Draft Prudential Practice Guide

3PG 222 – Intra-group Transactions and Exposures

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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 222 Intra-group Transactions and Exposures (3PS 222) sets out APRA's requirements in relation to the associations and dealings between institutions in a Level 3 group. This PPG aims to assist Level 3 Heads to comply with those requirements and, more generally, to outline prudent practices in relation to certain intra-group matters.

For the purposes of this guide, and consistent with the application of 3PS 222, the expression a 'Level 3 Head' will be used to refer to an authorised deposit-taking institution (ADI), a general insurer (GI), a life insurer (LI) or an authorised non-operating holding company (NOHC).

Subject to the requirements of 3PS 222, a Level 3 Head has the flexibility to structure its intra-group exposures framework in the way it considers most suited to achieving its business objectives. Not all practices outlined in this PPG will be relevant for every Level 3 Head and some aspects may vary depending upon the size, business mix and complexity of the Level 3 group's business operations.

Introduction

1. Intra-group transactions and exposures (ITEs) expose Level 3 institutions in a Level 3 group to contagion risks. Where an institution is facing financial or operational stress, this may affect other institutions within the group with material ITEs to that institution. Therefore, the Board of a Level 3 Head (the Board) needs to understand the material ITEs within the group and manage the associated risks prudently. ITEs that can pose a risk of contagion would include, for example:
   (a) equity investments;
   (b) loan or funding arrangements;
   (c) reinsurance arrangements;
   (d) guarantees or indemnities; and
   (e) operational risks from intra-group service provision.
2. To understand the nature and location of material ITEs, APRA expects the Level 3 Head would coordinate a holistic view of the institutions within the group and the interconnectedness of risks. Coordination is important as institutions may not be able to view the risks being undertaken by other institutions in the group.
3. 3PS 222 requires a Level 3 Head to establish and maintain an ITE policy. The policy forms a part of the group's risk management framework and supports the ability to identify, measure, aggregate, manage and report on material ITEs. These material exposures can arise from APRA-regulated and non-APRA-regulated institutions in the group.
4. Material ITEs include those that would have a potential to have a material impact, both financial and operational, on the Level 3 group or an APRA-regulated institution in the group. APRA expects that the Board would determine what it considers to be a material ITE, and that this would vary according to the group's risk profile. Where an institution is considered to have business operations that are material to the Level 3 group, a material ITE to that institution would constitute a material ITE for the group.
5. The materiality of an ITE depends on the size, nature and complexity of the exposure to the group. Where a material ITE is identified, the Board would also need to understand the material drivers of this risk. For instance, decision-makers may need to understand whether the ITE is comprised of a high number of low risk intra-group arrangements or a low number of material individual risk exposures.
6. A Level 3 Head's governance arrangements, ITE data capabilities, and reporting would reflect how the Board makes decisions and oversees material ITEs. APRA expects data capabilities and ITE risk reporting to be relevant and appropriate for the intended purpose and to meet business specifications (i.e. fit-for-purpose) for the needs of the Board and other decision-makers in the Level 3 group.

Governance and ITE Policy

7. The effective governance of ITEs would support the Level 3 group's risk management framework. The group ITE policy would be expected to outline governance arrangements for intra-group associations and is expected to be commensurate with group's risk appetite, risk management strategy and business plan.[1]
8. APRA expects the Board to have a holistic view of material ITEs within the group and establish a framework to monitor and control the associated risks. The Board would consider the group's critical business operations and assess the potential impact of a stress on these operations to the group.
9. APRA expects a Level 3 Head to use stress testing and scenario analysis to assess the adequacy of its data capabilities and risk reporting on ITEs. The results of these assessments would feed into the Board's awareness of material ITEs and would prompt consideration as to the Board's appetite for these exposures and the appropriateness of limits.
10. When determining limits on ITEs, the Board would consider the risks to the Level 3 group's capital and liquidity positions. APRA expects the limits on ITEs to appropriately balance the needs of capital

1 Refer to *Prudential Practice Guide CPG 220 Risk Management* for further guidance.

and liquidity requirements, as these limits may constrain the transfer of funds within the group. APRA expects the Level 3 Head would integrate the results of ITE stress testing and scenario analysis into the consideration of group capital[2], required capital, target surplus and liquidity.

11. The risks associated with ITEs could be magnified where the transactions with related parties have not been conducted on an arms-length basis or on equivalent terms and conditions given to third parties. APRA expects a Level 3 Head to have processes and controls to mitigate such risks. In accordance with 3PS 222, the Board is required to approve these non-arm's length transactions.

12. When establishing limits on ITEs, APRA expects a Level 3 Head to take into account the limits imposed on third parties of equivalent risk. These limits would be based on the size, nature and complexity of exposures and include a consideration of how the risk from these ITEs differs to equivalent exposures to third parties.

13. Governance arrangements would include considerations of organisational structures to support information flow between Level 3 institutions and the Level 3 Head. These organisational structures would align with the risk management framework so that the identification and management of ITEs is not impeded.

Level 3 Capital Adequacy

14. APRA emphasises that the ITEs calculated for determining a Level 3 group's capital adequacy[3] are of a more limited scope than the ITEs used for internal ITE risk reporting. ITEs in the former case are specifically limited to changes in an industry block's required capital, whereas ITEs for the purposes of 3PS 222 reflect all material exposures between institutions in the Level 3 group.

15. Under 3PS 110, a Level 3 Head may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of Level 3 institutions in the funds management (FM) or other activities (OA) block from which the risk emanates. This includes an assessment of whether exposures from non-separated Level 3 institutions to the relevant institution in the FM or OA block are subject to more stringent limits than other ITEs, as reflected in the group's ITE policy. APRA expects a Level 3 group would be able to clearly identify operationally separated or separable institutions, and establish specific and appropriate limits in its ITE policy for interactions with non-separated institutions.

Intra-group data capabilities

16. APRA expects intra-group data to be of sufficient quality[4] to enable the effective management of a Level 3 group's risk profile and support risk-based decision-makings. APRA expects Level 3 Heads to coordinate the aggregation of risk data for meaningful analysis of the risks associated with the ITEs.

17. APRA expects intra-group data capabilities would facilitate the sourcing of both qualitative and quantitative information that would inform decision-makers of the potential financial and operational impact of ITEs.

18. APRA expects Level 3 Heads to be able to identify the material ITEs between institutions. Being able to understand the material ITEs between institutions provides insight into how a material impact on one institution may spread throughout the group. Intra-group financial transactions can be more readily subject to quantitative assessment, while operational interdependencies may be more useful in qualitative assessments of the risk.

19. The ability to aggregate ITEs, where appropriate, is important to support the transparency of risks posed by individual institutions that engage in a high volume of small sized intra-group transactions. The aggregation of different types of ITEs, such as financial and operational, may not be appropriate and can result in a misunderstanding of risk. APRA expects that a Level 3 Head would consider the appropriateness of aggregating ITEs.

2 Refer to *Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review* for further guidance.
3 Refer to *Prudential Standard 3PS 110 Capital Adequacy* (3PS 110).
4 Refer to *Prudential Practice Guide CPG 235 Managing Data Risk* (CPG 235).

20. The needs of decision-makers should drive improvements in data aggregation capabilities. APRA expects that requests for improvements are appropriately documented, assessed, and appropriately escalated so that risk data capabilities continue to best serve the needs of decision-makers.[5]

21. APRA expects a Level 3 group to have practices and procedures to identify data deficiencies and, where necessary, implement an improvement program so that data management does not impede effective risk management.[6] Where there is a deficiency in data quality, APRA expects the Board to allocate sufficient oversight and resources for rectification. APRA expects that a Level 3 group would already have data on material ITEs and expects that this data would not be encumbered by unnecessary barriers to retrieval, or rely on onerous manual adjustments for collation.

Risk Reporting

22. Good practice is that risk reporting is accurate, comprehensive, clear and useful, and can be provided to decision-makers on a timely basis. Risk reporting would be based on risk data and be presented in a manner that is clear, concise, and useful to the intended recipient. A Level 3 Head would determine risk reporting requirements that best suit the needs of its Board and senior management of the Level 3 group given the size, business mix and complexity of the group.

23. APRA expects a Level 3 Head to have access to commission both regular and flexible *ad hoc* reporting. The frequency of risk reporting depends on the needs of decision-makers. APRA expects reporting on the group's material ITEs to the Board at least quarterly. In periods of stress, given the speed of decision-making likely to be needed and that the nature of risk can change quickly, the frequency of reporting would be expected to increase in such circumstances.

24. The reporting of material ITEs to the Board would have sufficient breadth to provide the Board with a coordinated view of the roles and relationships between subsidiaries to one another and to the Level 3 Head. This coordinated view would assist the Board and senior management of the Level 3 group in tracking how ITEs affect the risk profile of regulated institutions within the group.

25. APRA expects that the Board would request reports on material individual ITEs or the ITEs to particular institutions, accompanied by meetings with relevant senior management. Reporting would support the Board and the group's senior management in understanding and tracking of ITEs against the group's risk appetite and capital strength.

26. The amount of detail presented in reports would reflect the needs of decision-makers to fulfil their roles and responsibilities. APRA expects reporting to vary according to the institutions involved and the size, nature, and complexity of the ITEs being assessed. Where appropriate, reporting would also include how different ITEs are assumed to interact and transform the risk of contagion between institutions.

27. When determining what information to include in reporting, decision-makers would consider whether an appropriate balance between accuracy and information that is available has been achieved. A report may still satisfy a decision-maker's needs even if the data is merely indicative, is subject to a margin of error, or other relevant conditions. However, a comprehensive report may not meet the user's needs if it is not timely. Reporting would inform the decision-maker of the degree to which data is relevant, appropriate for the intended purpose, and meet business specifications.

5 Refer to data issue management in CPG 235.
6 Refer to CPG 235.

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