linked policies. Similarly, where an institution in the FM block passes funds through to other institutions in the FM block, RC for the FM block would count these funds only once.
39. Example (2): an RSE licensee in a Level 3 group receives superannuation funds from its members. These funds are external funds and, therefore, the RSE licensee does not adjust the Operational Risk Financial Requirement (ORFR) target amount it has applied at Level 1. All of the funds are placed with a funds management institution in the group. As the funds are sourced internally, the funds management institution excludes these funds from the FM block's RC.
40. *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement* clarifies that, at Level 1, an RSE licensee may determine that an investing RSE's investment in a related RSE licensee or life company reduces the RSE licensee's ORFR target amount to a minimum of 0.10 per cent of funds. To ensure that the Level 3 requirement for the funds does not become inappropriately low due to this adjustment, 3PS 110 imposes a minimum of 0.15 per cent on funds passed through in this manner by the RSE licensee. The receiving RSE licensee or life company excludes these funds from its block's RC as they are pass-through funds.
41. Example (3): an RSE licensee in a Level 3 group receives superannuation funds from its members. All of the funds are placed with a life company in the group. At Level 1, the RSE licensee is able to set an ORFR target amount of 0.10 per cent of funds. At Level 3, the Super block's RC is based on the minimum of 0.15 per cent of funds. As the funds are sourced internally, the life company excludes these funds from the LI block's RC calculation.
42. The adjustment for pass through-funds occurs not only between blocks but also within industry blocks.
43. Example (4): a funds management institution places external client funds with another funds management institution in the Level 3 group. The net fund assets of the FM block exclude the pass-through of funds between the two funds management institutions. The ICA for the FM block is based on the net funds.

44. The adjustment for pass-through funds occurs each time the funds move from one Level 3 institution in the group to another institution in the group. There is no limit on the number of iterations of pass-through that are eliminated from the determination of the Level 3 prescribed capital amount.
45. Example (5): an RSE licensee receives external superannuation funds from its members. It places all funds with a funds management institution in the FM block. This funds management institution subsequently places one quarter of the funds with another funds management institution in the group, another quarter with a life company's investment-linked policies and the remainder with a third-party funds management institution. The external funds entered the group through the RSE licensee. Therefore, the Super block's RC will reflect the risks associated with these funds in its ORFR target amount input. The LI and FM blocks exclude these funds from their RC calculations.
46. Pass-through within an individual institution is already eliminated in the inputs for *Reporting Form 3RF 110.0 Level 3 Prescribed Capital Amount* and does not require additional adjustments.
47. Example (6): an RSE receives external funds and invests these funds with a pooled superannuation trust within the RSE licensee's business operations. The RSE licensee's ORFR target amount included in the Super block's RC is not adjusted as the ORFR target amount already reflects the impact of pass-through between the trusts.
48. Funds that exit the Level 3 group to a third party but come back into the group are treated as two separate instances of the receipt of external funds, and both instances must be covered by RC.
49. Example (7): an RSE licensee receives external superannuation funds from its members. It places all funds with a third-party funds management institution. The third-party funds management institution in turn passes all funds through to a funds management institution in the Level 3 group. As the funds are received from an

external source both at the RSE licensee (from its members) and the funds management institution (from the third-party funds management institution), the group must include these funds in both the Super block RC and the FM block RC.

Shareholder funds

50. 3PS 110 defines 'shareholder funds' as 'funds invested on behalf of institutions in the Level 3 group where the group itself derives all gains and losses related to such exposures and investments'. 3PS 110 stipulates that the investment of shareholder funds by a Level 3 institution with another institution in a Level 3 group, where the latter institution is engaged in funds management activities, must not be excluded from the determination of the former Level 3 institution's RC figure. The receiving institution must eliminate the funds from its RC figure as they classify as pass-through funds.
51. Example: a general insurer invests shareholder funds through investment-linked policies held by a life company in the Level 3 group. At Level 1, the life company does not apply an asset risk charge to these policies but it does apply an operational risk charge. At Level 3, the operational risk charge in relation to this investment is eliminated from the life company's PCR and prescribed capital amount used as inputs in determining RC for the LI block. The general insurer is required at Level 1 to look through the investment-linked policy and determine its asset risk charge accordingly; the RC figure for the GI block does not need to be adjusted.

Operational separation or operational separability

52. 3PS 110 stipulates that a Level 3 group may be able to reduce its Level 3 prescribed capital amount if it is able to demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of Level 3 institution(s) in the FM and/or OA blocks. APRA will advise the Level 3 Head, in writing, whether it agrees that the group has credibly reduced the risk to APRA beneficiaries. Paragraphs 26 through 28 inclusive of this PPG provide additional guidance on APRA's expectations regarding operational separation and separability.
53. The contagion risks to APRA beneficiaries from operationally separated or separable institutions would be reduced where, for example, the group clearly and publicly indicates that its APRA-regulated institutions will not support operationally separated or separable institutions if they were to experience severe financial difficulties. As a result, an APRA-regulated institution's exposure to an operationally separated or separable institution in the Level 3 group would be treated as equivalent to an exposure to an entity that is not part of the group. Where a Level 3 institution that is not operationally separated or separable has an ITE with a Level 3 institution that is operationally separated or separable, 3PS 110 requires that such an ITE must not be eliminated.
54. Example (1): an ADI provides a loan to an operationally separated Level 3 institution in the OA block. For the Level 3 group's APRA beneficiaries, the loan provides a similar risk exposure to that of an equivalent loan to a third party with a credit risk profile similar to the institution's profile. As a consequence, the loan is not eliminated from the ADI's total risk-weighted assets that are used as an input in the ADI block's RC calculation, and the Level 3 prescribed capital amount includes the credit risk exposure from the ADI to the operationally separated Level 3 institution.
55. The impact on ITE adjustments from operationally separated or separable funds management activities differs from the approach outlined above. 3PS 110 notes that, where an operationally separated or separable funds management institution ultimately passes its external funds through to a Level 3 institution in the Level 3 group that is not operationally separated or separable, these funds must instead be included in the latter institution's RC calculation. This reflects the point at which the risks to the APRA beneficiaries have materially increased.
56. Example (2): an operationally separated funds management institution passes externally sourced client funds through to a life company in the Level 3 group. Even though the funds enter the Level 3 group through the funds management institution, as this institution is operationally separated the risks associated with the funds must be reflected in the LI block's RC rather than the FM block's RC.
57. Example (3): the operationally separated funds management institution first passes the client funds through to another operationally separated funds management institution before it is passed through to the life company. The outcome is the same as the previous example: as the funds management institutions are operationally separated, the risks associated with the funds must be reflected in the RC of the LI block, rather than the FM block.
58. Any funds that are passed through from a non-separated Level 3 institution to an operationally separated or separable funds management institution would not have to be adjusted. APRA notes that the indicators in 3PS 110 to assess whether an institution is operationally separated or separable include more stringent ITE policy limits⁶ between separated and non-separated institutions.
59. Example (4): an RSE licensee receives external superannuation funds from its members. It places certain funds with an operationally separated funds management institution in the FM block. The operational risks associated with the external funds are reflected in the Super block, and the FM block's RC excludes the pass-through funds.

6 Refer to 3PS 222.

Tax effects in general insurers and life companies

60. At Levels 1 and 2, general insurers and life companies 'insurers' tax-effect their prescribed capital amount. There may be circumstances where an insurer has a tax arrangement in place with part or all of the Level 3 group to which it belongs. In such a case, the potential impact of tax-effecting the prescribed capital amount and PCR is not captured at Level 1 or 2. 3PS 110 notes that, for the purposes of determining the GI and LI blocks' RC, insurers may, if allowed by tax legislation, recognise as an ITE the ability to tax-effect across the Level 3 group. It further stipulates that deferred tax liabilities already used as an offset for existing or potential deferred tax assets cannot be used for this purpose, and the prescribed capital amount used to determine the tax benefit must exclude all other ITEs.
61. Example: a life company in a Level 3 group and the group has established group policies and procedures that provide for the Level 3 institutions in the group to settle current tax assets and liabilities on a net basis. A life company may also choose to realise the assets and liabilities simultaneously for each period in which significant amounts of deferred tax assets or liabilities are to be settled or recovered. As netting occurs at the group level rather than the life company level, the life company's prescribed capital amount and PCR are not tax-effected. At Level 3, the life company can tax-effect the inputs to the LI block's RC.

Securitisation SPVs

62. The Level 3 capital adequacy framework has special requirements in relation to securitisation. 3PS 110 requires a Level 3 group to assess whether its securitisation SPVs meet, from a Level 3 perspective, the operational requirements for regulatory capital relief set out in Attachment B of *Prudential Standard APS 120 Securitisation* (APS 120). In particular, groups should assess the criterion regarding significant risk transfer.
63. This approach to securitisation SPVs aims to provide consistency across the group in dealing with the significant risk transfer criterion, in particular in assessing whether the group has materially transferred risks to third parties. Further, the approach avoids situations where an ADI would claim concessional treatment under APS 120 at Level 2 even though other group members are the main investors in the SPV. At Level 3, the concessional treatment would in this case be reversed as there has been no significant risk transfer to third parties.

Securitisation SPVs that meet the APS 120 requirements

64. In accordance with 3PS 110, a securitisation SPV that meets the APS 120 operational requirements for regulatory capital relief from a Level 3 perspective, may be treated as external to the group. In that case:
- (a) any securitisation exposures from Level 3 institutions in the Level 3 group to the securitisation SPV must be treated as third-party (external) exposures; and
 - (b) for the purposes of determining Level 3 EC, in accordance with 3PS 111, the securitisation SPV must be deconsolidated.
65. Example: an ADI in the Level 3 group originates a securitisation SPV. The securitisation SPV meets the APS 120 requirements from a Level 3 perspective and the Level 3 Head chooses to treat this SPV as external to the group. As the SPV also meets the APS 120 requirements from a Level 2 perspective, the ADI's risk-weighted assets already exclude the securitisation exposures. Therefore, the ADI block's RC remains unchanged. Any other Level 3 institutions in the group with exposures to the SPV do not eliminate these exposures when determining their industry block RC as they are not ITEs. The group excludes the SPV from its determination of Level 3 EC.

Securitisation SPVs that do not meet the APS 120 requirements

66. In accordance with 3PS 110, where a securitisation SPV fails to meet the APS 120 operational requirements for regulatory capital relief from a Level 3 perspective, or where the Level 3 Head chooses not to apply the approach set out above, the securitisation SPV must be treated as part of the Level 3 group. For the purposes of determining the Level 3 prescribed capital amount:
- (a) the securitisation SPV is consolidated into the originating Level 3 institution and the relevant industry block's RC must incorporate the securitisation SPV's risk exposures; and
 - (b) other Level 3 institutions in the group with exposures to the securitisation SPV must treat these exposures as ITEs and treat them accordingly.
67. Example: an ADI in the Level 3 group originates a securitisation SPV. While the securitisation SPV meets the APS 120 requirements for regulatory capital relief at Level 2, it fails to meet the requirements from a Level 3 perspective as a general insurer in the group has a significant exposure to the SPV. The Level 3 group must consolidate the SPV back into the ADI and adjust the ADI's risk-weighted assets accordingly for the purposes of determining the ADI block's RC. The general insurer must eliminate its exposures to the SPV for the purposes of calculating the GI block RC as these exposures are considered to be ITEs.



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