Prudential Standard LPS 110

Capital Adequacy

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure that the life company 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 key requirements of this Prudential Standard are that a life company must:

- have an Internal Capital Adequacy Assessment Process;
- maintain required levels of capital within each of its funds and for the company as a whole;
- determine each fund's prescribed capital amount having regard to a range of risk factors that may adversely impact the company's ability to meet its obligations. These factors include insurance risk, asset risk, asset concentration risk and operational risk;
- comply with any supervisory adjustment to capital imposed by APRA;
- make certain public disclosures about the capital adequacy position of each fund and the company as a whole;
- seek APRA's consent for certain planned capital reductions of the company; and
- inform APRA of any significant adverse changes in the capital position of the company as a whole or any of its funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. A life company must apply this Prudential Standard separately:

   (a) for a life company other than a friendly society: to each of its statutory funds, its shareholders' fund and the life company as a whole; and

   (b) for a friendly society: to each of its approved benefit funds, its management fund and the friendly society as a whole.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** (**EFLIC**) which is carried on through its Australian statutory funds but not otherwise.[2]

5. This Prudential Standard applies to life companies from 1 January 2013 **(effective date)**.

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

7. Unless otherwise indicated:

   (a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;

   (b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and

   (c) the term **fund** will be used to refer to a statutory fund or a general fund, as relevant.

~~Objective~~

~~8. The **prescribed capital amount** of a fund is intended to be sufficient, such that if a fund was to start the year with a **capital base** equal to the prescribed capital~~

[1] Refer to subsection 21(1) of the Act.
[2] Refer to section 16ZD of the Act.

~~amount, and losses occurred at the 99.5 per cent confidence level then the assets remaining would be at least sufficient to provide for the **adjusted policy liabilities** and **other liabilities** of the fund at the end of the year. The other liabilities to be provided for exclude those liabilities that satisfy the criteria for inclusion in the capital base.~~

Responsibility for capital management

~~9.~~8. Capital is the cornerstone of a life company's financial strength. It supports a life company's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of such losses, enables the life company to continue to meet its insurance obligations.

~~10.~~9. As a consequence of the key role played by capital in the financial health of a life company, the Board of directors (**Board**) of a life company must ensure that:

(a) the life company as a whole; and

(b) each fund

has capital that is adequate for the scale, nature and complexity of its business and its risk profile, such that it is able to meet its obligations under a wide range of circumstances.

Internal Capital Adequacy Assessment Process

~~11.~~10. A life company must have in place an **Internal Capital Adequacy Assessment Process** (**ICAAP**) that considers each fund of the life company, as well as the life company as a whole. The ICAAP must:

(a) be adequately documented, with the documentation made available to APRA on request; and

(b) be approved by the Board initially, and when significant changes are made to the process.

11. A life company's ICAAP must be appropriate to the life company's size, business mix and complexity of its operations.

12. A life company that is part of a group may rely on the ICAAP of the group provided that the Board of the life company is satisfied that the group ICAAP meets the criteria in paragraph 13 of this Prudential Standard in respect of the life company.

~~12.~~13. The ICAAP must include at a minimum:

(a) adequate policies, procedures, systems, controls and ~~procedures~~ personnel to identify, measure, monitor and manage the risks arising from the life company's activities on a continuous basis~~ to ensure that capital is maintained at a level consistent with the life company's risk profile and the Board's risk appetite~~, and the capital held against such risks;

(b) a strategy for ensuring adequate capital is maintained over time, including specific capital targets set in the context of the life company's risk profile, the Board's risk appetite and regulatory capital requirements. This includes plans for how target levels of capital are to be met and the means available for sourcing additional capital where required;

(c) actions and procedures for monitoring the life company's compliance with its regulatory capital requirements and capital targets. This includes the setting of triggers to alert management to, and specified actions to avert and rectify, potential breaches of the regulatory capital requirements;

(d) stress testing and scenario analysis relating to potential risk exposures and available capital resources;

(e) processes for reporting on the ICAAP and its outcomes to the Board and senior management of the life company, and for ensuring that the ICAAP is taken into account in making business decisions;

~~(d)~~(f) policies to address the capital impact of material risks not covered by explicit regulatory capital requirements; and

~~(e)~~(g) an **ICAAP summary statement** as defined in paragraph 14;

14. The ICAAP summary statement is a high level document that describes and summarises the capital assessment and management processes of the life company. It must outline at a minimum the aspects of the ICAAP listed in paragraphs 13 (a) to (f) and this paragraph. The ICAAP summary statement must also include:

(a) a statement of the objectives of the ICAAP, the expected level of financial soundness associated with the capital targets and the timeframe over which the ICAAP applies;

(b) a description of the key assumptions and methodologies used by the life company in its ICAAP, including stress testing and scenario analysis;

(c) triggers for reviewing the ICAAP in light of changes to business operations, regulatory, economic and financial market conditions, and other factors affecting the life company's risk profile and capital resources;

(d) a summary of the life company's policy for reviewing its ICAAP, including who is responsible for the review, details of the frequency and scope of the review, and mechanisms for reporting on the review and its outcomes to the Board and senior management;

(e) a description of the basis of measurement of capital used in the ICAAP, and an explanation of the differences where this basis differs from that used for regulatory capital; and

~~(a)~~(f) references to supporting documentation and analysis as relevant.

~~13.~~15. A life company must ensure its ICAAP is subject to regular and robust ~~independen~~t review ~~at regular intervals~~by appropriately qualified persons who are operationally independent of the conduct of capital management. The frequency and scope of the review must be appropriate to the life company, having regard to its size, business mix, complexity of its operations, and the nature and extent of any changes that have occurred or are likely to occur in its business profile or its risk appetite. ~~In any event, the review must not be any less frequent than every three years.~~A review must be conducted at least every three years. The review must be sufficient to reach a view on whether the ICAAP is adequate and effective. ~~The life company's policy for review of its ICAAP must be documented in the ICAAP summary statement, including the responsibility for the review, frequency and scope of the review, and reporting of the review to the Board and senior management.~~

16. A life company must, on an annual basis, provide a report on the implementation of its ICAAP to APRA (**ICAAP report**). ~~The ICAAP report must be provided to APRA within four months of the end of the financial year[3] of the life company~~A copy of the ICAAP report must be provided to APRA no later than three months from the date on which the report has been prepared.

~~14.~~17. The ICAAP report must include:

(a) detailed information on current and three-year projected capital levels relative to minimum regulatory capital requirements and target levels for each fund and the life company as a whole;

(b) detailed information on the actual outcomes of applying the ICAAP over the period, relative to the planned outcomes in the previous ICAAP report (including analysis of the life company's actual capital position relative to minimum capital requirements and capital targets and actual-versus-planned capital management actions);

(c) description of material changes to the ICAAP since the previous ICAAP report; and

(d) detail and outcomes of stress testing and scenario analysis used in undertaking the ICAAP;

(e) a breakdown of capital usage over the planning horizon, as relevant, by material:

(i) business activity;

(ii) geographic spread of exposures; and

(iii) risk types;

(f) an assessment of anticipated changes in the life company's risk profile or capital management processes over the planning horizon;

~~[3] As defined in section 77 of the Act.~~

(g) details of any review of the ICAAP since the previous ICAAP report, including any recommendations for change and how those recommendations have been, or are being, addressed; and

(h) references to supporting documentation and analysis as relevant.

18. The ICAAP report submitted to APRA by the life company must be accompanied by a declaration endorsed by the Board and signed by the CEO stating whether:

(a) capital management has been undertaken by the life company in accordance with the ICAAP over the period and, if not, a description of, and explanation for, deviations;

(b) the life company has assessed the capital targets contained in its ICAAP to be adequate given the size, business mix and complexity of its operations; and

~~(a)~~(c) the information included in the ICAAP report is accurate.

Capital base

~~15.~~19. In assessing the adequacy of a fund's or a life company's **capital base**, attention must be paid not only to the risks it is likely to face, but also the quality of the support provided by various forms of capital. In assessing the quality of support provided by a particular form of capital, regard must be had to the extent to which it:

(a) provides a permanent and unrestricted commitment of funds;

(b) is freely available to absorb losses;

(c) does not impose any unavoidable servicing charges against earnings; and

(d) ranks behind the claims of policy owners and creditors in the event of the winding-up of the life company.

~~16.~~20. Not all forms of capital meet these criteria equally. Due to the need to ensure that the capital base of a life company provides adequate support for its activities, APRA imposes some restrictions on the composition of the capital base. The forms of capital deemed eligible for inclusion in the capital base, and the conditions as to their inclusion, are specified in *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (**LPS 112**). LPS 112 defines the different categories and components of the capital base and the restrictions on the quality of the capital that is used to meet the required level of capital for regulatory purposes.

~~17.~~21. A fund or life company's balance sheet may contain certain assets (such as deferred tax assets, goodwill and other intangibles) that are acceptable from an accounting perspective. However, for supervisory purposes, such assets are either generally not available, or of questionable value, should the fund or life company encounter difficulties. Similarly, the **policy liabilities** on the balance

sheet may reflect allowance for future transactions (such as future premium income) that it is not appropriate to recognise for supervisory purposes. A life company is therefore required to make certain adjustments in determining the capital base. Details of these adjustments are provided in LPS 112.

Prudential Capital Requirement (PCR)

~~18.~~22. This Prudential Standard establishes a risk-based approach to measuring the capital adequacy of a fund or a life company. This required level of capital for regulatory purposes is referred to as the **Prudential Capital Requirement** (**PCR**). The PCR is intended to take account of the full range of risks to which a fund or life company is exposed.

~~19.~~23. A life company must ensure that the life company and each of its funds have a capital base, at all times, in excess of its PCR.

~~20.~~24. The PCR for a fund equals:

~~(a)~~(b) a **prescribed capital amount** determined either:

(i) by applying the **Standard Method** set out in this Prudential Standard; or

(ii) by using an internal model developed by the life company to reflect the circumstances of its business – the **Internal Model-Based Method (IMB Method)**; or

(iii) by using a combination of the methods specified in (i) or (ii) above; plus

~~(b)~~(c) any **supervisory adjustment** determined by APRA under paragraph 45.

~~21.~~25. The prescribed capital amount for a life company is the sum of the prescribed capital amounts of each of its funds. Regardless of the outcome of the method used for determining the prescribed capital amount, a life company's prescribed capital amount cannot be less than $10 million.

~~22.~~26. The prescribed capital amount for a statutory fund with liabilities for variable annuity business must be calculated in accordance with Attachment A.

~~23.~~27. A life company intending to issue **variable annuities** must, before it issues these policies, obtain approval from APRA of the method to be used for calculating the prescribed capital amount for the statutory fund issuing these variable annuities.

~~24.~~28. The PCR for a life company is the sum of the PCRs of each of its funds (or such higher amount as determined by APRA under paragraph 45).

Standard Method

~~25.~~29. For life companies using the Standard Method, the prescribed capital amount for a fund is determined as:

(a) the **Insurance Risk Charge**; plus

(b) the **Asset Risk Charge**; plus

(c) the **Asset Concentration Risk Charge**; plus

(d) the **Operational Risk Charge**; less

(e) an **aggregation benefit**; plus

(f) a~~n adjustment for tax benefits and management actions~~ combined stress scenario adjustment.

30. The prescribed capital amount of a fund determined under the Standard Method is intended to be sufficient, such that if a fund was to start the year with a capital base equal to the prescribed capital amount, and losses occurred at the 99.5 per cent confidence level then the assets remaining would be at least sufficient to provide for the **adjusted policy liabilities** and **other liabilities** of the fund at the end of the year. The other liabilities to be provided for exclude those liabilities that satisfy the criteria for inclusion in the capital base.

Insurance Risk Charge

~~26.~~31. The Insurance Risk Charge relates to the risk of adverse impacts due to movements in future mortality, morbidity, longevity, **servicing expenses**, lapses and other **insurance risks** such as option take-up rates.

~~27.~~32. The Insurance Risk Charge for a fund is determined by assessing the impact on the capital base of the fund of adverse changes in the variables in paragraph 31. The method for determining the Insurance Risk Charge is set out in *Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge*.

Asset Risk Charge

~~28.~~33. The Asset Risk Charge relates to the risk of adverse movements in the value of a fund's on-balance sheet and off-balance sheet exposures. Asset risk can be derived from a number of sources, including market risk and credit risk.

~~29.~~34. The method for determining the Asset Risk Charge is set out in *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge*.

Asset Concentration Risk Charge

~~30.~~35. The Asset Concentration Risk Charge relates to the risk resulting from investment concentrations in individual assets or large exposures to individual counterparties or groups of related counterparties. The method for determining

Asset Concentration Risk Charge is set out in *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge*.

Operational Risk Charge

~~31.~~36. The Operational Risk Charge relates to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The method for determining the Operational Risk Charge for a fund is set out in *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge*.

Aggregation benefit

~~32.~~37. The aggregation benefit makes an explicit allowance for diversification between asset and insurance risks in the calculation of the prescribed capital amount.

~~33.~~38. The aggregation benefit formula is:

$$\text{Aggregation benefit} = (A + I) - \sqrt{A^2 + I^2 + 2 \times \text{correlation} \times A \times I}$$

where:

(a) 'A' is the Asset Risk Charge;

(b) 'I' is the Insurance Risk Charge; and

(c) 'correlation' is 20 per cent.

~~34.~~39. The Asset Concentration Risk Charge and the Operational Risk Charge are not included in the calculation of the aggregation benefit.

Combined stress scenario adjustment ~~for tax benefits and management actions~~

~~35.~~40. Future shareholder tax benefits arising in the stressed scenarios are recognised in determining the Insurance Risk Charge and Asset Risk Charge. A life company must increase the prescribed capital amount by the aggregate amount of any tax benefits that cannot be netted against deferred tax liabilities as specified in LPS 112.

~~36.~~41. In the calculation of the Insurance Risk Charge and Asset Risk Charge, an allowance may be made for any anticipated management actions that would reduce future policy benefits, for example, increasing fees and premium rates, reducing surrender values and reducing **bonuses** and other **discretionary additions** to policy owner benefits. However, there are limits to the extent to which policy benefits can be reduced. A life company must increase the prescribed capital amount if the aggregated management actions would reduce policy benefits below these limits.

~~37.~~42. The method for calculating the combined stress scenario adjustment ~~for tax benefits and management actions~~ is specified in Attachment B.

APRA may adjust the Standard Method for calculating the prescribed capital amount

~~38.~~43. If APRA is of the view that the Standard Method for calculating the prescribed capital amount does not produce an appropriate outcome in respect of a particular fund, or a life company has used inappropriate judgement or estimation in calculating the prescribed capital amount, APRA may, in writing, adjust any aspect of the prescribed capital amount calculation for that fund. If such an adjustment is applied to a fund under this paragraph, a life company must comply with the adjusted calculation.

Internal Model-Based Method

~~39.~~44. A life company may use its own capital measurement model to calculate the prescribed capital amount. Use of the IMB Method is conditional on APRA's approval. APRA must be satisfied that the model is well designed, the analysis and assumptions used are sound, and that the results of applying the model are reasonable from a prudential viewpoint. Life companies which do not use an internal model that has been approved by APRA under this paragraph must use the Standard Method described in this Prudential Standard.

Supervisory adjustment ~~to capital~~

~~40.~~45. APRA recognises that any measure of the adequacy of a fund or a life company's capital involves judgement and estimation, including quantification of risks that may be difficult to quantify. If APRA is of the view that there are prudential reasons for doing so, APRA may, in writing, determine a supervisory adjustment to be included in the PCR of a fund or life company.

Disclosure

~~41.~~46. To improve the understanding of its capital adequacy position by policy owners and other market participants, a life company must publish, at least annually, the following items for the life company as a whole:

(a) the amount of **Common Equity Tier 1 Capital**;

(b) the aggregate amount of any regulatory adjustments applied in the calculation of Common Equity Tier 1 Capital;

(c) the amount of **Additional Tier 1 Capital**;

(d) the aggregate amount of any regulatory adjustments applied in the calculation of Additional Tier 1 Capital;

(e) the amount of **Tier 2 Capital**;

(f) the aggregate amount of any regulatory adjustments applied in the calculation of Tier 2 Capital;

(g) the total capital base of the life company derived from the items (a) to (f);

(h) the prescribed capital amount; and

(i) the capital adequacy multiple (item (g) divided by item (h)).

~~42.~~47. A life company must also publish, at least annually, the following items for each of its funds:

(a) the amount of the fund's **net assets**, after applying any regulatory adjustments;

(b) the aggregate amount of any regulatory adjustments applied to the fund's net assets;

(c) the amount of Tier 2 Capital held by the fund;

(d) the aggregate amount of any regulatory adjustments applied in the calculation of the fund's Tier 2 Capital;

(e) the total capital base of the fund derived from the items (a) to (d);

(f) the fund's prescribed capital amount;

(g) the components of the fund's prescribed capital amount[4] specified in paragraph 29[5]; and

(h) the capital adequacy multiple of the fund (item (e) divided by item (f)).

~~43.~~48. A life company must publish the information specified in paragraphs 46 and 47 so that it is readily accessible to both policy owners and other market participants.

~~44.~~49. A life company must not disclose any supervisory adjustment included in the PCR of the life company itself or any of its funds.

Reductions in capital base

~~45.~~50. A life company must obtain APRA's written consent prior to making any planned reduction in the capital base of the company. APRA's consent may be subject to conditions.

~~46.~~51. A reduction in a life company's capital base includes, but is not limited to[6]:

(a) a share buyback;

[4] This item must separately identify any transition amount approved by APRA under the capital standards.

[5] A fund containing variable annuity business is not required to separately disclose an Asset Risk Charge, Insurance Risk Charge and aggregation benefit.

[6] For an EFLIC, the requirements relating to reductions in capital base must be applied at the level of each statutory fund of the Australian operations.

(b) the redemption, repurchase or early repayment of any qualifying Additional Tier 1 and Tier 2 capital instruments issued by the life company;

(c) trading in the life company's own shares or capital instruments outside of any arrangement agreed upon with APRA in accordance with LPS 112;

(d) payment of dividends on common shares that exceed a life company's after-tax earnings (as reported to APRA in the life company's **statutory accounts**), after including any payments on more senior capital instruments, in the financial year to which they relate; and

(e) dividend or interest payments (whether whole or partial) on Additional Tier 1 or Tier 2 Capital that exceed a life company's after-tax earnings (as reported to APRA in the life company's statutory accounts), including any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate.

~~47.~~52. A life company proposing a capital reduction must provide APRA with an updated ICAAP report incorporating the proposed reduction. The life company must satisfy APRA that its capital base, after the proposed reduction, will remain adequate for its future needs.

~~48.~~53. For these purposes, 'financial year' refers to the last four quarters for which the life company was required to submit quarterly returns[7] to APRA preceding the date of the proposed payment of interest or dividend.

Materiality

~~49.~~54. A life company may take into account materiality when calculating its capital base and prescribed capital amount. Particular values or components are considered material to the overall result of a calculation if misstating or omitting them would produce results likely to be misleading to the users of the information.

Notification requirements

~~50.~~55. A life company must inform APRA as soon as practicable of:

(a) any breach or prospective breach of its PCR or the PCR of any of its funds;

(b) any significant departure from its ICAAP; or

(c) any significant adverse changes in the capital base or PCR of the company or any of its funds.

The notice must include any remedial actions taken or planned to be taken to address the situation and the timing of these actions.

[7] In accordance with reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

Adjustments and exclusions

~~51.~~56. APRA may, by notice in writing to a life company, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that life company.

Transition

~~52.~~57. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than 31 December 2014.

Attachment A

Variable annuities

1. The calculation of the prescribed capital amount for a statutory fund containing variable annuity business must be undertaken in accordance with this Attachment.

2. Variable annuities are a type of life insurance product that has special features that are not adequately catered for under the Standard Method. Accordingly, more sophisticated modelling must be performed to determine the prescribed capital amount for a statutory fund with liabilities for this type of product.

3. The required modelling could be undertaken using stochastic techniques or scenario-based techniques, as long as the techniques are adequate for assessing the risks inherent in the relevant variable annuities. The modelling must consider both asset and insurance risks simultaneously.

4. The modelling of asset and insurance risks must be consistent with the principles outlined in paragraph 8.

5. The following issues must be addressed in determining the prescribed capital amount for a statutory fund with liabilities for variable annuities:

   (a) the uncertainty associated with the company's ability to implement any required hedging strategy in a timely and effective manner;

   (b) the effectiveness of hedging arrangements;

   (c) the ability to access suitable hedge instruments in the future;

   (d) whether a matched asset and liability profile within 12 months can be achieved for this type of product, particularly given the risks that exist for these type of products beyond 12 months e.g. ratchets and path dependencies;

   (e) allowance for any discretions available; and

   (f) allowance for management corrective action to achieve a matched asset and liability profile within 12 months.

6. The prescribed capital amount (before addition of the Asset Concentration Risk Charge and the Operational Risk Charge) for a statutory fund with liabilities for variable annuity business must be determined via the following formula:

   Capital = E * Capital (including hedging) + (1-E) * Capital (excluding hedging)

   where**:**

   (a) Capital (including hedging) = the capital requirement for asset and insurance risks calculated assuming that dynamic hedging is included in the model

(b) Capital (excluding hedging) = the capital requirement for asset and insurance risks assuming there is no dynamic hedging but allowance can be made for hedge positions that exist at the valuation date

(c) E = an effectiveness factor that reflects the level of sophistication of the dynamic hedging in the model.

A dynamic hedging strategy is a hedging strategy that requires frequent rebalancing of the asset portfolio. The Capital (including hedging) and Capital (excluding hedging) may allow for diversification between asset and insurance risks but must not attribute any value to tax benefits that cannot be netted against deferred tax liabilities.

7. In determining E, the following points must be taken into account:

(a) E cannot be greater than 0.70 because most models would include at least some approximations or idealistic assumptions;

(b) if certain economic risks are not hedged, yet the model does not generate scenarios that sufficiently capture those risks, E must be in the lower end of the range of 0.0 to 0.7;

(c) a life company that does not have 12 months of experience to date must set E to a value no greater than 0.30[8]; and

(d) the ultimate effect of the current hedging strategy (including currently held hedge positions) needs to recognise all:

(i) risks;

(ii) associated costs;

(iii) imperfections in the hedges; and

(iv) hedging mismatch tolerances associated with the hedging strategy.

8. The risks referred to in subparagraph 7(d)(i) above include, but are not limited to:

(a) basis;

(b) gap;

(c) price;

(d) parameter estimation; and

(e) variation in any assumptions (mortality, lapses, annuitisation, etc.).

[8] Such a company must take into account the factors in paragraph 7 to determine E within the range of 0.0 to 0.3.

9. The costs referred to in paragraph 7(d)(ii) above include, but are not limited to:

   (a) transaction, margin (opportunity costs associated with margin requirements); and

   (b) administration.

10. APRA may require a life company to adopt a value for E specified by APRA in writing if APRA is satisfied that the value of E adopted by the company is not appropriate.

11. The Asset Concentration Risk Charge and the Operational Risk Charge apply to statutory funds with liabilities for variable annuities in addition to the capital requirement calculated under this Attachment.

Attachment B

~~Adjustment for tax benefits and management actions~~Combined stress scenario adjustment

1. The ~~adjustment for tax benefits and management actions~~combined stress scenario adjustment must be calculated from a single scenario in which all of the asset risk and insurance risk stresses are applied. The stresses must be modified by multiplying them by diversification factors.

2. The combined stress scenario adjustment ~~for tax benefits and management actions~~ must be calculated as:

   (a) the capital charge for the single scenario;

   (b) less the Insurance Risk Charge;

   (c) less the Asset Risk Charge;

   (d) plus the aggregation benefit.

   The combined stress scenario adjustment ~~for tax benefits and management actions~~ cannot be less than zero.

3. The capital charge for the single scenario is the reduction in the capital base in this scenario.

4. The stressed policy liabilities for the single scenario are defined in the same way as for the Insurance Risk Charge.

5. The insurance risk stresses for the single scenario must be the adjusted stress margins[9] used in determining the Insurance Risk Charge, multiplied by the **aggregation diversification factor** between insurance risks and asset risks.

6. The aggregation diversification factor must be calculated as the sum of:

   (a) the Insurance Risk Charge;

   (b) the Asset Risk Charge;

   (c) less the aggregation benefit;

   divided by the sum of the Insurance Risk Charge and the Asset Risk Charge.

7. The asset risk stresses for the single scenario must be the stresses used in determining the Asset Risk Charge, multiplied by both the aggregation diversification factor and an **asset risk diversification factor**. The asset risk diversification factor is calculated as the Asset Risk Charge divided by the sum of the capital charges for the seven asset risk stresses. For the stresses that apply

[9] As defined in LPS 115.

in two directions, the capital charge for the direction that determines the overall amount of the Asset Risk Charge must be used.

8. For the purpose of deducting deferred tax assets net of deferred tax liabilities from the capital base, these amounts must be adjusted to include all additional tax assets and liabilities accruing over the 12 months following the reporting date.

9. The taking of discretionary management actions in the single scenario can only be assumed to the extent that they are appropriate, justifiable and equitable in the adverse conditions assumed.

10. For a statutory fund that has liabilities for life policies that provide participating benefits or discretionary additions to benefits, the life company must use a single scenario where the direction of the asset risk stresses for real interest rates and expected inflation are both down, if this scenario would result in a higher capital charge.

Prudential Standard LPS 114

Capital Adequacy: Asset Risk Charge

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the asset risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure the life company 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 Asset Risk Charge is the minimum amount of capital required to be held against asset risks. The Asset Risk Charge relates to the risk of adverse movements in the value of a fund's on-balance sheet and off-balance sheet exposures. Asset risk can be derived from a number of sources, including market risk and credit risk.

This Prudential Standard sets out the method for calculating the Asset Risk Charge. This charge is one of the components of the Standard Method for calculating the Prudential Capital Requirement for life company statutory funds and general funds.

Table of Contents

Attachments

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. A life company must apply this Prudential Standard separately:

   a) for a life company other than a friendly society: to each of its statutory funds and its shareholders' fund; and

   b) for a friendly society: to each of its approved benefit funds and its management fund.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** (**EFLIC**) which is carried on through its Australian statutory funds but not otherwise.[2]

5. ~~Subject to any specific transition rules, t~~This Prudential Standard applies to life companies from 1 January 2013 (**effective date**).

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

7. Unless otherwise indicated:

   a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;

   b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and

   c) the term **fund** will be used to refer to a statutory fund or a general fund, as relevant.

Asset Risk Charge

8. This Prudential Standard sets out the method for calculating the **Asset Risk Charge** for each statutory fund of a life company and its general fund.

---

1 Refer to subsection 21(1) of the Act.
2 Refer to section 16ZD of the Act.

9. The Asset Risk Charge relates to the risk of an adverse movement in a fund's **capital base** due to credit or market risks. Both assets and liabilities may be affected. Off-balance sheet exposures may also be affected.

Asset Risk Charge Calculation

10. The Asset Risk Charge for a fund is calculated as the **aggregated risk charge components** determined in accordance with paragraph 11.

Aggregated risk charge components

11. A life company must calculate, for each of its funds, the **risk charge components** defined in paragraph 12, by considering the impact on the capital base of the fund of a range of stresses. These risk charge components are then aggregated using the formula set out in paragraphs 77 to 79, which allows for the likelihood of the stress tests occurring simultaneously. The result of applying the formula is defined as aggregated risk charge components.

Risk charge components

12. The risk charge components are calculated by determining the fall in the capital base of the fund in seven stress tests:

    (a) **real interest rates** determined in accordance with paragraphs 32 to 37;

    (b) **expected inflation** determined in accordance with paragraphs 38 to 41;

    (c) **currency** determined in accordance with paragraphs 42 to 45;

    (d) **equity** determined in accordance with paragraphs 46 to 49;

    (e) **property** determined in accordance with paragraphs 50 to 54;

    (f) **credit spreads** determined in accordance with paragraphs 55 to 66; and

    (g) **default** determined in accordance with paragraphs 69 to 76.

    These stresses are applied either directly to asset values or by way of changes to economic variables which in turn affect the value of both assets and liabilities. Some assets and liabilities may be impacted by more than one of the seven stress tests and will need to be considered in each relevant stress test. For the stresses in (a), (b) and (c), the impact on the capital base will be two separate amounts and these need to be included in the aggregation formula.

13. For the purposes of paragraph 12, no risk charge component can be negative, and therefore if there is no fall in the capital base of the fund due to the application of the stresses, the risk charge component is assumed to be zero.

Tax benefits

14. Any tax benefits that would arise as a result of applying the asset risk stresses should be assumed to be realisable for the purpose of determining the Asset

Risk Charge. An adjustment must be made to the **prescribed capital amount** when the capital charges are aggregated, if some or all of the tax benefits cannot be offset against deferred tax liabilities. This adjustment is specified in *Prudential Standard LPS 110 Capital Adequacy* (**LPS 110**).

Assets and liabilities to be stressed

15. In determining each risk charge component, a life company must include the effective exposure of the fund's assets and liabilities to each of the risks if the exposure is impacted by the stress test. Some assets and liabilities may have effective exposures to multiple risks.

~~15.~~16. Investment income receivables must be included with the asset that generated the income and then subject to the appropriate stress tests.

~~16.~~17. Changes to asset values may affect the valuation of **policy liabilities** where policies include **discretionary participation features**. The amount of other assets and liabilities, such as tax assets and tax liabilities, may also be indirectly affected by the prescribed stresses.

~~17.~~18. The following assets and liabilities must not be stressed:

a) assets whose value must be deducted from the capital base in *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (**LPS 112**) (e.g. goodwill in subsidiaries); and

b) any part of assets in excess of the asset concentration limits specified in *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge*.

~~18.~~19. In addition to paragraph 18, a life company that is an employer sponsor of a defined benefit superannuation fund does not need to reassess any deficit in the fund as a result of the seven stress tests, unless the life company has provided a guarantee in relation to the benefits.

Off-balance sheet exposures

~~19.~~20. A fund can be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet. Each of the stress tests must include any changes to the fund's on-balance sheet assets and liabilities that would result from application of the stresses to the fund's off-balance sheet exposures. A life company must use effective exposure for any off-balance sheet exposures of the fund. Detailed information on the treatment of off-balance sheet exposures is set out in Attachment A.

Collateral and guarantees

~~20.~~21. The impact of applying the asset risk stresses may be reduced where the life company holds certain types of collateral against an asset, or where the asset has been guaranteed. Detailed information on the eligibility of collateral and guarantees is set out in Attachment B.

Treatment of specific asset classes

~~21.~~22. Hybrid assets such as convertible notes must be split into their interest-bearing and equity/option exposures. A life company must consider the changes in value of the two exposures separately for each of the asset risk stresses.

23. For assets of a life company held under a trust or in a controlled investment entity,[3] the life company may calculate the asset risk charge by looking-through to the assets and liabilities of the trust. Alternatively, the investment may be treated as an equity asset (a listed equity asset if the investment is listed, and an unlisted equity asset if the investment is unlisted). Look-through must be used if the trust or controlled investment entity is both unlisted and geared.

~~22.~~24. A security which is the subject of a repurchase or securities lending agreement must be treated as if it were still owned by the lender of the security. Any counterparty risk that arises from the transaction must be recognised in the default stress.

~~23.~~25. Term deposits issued by an **ADI** must be treated in the same way as a corporate bond issued by the ADI. If the ADI guarantees a minimum amount on early redemption, the minimum amount can be recognised as a floor to the stressed value of the asset in each of the real interest rates and expected inflation stresses. In the credit spreads stress the minimum amount can be recognised as a floor to the stressed value, but it must be reduced by multiplying it by (1 – default factor).

Extended Licence Entity

~~24.~~26. In certain circumstances, a life company may choose to hold assets in a **Special Purpose Vehicle** (**SPV**) or other related entity, rather than on its own balance sheet. Detailed information on the treatment of an Extended Licence Entity is set out in Attachment C.

Management actions

~~25.~~27. When determining the change in liabilities in response to each of the asset stresses, a life company must make allowance for the actions that it could take in response to each of the stresses.

[3] For this purpose, an investment entity is an entity where the sole purpose of the entity is investment activities.

~~26.~~28. These actions may include, but are not limited to:

- reducing **termination values**;
- reducing future **discretionary additions** to benefits; and
- altering the asset exposures of the fund after the stresses have occurred.

~~27.~~29. The allowances for management actions must be appropriate, justifiable and equitable. Any representations made in the relevant product disclosure documents must be taken into account in determining the management actions that would be applied. Management actions must satisfy policy owners' reasonable expectations.

~~28.~~30. It cannot be assumed that termination values will be reduced below **minimum termination values**. It can be assumed that termination values are reduced at the reporting date.

~~29.~~31. The management actions assumed for friendly societies must be in accordance with the existing rules of the benefit fund and not the broader management actions that may be accessed through a process of amending those rules.

Real interest rates stress

~~30.~~32. This stress measures the impact on the capital base of a fund from changes in real interest rates.

~~31.~~33. Real interest rates are the portion of the nominal risk-free interest rates (before addition of any illiquidity premium) that remain after deducting expected CPI inflation.

~~32.~~34. All assets and liabilities whose values are dependent on real or nominal interest rates must be revalued using the stressed real or nominal rates.

~~33.~~35. The stress adjustments to real interest rates are determined by multiplying the nominal risk-free interest rates (before addition of any illiquidity premium) by 0.25 (upward stress) or by -0.20 (downward stress). The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to real yields if these are used explicitly in the valuation of an asset or liability (e.g. inflation indexed bonds).

~~34.~~36. The maximum stress adjustment is 200 basis points in either direction.

~~35.~~37. A life company must calculate the impact on the capital base of a fund of an upward movement and a downward movement in real interest rates. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 77.

Expected inflation stress

~~36.~~38. This stress measures the impact on the capital base of changes to expected Consumer Price Index (CPI) inflation rates. The expected inflation stress also

affects nominal interest rates. The expected inflation stress does not apply to assets that are affected by the property or equity stresses.

~~37.~~39. In each scenario, assets and liabilities whose values are dependent on expected inflation or nominal interest rates must be revalued using the stressed expected inflation and stressed nominal interest rates.

~~38.~~40. The stress adjustments to expected inflation rates are an increase of 125 basis points and a decrease of 100 basis points. The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to any explicit expected inflation rates used in the valuation of assets or liabilities.

~~39.~~41. A life company must calculate the impact on the capital base of a fund of an upward movement and a downward movement in expected inflation or nominal interest rates. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 77.

Currency stress

~~40.~~42. This stress measures the impact on the capital base of changes in foreign currency exchange rates.

~~41.~~43. A life company must calculate the impact on the capital base of a fund of both an increase and a decrease of 25 per cent in the value of the Australian dollar against all foreign currencies. In each of these scenarios, the Australian dollar must be assumed to move in the same direction against all foreign currencies. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 77.

~~42.~~44. An increase in the capital base arising from a movement of the Australian dollar against one foreign currency cannot be used as an offset to reductions in the capital base arising from the movement of the Australian dollar against other foreign currencies.

~~43.~~45. For statutory funds whose liabilities are only denominated in foreign currencies, the predominant currency of the liabilities may be used as the reference point for the stresses instead of the Australian dollar.

Equity stress

~~44.~~46. This stress measures the impact on the capital base of a fall in equity and other asset values. This stress applies to both listed and unlisted equity assets and to any other assets that are not considered in any of the other asset risk stresses. This stress also includes an increase to equity volatility. The volatility stress will affect assets whose value is affected by movements in equity volatility (e.g. equity derivatives) and will also affect policy liabilities if they include any financial options or guarantees whose value depends on equity volatility.

~~45.~~47. For listed equities the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by 2.5 per cent. The same proportionate fall in value must be applied to both Australian and overseas listed equities.

~~46.~~48. For unlisted equities and other assets, the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by three per cent. The same proportionate fall in value must be applied to all unlisted equities and other assets. The ASX 200 dividend yield must be determined using dividends for the 12 months prior to the reporting date and asset values at the reporting date.

~~47.~~49. An addition of 15 per cent must be made to the forward-looking equity volatility parameter for all durations.

Property stress

~~48.~~50. This stress measures the impact on the capital base of changes in property and infrastructure asset values.

~~49.~~51. The fall in value of the assets must be determined by increasing the rental yield for property assets or earnings yield for infrastructure assets by 2.75 per cent.

~~50.~~52. For property assets, the rental yields are to be based on the most recent leases in force and are determined net of expenses.

~~51.~~53. For infrastructure assets, the yields to be used are the earnings yields before tax.

~~52.~~54. The rental yields and fall in value can be determined separately for each asset, or on a portfolio basis.

Credit spreads stress

~~53.~~55. This stress measures the impact on the capital base of an increase in credit spreads and the risk of default.

~~54.~~56. This stress applies to interest bearing assets, including cash deposits and floating rate assets. Credit derivatives and zero-coupon instruments such as bank bills must also be included. This stress also applies to liabilities whose value depends on the illiquidity premium.

~~55.~~57. The stressed value of an asset must be determined by adding the spread specified in the table below to the current yield on the asset and then multiplying the reduced value of the asset by (1 – default factor). The credit spreads and default factors depend on the **counterparty grade** and the nature of the asset:

Table 1: Credit spreads and default factors

Counterparty grade	Default (%)	Bonds[4] spread (%)	Structured/ securitised spread (%)	Re-securitised spread (%)
1 (government)	0.0	0.0	0.0	0.0
1 (other)	0.2	0.6	1.0	1.8
2	0.6	0.8	1.4	2.4
3	1.2	1.2	2.0	3.2
4	3.0	1.6	2.5	4.0
5	6.0	2.0	3.0	5.0
6	10.0	2.5	3.5	6.0
7	16.0	3.0	4.5	7.5

~~56.~~58. A securitised/structured asset is an asset that provides an exposure to a pool or portfolio of assets or risks. This is typically in the form of a tranched exposure and includes credit related securitisation exposures and insurance linked securities. Examples of these include Residential Mortgage Backed Securities (RMBS), Asset-backed Securities (ABS) and Catastrophe Bonds. A covered bond issued by an ADI must not be treated as a securitised/structured asset.

~~57.~~59. An investment that provides exposure to an untranched pool of multiple reference entities, assets or risks must be treated:

(a) on a 'look through' basis; or

(b) as an equity asset (applying the equity stress instead of the credit spreads stress); or

~~(a)~~(c) ~~A life company may apply to APRA, to treat these exposures~~ as a securitised asset using the ~~external~~ counterparty grade~~rating~~ of the untranched pool ~~or the weighted average rating of the constituents~~.

[4] and other non-securitised assets including covered bonds issued by an authorised deposit-taking institution.

~~58.~~60. Credit wrapped bonds must be treated as a securitised asset if the external rating of the bond makes some allowance for the structural protection offered by the credit wrap. Otherwise the bond ~~should~~ must be treated as a bond with no credit wrap.

~~59.~~61. A re-securitisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more re-securitisation exposures is a re-securitisation exposure.

~~60.~~62. For floating rate assets, the increase in yield must be assumed to apply for the period until a life company has the contractual right to redeem the asset at face value. For at-call floating rate assets, only the default factor must be applied. For floating rate assets that are not immediately redeemable both the credit spread and default factors must be applied.

~~61.~~63. For fixed rate assets where the life company has a contractual right to early redemption of the asset, the stressed value of the asset is subject to a minimum of the guaranteed redemption value multiplied by (1 – default factor).

~~62.~~64. Unsecured loans that have a 100 per cent charge applied in the default stress in accordance with paragraph 74 must be assumed to be unaffected by the credit spreads stress.

~~63.~~65. The 'government' category applies to assets guaranteed by the Commonwealth Government and assets guaranteed by foreign governments that have a counterparty grade of 1 and are denominated in the official or national currency of the guarantor.

66. Assets guaranteed by an Australian state or territory government may be rated up one grade. For example, assets with counterparty grade 1 can be treated as grade 1 (government) and assets with counterparty grade 2 can be treated as grade 1 (other).

Illiquidity premium

67. Liabilities whose value depends on the illiquidity premium must be revalued using a stressed illiquidity premium. The stress adjustment to the illiquidity premium is an increase of 30 basis points to the forward rates for the first 10 years after the reporting date and zero thereafter. The stressed illiquidity premium is subject to a maximum of 150 basis points.

~~64.~~68. The risk charge component for the credit spreads stress must not be less than an amount calculated by multiplying the value of each asset by the default factor specified in paragraph 57 and adding the results for all assets to which the credit spreads stress applies.

Default stress

~~65.~~69. This stress applies to reinsurance assets, over the counter derivatives, unpaid premiums, and all other credit or counterparty exposures that have not been affected by the credit spreads stress.

~~66.~~70. This stress includes the risk of counterparty default. A life company must determine risk charges for the default stress for the risk of counterparty default on exposures that include (but are not limited to) reinsurance assets, unpaid premiums, futures and options, swaps, hedges, warrants, forward rate and repurchase agreements.

71. The default factors are specified in the following table. These factors apply to all assets affected by this stress, with the exception of certain types of assets specified in later paragraphs in this section.

Table 2: Default factors by counterparty grade

Counterparty grade	Default factor (%)
1 (government)	0
1 (other)	2
2	2
3	4
4	6
5	8
6	12
7	20

~~67.~~72. For the purpose of the default stress, the value of reinsurance assets must be determined by calculating the adjusted policy liabilities gross of reinsurance, and deducting the corresponding net of reinsurance values. For other assets, the default factor must be applied to the amount of loss that would be incurred if the counterparty defaulted and no recovery was made.

~~68.~~73. For unpaid premiums the factors are four per cent for premiums due less than six months previously and eight per cent for other premiums. These factors only apply if the unpaid premiums cannot be recovered by reducing the termination value of the policy.

~~69.~~74. The following types of unsecured loans have a 100 per cent default factor applied:

(a) Loans to directors of the life company, or their spouses;

(b) Loans to directors of related bodies corporate, or their spouses;

(c) Loans to a parent or related company that are not on commercial terms; and

(d) Loans to employees exceeding $1,000.

~~70.~~75. Assets that are exempt from being deducted from the capital base under Attachment B of LPS 112 must have a 100 per cent default factor applied to them.

~~71.~~76. Assets guaranteed by an Australian state or territory government may be rated up one grade. For example, assets with counterparty grade 1 can be treated as grade 1 (government) and assets with counterparty grade 2 can be treated as grade 1 (other).

Aggregation formula

~~72.~~77. The aggregated risk charge component is calculated as:

$$A_{default} + \sqrt{\sum_{x,y} Max(0, Corr_{x,y} . A_x . A_y . sign(x) . sign(y))}$$

where

(a) A_x is the risk charge component for asset risk stress x

(b) A_y is the risk charge component for asset risk stress y

(c) $\sum_{x,y}$ is the sum over all combinations of asset risk stresses, excluding the default stress

(d) $Corr_{x,y}$ is the correlation between asset risk stresses x and y

(e) $sign(x)$ is 1 for the equity, property and credit spreads stresses. For the real interest rates and expected inflation stresses, $sign(x)$ is 1 if the stress is a decrease in rates, otherwise it is -1. For the currency stress, $sign(x)$ is 1 if the stress is a depreciation of the Australian dollar against foreign currencies, otherwise it is -1; and

(f) $sign(y)$ is defined in the same way as $sign(x)$.

78. The correlation matrix is:

Table 3: Asset Risk Charge correlation matrix

	RIR	INF	CUR	EQY	PROP	CSP
RIR	1	0.2	0.2	0.2	0.2	0.2
INF	0.2	1	0.2	0.4	0.4	0.2
CUR	0.2	0.2	1	0.6	0.2	0.4
EQY	0.2	0.4	0.6	1	0.4	0.8
PROP	0.2	0.4	0.2	0.4	1	0.4
CSP	0.2	0.2	0.4	0.8	0.4	1

~~73.~~79. The real interest rates, expected inflation and currency stresses apply in two directions. The aggregation needs to be performed twice for each of these stresses if both stresses produce a non-zero risk charge component, with the larger of the aggregates chosen. If two of the bidirectional stresses have a non-zero risk charge component for stresses in both directions, the aggregation will need to be performed four times – once for each combination of stresses. If all three of the bidirectional stresses have a non-zero risk charge component for stresses in both directions, the aggregation will need to be performed eight times.

Adjustments and exclusions

~~74.~~80. APRA may, by notice in writing to a life company, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that life company.

Transition

~~75.~~81. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than ~~up until~~ 31 December 2014.

Attachment A

Off-balance sheet exposures

1. A fund can be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet.

2. The principle of considering the effective exposure of the fund to asset risks must be applied to any off-balance sheet exposures of the fund. Changes to the capital base arising from off-balance sheet exposures must be recognised in each of the asset risk stresses.

3. As a general rule, a life company must not be exposed to a counterparty for an unlimited amount and any exposure must be for a finite period. An exception to this rule is where a potential credit exposure results from reinsurance of an insurance contract that is required by law to be unlimited. Before a life company does enter into an arrangement with a counterparty that does not have appropriate limits, it must:

   (a) notify APRA;

   (b) explain how this arrangement complies with its Risk Management Strategy; and

   (c) explain how it will be valued for the purposes of capital adequacy calculations.

   Such an exposure may cause APRA to review the life company's prescribed capital amount and adjust this in accordance with paragraph 43 of LPS 110.

Direct credit substitutes

4. To the extent that a life company has issued instruments of the following kind:

   a) guarantees (including written put options serving as guarantees);

   b) letters of credit; or

   c) any other credit substitute (other than insurance) in favour of another party,

   the life company is exposed to the risk of having to make payment on these instruments should a default event occur which requires the life company to pay an amount under the instrument. The risk of such events occurring must be considered in the default stress. The default factors must be applied to the face value of each exposure. Where the credit substitute is supported by collateral or a guarantee, the provisions of relevant paragraphs from Attachment B may be applied.

Derivatives

5. Derivatives include forwards, futures, swaps, options and other similar contracts. Derivatives expose life companies to the full range of investment risks, even though in many cases there may be no, or only a very small, initial outlay.

6. Changes to the capital base that would arise from changes in the value of derivatives ~~(and other hedging instruments)~~ must be included in the capital charges arising from each of the asset risk stresses.

7. A capital charge must be applied to the fair value of over the counter derivatives in the default stress to allow for the risk of counterparty default. This is in addition to any charges that would arise from other asset risk stresses.

~~8. A life company must consult with APRA prior to entering into derivative contracts other than those over:~~

~~(a) equities;~~

~~(b) interest rates; and~~

~~foreign exchange; and~~

~~(c) credit risks.~~

~~Such an exposure may cause APRA to review the life company's prescribed capital amount and adjust this in accordance with paragraph 39 of LPS 110.~~

Attachment B

Treatment of collateral and guarantees as risk mitigants

1. The impact of applying the asset risk stresses may be reduced where the fund holds certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk.

Collateral

2. Collateral held against an asset may be considered in place of the asset if this would reduce the asset risk charge. Where the fair value of the collateral does not cover the full value of the asset, the collateral can only replace that part of the asset that is covered by the collateral.

3. Collateral can be recognised in place of an asset only to the extent that it takes the form of a registered charge, registered mortgage or other legally enforceable security interest in, or over, an Eligible Collateral Item. Eligible Collateral Items are cash, government securities, or debt obligations (i.e. loans, deposits, placements, interest rate securities and other receivables) where the counterparty has a counterparty grade of 1, 2 or 3. The Eligible Collateral Item must also be held for a period not less than that for which the asset is held.

Guarantees

4. The stresses applied in the credit spreads and default stresses may be determined using the counterparty grade of a third-party guarantor if the guarantee is explicit, unconditional, irrevocable and legally enforceable for the remaining term to maturity of the related asset. The guarantor must have a counterparty grade (or for governments, a long-term foreign currency credit rating) of 1, 2 or 3. Guarantees provided by the life company's parent or related entities are not eligible for this treatment.

Attachment C

Extended Licensed Entity (ELE)

1. In certain circumstances, a life company may choose to hold assets in an SPV or other related entity, rather than on its own balance sheet. Where a life company receives approval under paragraph 3 of this attachment, the life company will be able to determine its Asset Risk Charge based on the individual assets and liabilities of the related entity, rather than simply on the life company's direct exposure to that entity. This treats the activities of the life company and the related entity as comprising an Extended Licensed Entity (ELE).

2. The extent to which the risk of a life company's exposure to a related entity is commensurate with the underlying holdings of that entity, depends on the extent to which the life company has control over, or is integrated with the entity, as well as on the existence of material third party liabilities of the entity. The life company must consider any potential complications under a scenario where underlying asset holdings must be liquidated during financial stress.

3. Subject to the specific requirements set out in paragraph 4 of this attachment, a life company may apply to APRA to have one or more related entities approved as part of its ELE. Once approved, APRA will allow the life company to 'look through' the legal structures involved, and to 'consolidate' the balance sheet of the related entity with its own, for the purpose of determining the Asset Risk Charge. In effect, this allows the life company to treat its own balance sheet and that of the approved related entity as a single entity for the purpose of calculating that charge.

4. In deciding whether to approve an entity as part of a life company's ELE, APRA will have regard to the following criteria in respect of the relationship between the life company and the related entity:

   (a) the related entity must be wholly owned and controlled by the life company, with a Board of directors/trustees that is comprised entirely of members of the life company's Board or senior management;

   (b) the life company must demonstrate to APRA that there are no legal or regulatory barriers (e.g. restrictions imposed by law or a regulator in a foreign jurisdiction) to the transfer of the assets back to the life company;

   (c) the life company's risk management systems and controls must apply fully to the operations of the related entity. The senior management of the life company must be in a position to monitor the operations of the related entity to the same extent as the operations of the life company itself. Systems for monitoring and maintaining control over the related entity must be included within the internal and external audit programs of the life company;

   (d) the life company must be able to furnish stand-alone accounting records for the related entity, and provide APRA with full and unfettered access to this information at any time (including during on-site visits);

(e) where the related entity holds or invests in assets on behalf of the life company, the related entity must have no material third party liabilities, other than exempt tax liabilities and employee entitlements;

(f) where the related entity borrows on behalf of the life company, all funds must be on-lent directly to the life company; and

(g) the related entity must not conduct any business that the life company would otherwise be prevented from conducting under the Act.

Prudential Standard LPS 115

Capital Adequacy: Insurance Risk Charge

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the insurance risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure that the life company 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 of adverse impacts due to movements in future mortality, morbidity, longevity, servicing expenses and lapses.

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 Prudential Capital Requirement for life company statutory funds and general funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. A life company must apply this Prudential Standard separately:

   a) for a life company other than a friendly society: to each of its statutory funds; and

   b) for a friendly society: to each of its approved benefit funds and its management fund.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** (**EFLIC**) which is carried out through its Australian statutory funds but not otherwise.[2]

5. ~~Subject to any specific transition rules,~~ This Prudential Standard applies to life companies from 1 January 2013 (**effective date**).

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

7. Unless otherwise indicated:

   a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;

   b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and

   c) the term **fund** will be used to refer to a statutory fund or a general fund, as relevant.

Insurance Risk Charge

8. This Prudential Standard sets out the method for calculating the **Insurance Risk Charge.**

---

1 Refer to subsection 21(1) of the Act.
2 Refer to section 16ZD of the Act.

9. The Insurance Risk Charge for a statutory fund provides a buffer against the risks of adverse experience or changes to **best estimate assumptions** with regards to:

   (a) mortality;

   (b) morbidity;

   (c) longevity;

   (d) lapses;

   (e) servicing expenses; and

   (f) other insurance risks such as option take-up rates.

10. The Insurance Risk Charge for a statutory fund is the reduction, if any, in the **capital base** that would occur if the **adjusted policy liabilities** were changed to an amount equal to the **stressed policy liabilities** determined under this Prudential Standard.

11. The Insurance Risk Charge for the general fund of a friendly society is the **servicing expense reserve** as defined in paragraphs 52 to 55 of this Prudential Standard.

12. There is no Insurance Risk Charge for the general fund of a life company other than a friendly society.

Stressed policy liabilities

13. The stressed policy liabilities for non-participating benefits must be determined in the same way as the **risk-free best estimate liability (RFBEL)**, but using **stressed assumptions** instead of best estimate assumptions in respect of mortality, morbidity, longevity, lapses, servicing expenses and any other insurance risks such as take-up rates for non-financial options.

14. The stressed policy liabilities for participating benefits must be determined in the same way as the **participating policy liability (PPL)**, but using stressed assumptions instead of best estimate assumptions in respect of mortality, morbidity, longevity, lapses, servicing expenses and any other insurance contingencies such as take-up rates for non-financial options.

15. Stressed assumptions must be used in determining the stressed policy liabilities for existing claims which have not yet been finalised, claims that have been incurred but not reported, and claims that are expected to be incurred in future.

16. The stressed policy liabilities must provide for ~~**termination values**~~adjusted policy liabilities (calculated using the stressed assumptions) to be funded 12 months from the reporting date for those policies that are projected to remain in force at that date. This test must be applied separately for the following groups:

    (a) Non-participating benefits without entitlement to **discretionary additions**;

    (b) Non-participating benefits with entitlement to discretionary additions; and

    (c) Participating benefits.

    The stressed policy liabilities must be determined at sub-group level if the policy benefits ~~life company ring-fences investment earnings~~ for a sub-group of policies are determined by reference to the performance of particular assets that the life company has allocated to the liabilities for that sub-group.~~articipating benefits or non-participating benefits with entitlement to discretionary additions.~~

Recognition of tax benefits

17. Any tax benefits that would arise as a result of increasing the policy liabilities from the adjusted policy liabilities to the stressed policy liabilities should be assumed to be realisable for the purpose of determining the Insurance Risk Charge. An adjustment must be made to the **prescribed capital amount** when the capital charges are aggregated, if some or all of the tax benefits cannot be offset against deferred tax liabilities.

Management actions

18. When determining the impact of each individual stress margin, and when determining the stressed policy liabilities, a life company must make allowance for the actions that it would expect to take in response to each type of stress, subject to the restrictions described below.

19. These actions may include, but are not limited to:

    (a) reducing termination values;

    (b) reducing discretionary additions to benefits;

    (c) increasing premium rates;

    (d) increasing the fees deducted from policies; and

    (e) reducing the fees payable by a friendly society benefit fund to its management fund.

20. The allowances for management actions must be appropriate, justifiable and equitable in each of the scenarios. Any representations made in the relevant product disclosure documents must be taken into account in determining the management actions that would be applied. Management actions must satisfy policy owners' reasonable expectations.

21. Termination values cannot be assumed to be reduced below **minimum termination values**.

22. Premium rate and fee increases cannot be assumed to occur within 12 months of the reporting date.[3] The 12 month period must be extended to allow for the time it would take for the life company to increase premium rates or fees in response to stresses occurring over the 12 month period. Any contractual guarantees that may restrict the timing and amount of premium rate or fee increases must be recognised.

23. Premium rate or fee increases cannot be assumed as a response to the random mortality stress, the random morbidity stress or the event stress.

24. The present value of any assumed premium or fee increases (determined using stressed assumptions) cannot exceed the increase in the present value of claims and expenses incurred after the date at which the premium or fees increases are assumed to become effective. This test must be applied to each group of policies that would be affected by the assumed premium or fee increases.

25. The management actions for friendly societies must be in accordance with the existing rules of the benefit fund and not the broader range of management actions that may be accessed through a process of amending those rules.

Stress margins

26. The stressed assumptions must be determined by a life company, by applying **stress margins** to the best estimate assumptions. The stress margins must reflect the risk that outcomes may be worse than the best estimate assumptions.

27. The following stress margins are required:

    (a) mortality random stress;

    (b) morbidity random stress;

    (c) mortality future stress;

    (d) morbidity future stress;

    (e) event stress;

    (f) longevity stress;

    (g) lapse stress;

    (h) servicing expense stress; and

    (i) other insurance contingencies.

[3] Fee and premium rate increases that have been approved by a life company prior to the reporting date, but not yet implemented, are exempt from this requirement.

28. The stress margins for random, future, event and longevity risks must be adjusted to allow for diversification between these risks as described in the section starting at paragraph 40.

29. The mortality random and future stresses must only be applied to life policies where an increase in future mortality rates would increase net cash outflows from the life company. The longevity stress must only be applied to life policies where an increase in future mortality rates would reduce net cash outflows from the life company.

30. The stress margins, before the adjustment for diversification, must be determined at a 99.5 per cent probability of sufficiency over a 12 month period. This means that, in the assessment of the **Appointed Actuary**, there is no more than a 0.5 per cent probability that the actual cost of claims will exceed the stressed estimate.

31. For each type of stress, different margins may be applied to different types of policy. For example, there may be different morbidity random stresses for lump sum policies and disability income insurance policies. For disability income insurance policies, separate margins must be applied to the best estimate claim incidence and claim termination assumptions

Random stresses for mortality and morbidity

32. The **random stress** margins, before the adjustment for diversification, must be determined by the Appointed Actuary, having regard to the nature of the mortality and morbidity risks to which the company is exposed. The margins for random stresses must be applied for 12 months from the reporting date. Each random stress must reflect the uncertainty arising due to adverse fluctuations in experience, but excluding the impact of single events such as pandemics, terrorist attacks and natural catastrophes that could cause large numbers of claims. The size of these margins will depend on factors such as the number of expected claims, the distribution of sums insured, and the impact of existing **reinsurance** arrangements.

Future stresses for mortality and morbidity

33. The **future stress** margins, before the adjustment for diversification, must be determined by the Appointed Actuary, having regard to the nature of the mortality and morbidity risks to which the company is exposed.

34. The margins for future stress must be applied from the reporting date for the remaining term of the liabilities. They must allow for the possibility that the best-estimate assumptions may need to be changed in 12 months time, either because they were miss-estimated at the reporting date or because adverse trends have been identified during this period. The size of the margin will depend on the adequacy of the investigations used to determine the best-estimate assumptions, and the range of adverse factors that could affect trends in claims experience.

Event stress

35. The **event stress** allows for the impact of single events that could commence in the 12 months following the reporting date and cause multiple claims. These events could include pandemics, terrorist attacks and natural catastrophes and may affect either or both of mortality and morbidity experience. The Appointed Actuary must determine an appropriate event stress that provides a 99.5 per cent probability of sufficiency with respect to single events that could potentially commence over the following 12 months.

36. The event stress, before adjustment for diversification, must at a minimum include a pandemic scenario with the following impacts on mortality and morbidity claims experience:

    (a) annual mortality rates at each age increase by 0.5 per thousand for the 2 years following the reporting date;

    (b) an annual incidence rate of total disablement at each age, as a result of the event, of 10 per cent of lives insured for the 2 years following the reporting date;

    (c) of those lives becoming disabled as a result of the event, half remain disabled after 14 days, one quarter remain disabled after 30 days and none remain disabled after 60 days; and

    (d) if disability continues to the end of the policy waiting period, one month's benefit will be paid. For waiting periods other than zero, 14, 30 or 60 days, interpolation must be used to find the proportion of policies for which a benefit will be paid.

37. The pandemic scenario may be assumed to reduce the stressed policy liabilities for policies subject to longevity risk. However the outcome of applying the pandemic scenario must not result in stressed policy liabilities being less than adjusted policy liabilities for any of the product groups defined in paragraph 16.

Longevity stress

38. The **longevity stress**, before adjustment for diversification, is a 20 per cent decrease in the best estimate mortality rate for each age from the reporting date for the remaining term of the liabilities.

Impact of individual stress margins

39. The impact of applying each of the random, future, event and longevity stresses must be determined in isolation as the increase to:

    (a) the RFBEL for non-participating benefits; and

    (b) the PPL for participating benefits.

Diversification factors and adjusted stress margins

40. The stressed policy liabilities must be determined using **adjusted stress margins** and management actions for the random, future, event and longevity risks. The adjustments are to allow for diversification between risks. The method for determining the adjusted stress margins and management actions is described in the following paragraphs.

41. The combined impact of the random, future, event and longevity stresses, after allowing for correlations between these stresses must be determined using the formula:

$$\sqrt{\sum_{x,y} Corr_{x,y} \,.\, A_x \,.\, A_y}$$

Where A_x = the capital charge for insurance stress x, summed over all policies in the statutory fund

$\sum_{x,y}$ = the sum over all combinations of stresses

$Corr_{x,y}$ = the correlation between stresses x and y

42. The specified correlation matrix is:

	Mortality		**Morbidity**		**Event**	**Longevity**
	Future	**Random**	**Future**	**Random**		
Mortality Future	1	0	0.25	0	0	-0.25
Mortality Random	0	1	0	0	0	0
Morbidity Future	0.25	0	1	0	0	0
Morbidity Random	0	0	0	1	0	0
Event	0	0	0	0	1	0
Longevity	-0.25	0	0	0	0	1

43. The adjusted stress margins must be determined so that when the adjusted stress margins and management actions for the random, future, event and longevity stresses are applied simultaneously, the increase in RFBEL and PPL equals the combined impact of the individual stresses, as determined using the formula in paragraph 41.

44. If the stressed RFBEL or stressed PPL changes in a linear relationship with changes in the stressed margin, the adjusted stress margin can be determined by multiplying the unadjusted stress margins by a diversification factor. The diversification factor is determined by taking the combined impact of the individual stresses, as determined using the formula in paragraph 41, and dividing this amount by the sum of the individual stress impacts.

45. If the relationship between stressed RFBEL or stressed PPL, and stressed margin is not linear, an alternative method of determining the adjusted stress margin must be used that satisfies the requirements of paragraph 43. An alternative method must always be used for determining the adjusted stress margin for Disability Income Insurance claim termination rates.

Lapses

46. The stress margin for lapses[4] must be determined by the Appointed Actuary, having regard to the nature of the company's lapse risks. The stress must be determined so that the Insurance Risk Charge for the statutory fund has a 99.5 per cent probability of sufficiency over a 12 month period. The lapse stress may allow for correlations with other insurance stresses, with the exception of servicing expenses. The lapse stress may vary for different types of policy. A decision as to whether to increase or reduce lapse rates must be made for each type of policy depending on whether an increase or reduction would increase the stressed policy liabilities.

Servicing expenses

47. The stress margin for servicing expenses is a 10 per cent increase to the best estimate of future unit costs for servicing expenses.

48. The stress need not be applied to any component of the statutory fund expenses which is contractually agreed for the life of the policy, for example, renewal commission. The stress need not be applied to the fees payable by a friendly society benefit fund to its management fund.

49. Unit costs must cover the expected maintenance cost of servicing each policy in the twelve months following the reporting date.

50. If the Best Estimate Assumption depends on a service agreement or other contractual arrangement which does not adequately reflect the long term, sustainable costs of operating the business, the stress of 10 per cent must be increased to make up for the shortfall between actual and long term, sustainable costs.

Other insurance risks

51. The Appointed Actuary must determine an appropriate stress margin for risks arising from any other contingencies not specifically mentioned above. These

[4] Lapses, for this purpose, include policy terminations that occur at the request of the policy owner, policy terminations occurring as a result of non-payment of premiums and the lapse of individual members covered by group policies.

risks may include, but are not limited to, changes to take-up rates on insurance options ~~and education bond business,~~ and premium dormancy rates. The stress must be determined so that the insurance risk charge for the statutory fund has a 99.5 per cent probability of sufficiency over a 12 month period. The stress may include allowance for correlations with other insurance stresses, with the exception of servicing expenses.

Servicing expense reserve

52. The Insurance Risk Charge for the general (management) fund of a friendly society is the servicing expense reserve. The servicing expense reserve must be determined as:

    (a) three times the deficiency (if any) expected to arise over the twelve months subsequent to the reporting date, between expected management fees in that period and expected servicing expenses relating to its life insurance activities; plus

    (b) any additional deficiency that would arise if expected servicing expenses were increased by 10 per cent.

53. Where an allocation of the expenses of the management fund relating to life insurance activities into **expense categories** is not undertaken by a friendly society, servicing expenses are to be taken as 50 per cent of the total expenses related to the life insurance business.

54. If the management actions assumed in response to the asset risk or insurance risk stresses include a reduction in management fees paid by a benefit fund to the management fund, the reduced management fees must be used when determining the servicing expense reserve.

55. Any tax benefits that would arise as a result of including the servicing expense reserve in the liabilities of the friendly society for tax purposes should be assumed to be realisable for the purpose of determining the Insurance Risk Charge. An adjustment must be made to the prescribed capital amount when the capital charges are aggregated, if some or all of the tax benefits cannot be offset against deferred tax liabilities.

Adjustments and exclusions

56. APRA may, by notice in writing to a life company, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that life company.

Transition

57. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than ~~up until~~ 31 December 2014.

Prudential Standard LPS 117

Capital Adequacy: Asset Concentration Risk Charge

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the asset concentration risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure that the life company 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 Asset Concentration Risk Charge is the minimum amount of capital required to be held against asset concentration risks. The Asset Concentration Risk Charge relates to the risk of a life company's concentration in particular assets resulting in adverse movements in the life company's capital base.

This Prudential Standard sets out the method for calculating the Asset Concentration Risk Charge. This charge is one of the components of the Standard Method for calculating the Prudential Capital Requirement for life company statutory funds and general funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. A life company must apply this Prudential Standard separately:

   (a) for a life company other than a friendly society: to each of its statutory funds and its shareholders' fund; and

   (b) for a friendly society: to each of its approved benefit funds and its management fund.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** (**EFLIC**) which is carried on through its Australian statutory funds but not otherwise.[2]

5. ~~Subject to any specific transition rules,~~ This Prudential Standard applies to life companies from 1 January 2013 (**effective date**).

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

7. Unless otherwise indicated:

   (a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;

   (b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and

   (c) the term **fund** will be used to refer to a statutory fund or a general fund, as relevant.

---

1 Refer to subsection 21(1) of the Act.
2 Refer to section 16ZD of the Act.

Asset Concentration Risk Charge

8. This Prudential Standard sets out the method for calculating the **Asset Concentration Risk Charge** for a life company's statutory funds and its general fund.

9. The method for calculating **Asset Risk Charge** is set out in *Prudential Standard LPS 114 Asset Risk Charge* (**LPS 114**). It is calibrated for funds whose investments in each asset class are well diversified. Additional capital is therefore required if there are excessive concentrations of investments in individual assets or in exposures to single counterparties (or groups of related counterparties).

10. The Asset Concentration Risk Charge is the amount by which the values of individual asset and credit exposures (or groups of related exposures) exceed certain limits. The limits, by type of asset exposure, are set out in Attachment A. Modifications to the limits that apply to **specialist reinsurers** are set out in paragraph 29 of this Prudential Standard.

11. Individual assets that are exposed to common risks (e.g. strata titles in the same property, or exposures to a single creditor) must be aggregated.

12. The prescribed limits are expressed as percentages of the value of the assets of the statutory fund or general fund (**VAF**), as percentages of the **capital base** of the fund, or as fixed dollar limits.

13. For the purpose of determining the asset concentration risk charge, liabilities ceded under reinsurance **(reinsurance assets)** are to be treated as an asset of the fund.

14. For the purpose of determining the asset concentration limits for non-reinsurance assets, VAF is the total~~value of the~~ assets of the fund as per the life company's **statutory accounts**.

15. For the purpose of determining the asset concentration limits for reinsurance assets:

a) , ~~VAF includes~~these assets must be valued on a stressed basis. ~~the **stressed value of liabilities** ceded under reinsurance instead of the gross **policy liabilities** ceded that are included in the life company's statutory accounts.~~ The stressed value of ~~liabilities ceded under~~ reinsurance assets is the amount by which the stressed policy liabilities determined under *Prudential Standard LPS 115 Insurance Risk Charge* would increase, if the stressed policy liabilities were determined gross of reinsurance; and~~.~~

~~a)~~b) VAF includes the stressed value of reinsurance assets instead of the amounts included in the life company's statutory accounts.

~~15.~~16. All exposures to a reinsurer or reinsurance group are to be considered a single counterparty exposure (for the purposes of applying the relevant limits in Attachment A).

~~16.~~17. Where arrangements with a reinsurer involve both liability and asset components, these may be taken as a single net exposure to the extent they are subject to a legally enforceable right of offset (including in a winding up of the reinsurer).

~~17.~~18. Exposures must be the effective exposures of the fund to each asset or counterparty, including both on-balance sheet and off-balance sheet exposures. If collateral or a third party guarantee has been used in place of an asset under LPS 114, the collateral or exposure to the guarantor must also be used in place of the asset for the purposes of this Prudential Standard. If a look through basis has been used for assets under LPS 114, the same look through basis must be used for the purposes of this Prudential Standard.

~~18.~~19. Where the fund has a significant cumulative exposure through different classes of assets to a single counterparty or related counterparties the limit for that counterparty in respect of any particular asset class must be reduced by the lesser of the actual exposure or the exposure limit to that same counterparty in respect of all asset classes with lower limits in Attachment A.

~~19.~~20. Where the policy liabilities are in respect of investment-linked benefits linked to the asset or credit exposure in question and there has been full disclosure to policy owners of the risks to which they are exposed, no asset concentration limits apply.

~~20.~~21. Where the asset or credit exposure is in respect of bank bills or bank deposits, bank for this purpose means:

(a) a deposit taking institution authorised by APRA under the *Banking Act 1959* (**Banking Act**); and

(b) in the case of overseas business, a bank in the same country as that in which the business is written, provided that country has capital requirements in respect of banking business comparable to those in the Banking Act.

~~21.~~22. The value of an asset can be offset by deferred tax provisions or other liabilities related to the asset, if those provisions/liabilities would be realised if the asset was sold.

~~22.~~23. The value of an asset can be reduced by any amounts that have been treated as deductions from the capital base, as determined under *Prudential Standard LPS 112 Capital Adequacy Measurement of Capital*.

~~23.~~24. A reinsurance asset must be treated as an unsecured loan unless, subject to a six month grace period from risk inception, the asset arises under an executed and legally binding contract which is enforceable by the life company.

Treatment of collateral and guarantees as risk mitigants

~~24.~~25. The impact of applying the asset concentration limits may be reduced where the fund holds certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk.

~~25.~~26. Collateral held against an asset may be considered in place of the asset if this would reduce the asset concentration risk charge. Where the fair value of the collateral does not cover the full value of the asset, the collateral can only replace that part of the asset that is covered by the collateral.

~~26.~~27. Collateral can be recognised only to the extent that it takes the form of a registered charge, registered mortgage or other legally enforceable security interest in, or over, an **eligible collateral item**. Eligible collateral items are cash, government securities, or debt obligations (i.e. loans, deposits, placements, interest rate securities and other receivables) where the counterparty has a **counterparty grade** of 1, 2 or 3. The eligible collateral item must also be held for the period for which the asset is held.

~~27.~~28. Credit risk may be assessed using the counterparty grade of a third-party guarantor if the guarantee is explicit, unconditional, irrevocable and enforceable for the remaining term to maturity. The guarantor must have a counterparty grade (or for governments, a long-term foreign currency credit rating) of 1, 2 or 3. Guarantees provided by the life company's parent or **related entities** are not eligible for this treatment.

Specialist Reinsurers

~~28.~~29. In the case of a specialist reinsurer, the following asset concentration limits apply in respect of retrocessions by that specialist reinsurer to an overseas parent, associated, or subsidiary company which, with APRA's agreement, has been identified as an appropriate retrocessionaire for the purposes of this paragraph:

(a) where the retrocessionaire has a current counterparty grade of 1, 2 or 3 – 50 per cent of VAF;

(b) where the retrocessionaire does not have a current counterparty grade of 1, 2 or 3, but had such a grade at the time the retrocession arrangement was entered into;

(i) within the first 3 months after the downgrade below Grade 3 – 50 per cent of VAF;

(ii) within the next 9 months – 33 per cent of VAF;

(iii) within the second 12 months after the downgrade – 17 per cent of VAF; and

(iv) thereafter, the retrocession arrangements do not qualify for the concessional treatment afforded to Specialist Reinsurers.

(c) in all other circumstances, the retrocession arrangements do not qualify for the concessional treatment afforded to specialist reinsurers.

Adjustments and exclusions

~~29.~~30. APRA may, by notice in writing to a life company, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that life company.

Transition

~~30.~~31. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than~~up until~~ 31 December 2014.

Attachment A

	Asset exposure	**Limit**
(a)	Assets guaranteed by an Australian State or Federal government or by the national government of the country in whose currency the liabilities of the statutory fund or general fund are denominated:	No limit
(b)	A life insurance policy issued to the life company by a registered life company which is a related entity of the life company	No limit
(c)	Bank bills; or Assets guaranteed by an overseas provincial government (equivalent in status to an Australian State government), in the country in whose currency the liabilities of a statutory fund or a general fund are denominated:	The greater of: i) 25% of VAF; and ii) AUD 20 million.
(d)	Bank deposits	The greatest of: i) 50% of VAF less the value of the assets of the fund secured by bank bills; ii) 25% of VAF; and iii) AUD 20 million.
(e)	i) a reinsurance arrangement with a registered life company that is not a related entity of the life company; or ii) with APRA's written approval, a reinsurance arrangement in respect of overseas business, with a related entity of a registered life company that has a statutory fund which is a specialist reinsurer:	The greater of: i) 25% of VAF; and ii) AUD 20 million.
(f)	Outstanding premiums receivable by a reinsurer under a reinsurance policy with a registered life company:	The greater of: i) 25% of VAF; and ii) AUD 20 million.

(g)	i) any other actively traded security; ii) a non-traded security, loan, or reinsurance arrangement with a counterparty grade of 1, 2 or 3; iii) real estate; or iv) other income producing real property asset:	The greater of: i) 5% of VAF; and ii) 25% of capital base.
(h)	Any asset not covered by any of the above categories:	The greater of: i) 2.5% of VAF; and ii) 12.5% of capital base.

Prudential Standard LPS 118

Capital Adequacy: Operational Risk Charge

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the operational risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure that the life company 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 Prudential Capital Requirement for life company statutory funds and general funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (**the Act**).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], except where expressly noted otherwise.

3. A life company must apply this Prudential Standard separately:

   (a) for a life company other than a friendly society: to each of its statutory funds; and

   (b) for a friendly society: to its management fund.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** (**EFLIC**) which is carried out through its Australian statutory funds but not otherwise.[2]

5. This Prudential Standard applies to life companies from 1 January 2013 (**effective date**).

Interpretation

6. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard LPS 001 Definitions*.

Operational Risk Charge

7. The **Operational Risk Charge:**

   (a) for a statutory fund of a life company that is not a friendly society, is the amount of capital that the fund is required to hold for operational risk in accordance with this Prudential Standard;

   (b) for a benefit fund of a friendly society, is zero;

   (c) for the shareholders' fund of a life company that is not a friendly society, is zero; and

   (d) for the management fund of a friendly society, is the amount of capital that the friendly society is required to hold for operational risk in accordance with this Prudential Standard.

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

---

1 Refer to subsection 21(1) of the Act.

2 Refer to section 16ZD of the Act.

Calculation of the Operational Risk Charge

9. The Operational Risk Charge is calculated as the sum of:

   (a) the Operational Risk Charge for **risk business** (**ORCR**) defined in paragraph 11;

   (b) the Operational Risk Charge for investment-linked business (**ORCI**) defined in paragraph 14; and

   (c) the Operational Risk Charge for other business (**ORCO**) also defined in paragraph 14.

10. For the purposes of paragraphs 11 to 14:

   (a) '**Premium income**' includes all premiums for life policies with the exception of premiums that are sourced from benefits paid under another life policy issued by the life company.

   (b) '**Claim payments**' include all payments to meet liabilities to policy owners with the exception of payments that are used as premium income for another life policy issued by the life company.

11. The Operational Risk Charge for risk business (ORCR) is calculated as follows:

   $ORCR = A\times \{maximum(GP_1, NL_1) + maximum(0, |GP_1 – GP_0| – 0.2 \times GP_0)\}$

   where:

   (a) A is 2 per cent for a statutory fund that is a **specialist reinsurer** and 3 per cent for other funds;

   (b) GP_1 is premium income (gross of reinsurance) for the 12 months ending on the reporting date;

   (c) NL_1 is the **adjusted policy liabilities** (net of reinsurance) at the reporting date;

   (d) GP_0 is premium income (gross of reinsurance) for the 12 months ending on the date 12 months prior to the reporting date;

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

12. For the management fund of a friendly society, GP_1, NL_1 and GP_0 must be summed across all of the risk business in the friendly society's benefit funds.

13. For a statutory fund of a life company that is not a friendly society, GP_1, NL_1 and GP_0 must be summed across all of the risk business in the statutory fund.

14. The Operational Risk Charge for investment-linked business (ORCI) and the Operational Risk Charge for other business (ORCO) are calculated as follows:

$$ORCI \text{ or } ORCO = B \times \{NL_1 + \text{maximum}(0, GP_1 - 20\% \times GL_0) + \text{maximum}(0, C_1 - 20\% \times GL_0)\}$$

where:

(a) B is 0.15 per cent for a statutory fund that is a specialist reinsurer and 0.25 per cent for other funds

(b) NL_1 is the adjusted policy liabilities (net of reinsurance) at the reporting date

(c) GP_1 is premium income (gross of reinsurance) for the 12 months ending on the reporting date

(d) GL_0 is the adjusted policy liabilities (gross of reinsurance) at the date 12 months prior to the reporting date

(e) C_1 is all payments to meet liabilities to policy owners (gross of reinsurance) for the 12 months ending on the reporting date

15. For the management fund of a friendly society, NL_1, GP_1, GL_0 and C_1 in paragraph 14 must be summed across all of the investment-linked business of the society (for ORCI) and all the other business of the friendly society that is neither risk business nor investment-linked business (for ORCO).

16. For a statutory fund of a life company that is not a friendly society, NL_1, GP_1, GL_0 and C_1 in paragraph 14 must be summed across all of the investment-linked business in the statutory fund (for ORCI) and all of the other business in the statutory fund that is neither risk business nor investment-linked business (for ORCO).

Adjustments and exclusions

17. APRA may, by notice in writing to a life company, adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that life company.

Transition

18. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than ~~up until~~ 31 December 2014.