



Discussion Paper

Supervision of conglomerate groups

18 March 2010

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Preamble

This discussion paper describes APRA's proposed approach to the supervision of conglomerate groups that include APRA-regulated entities and conduct business in more than one industry.

A summary of the proposed approach is provided in the Executive Summary and details are provided in the discussion paper and appendices.

APRA invites comments on the proposals in this discussion paper. Written submissions should be emailed to Level3framework@apra.gov.au by 18 June 2010 and addressed to:

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Following the receipt and analysis of submissions, APRA will prepare draft prudential standards and draft reporting standards, reporting forms and instructions to give effect to the proposals. These will be subject to public consultation.

The prudential standards for conglomerate groups are expected to be finalised during 2011 with a view to commencement during 2012. Any transitional provisions considered appropriate will be included as part of the standards.

Important

Submissions will be treated as public unless clearly marked as confidential and the confidential information contained in the submission is identified.

Submissions may be the subject of a request for access made under the Freedom of Information Act 1982 (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA.

Information in the submission about the regulated entity which is not in the public domain will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and therefore will ordinarily be exempt from production under the FOIA.

Contents

Executive summary	5
Glossary	7
Chapter 1 – Introduction	8
The purpose of group supervision	9
APRA's current supervision hierarchy	9
The proposed Level 3 supervision framework	10
Benefits of the proposed framework	12
Chapter 2 – Determining whether a group is a Level 3 group	14
What is a material entity?	14
Some structural aspects	15
Chapter 3 – Group capital adequacy	16
Capital adequacy concepts	16
Level 3 capital adequacy proposals	17
The group capital management plan	17
Defining eligible capital at Level 3	19
Chapter 4 – Measurement of Level 3 capital	21
Required capital at Level 3	21
Level 3 capital adjustments	23
Chapter 5 – Group governance and risk management requirements	24
The proposals	24
Chapter 6 – Supervisory processes	27
Chapter 7 – Request for cost-benefit analysis information	28
Appendix 1 – Summary of proposals	29
Appendix 2 – International developments	31
Appendix 3 – Methodology – Measurement of Level 3 capital adequacy	33

Executive summary

This discussion paper outlines APRA's proposals to extend its current prudential supervision framework to conglomerate groups (containing APRA-regulated entities) that have material operations in more than one APRA-regulated industry and/or have one or more material unregulated entities.

APRA has, since its establishment, been conscious of the need to understand and assess the financial and operational aspects of conglomerate groups, as well as the individual APRA-regulated entities within them. APRA is already supervising banking and general insurance groups on a group basis. History has demonstrated that the failure of one entity (regulated or not) within a conglomerate group may damage or even cause the failure of related entities. Hence, a narrow, stand-alone view of regulated entities is insufficient to obtain a full picture of the financial risks to which depositors and policyholders may be exposed.

Although membership of a conglomerate group may provide benefits to APRA-regulated entities, it may also increase and change the risks they face. The more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities, and the greater the danger of a supervisory 'blind spot' that may result in risks building up without adequate remediation.

APRA's proposed Level 3 supervision framework aims to ensure that prudential supervision adequately captures the risks to which APRA-regulated entities within a conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential frameworks at Level 1 and (where it applies) Level 2. Internationally, this need for a broader group-wide view has been well recognised.

The proposed framework is a flexible one intended to ensure that group structures are not unduly restricted by supervisory intervention whilst giving both APRA and the group itself a better understanding of the risks that arise from the group and its activities.

Determining whether a group is a Level 3 group

Under the proposed framework, some conglomerate groups will be supervised at both Level 2 and Level 3. In general, APRA will apply Level 3 supervision to conglomerate groups containing two or more material entities that are either APRA-regulated entities operating in different industries, or a combination of at least one APRA-regulated entity and at least one material unregulated entity. APRA's decision to apply Level 3 supervision will have regard to whether the group's structure allows for effective supervision and whether the additional requirements of group supervision will enhance the protection of the beneficiaries of APRA-regulated entities; the decision will be guided by high-level principles.

The Level 3 group will comprise the Level 3 Head and its subsidiaries. APRA is proposing that the Level 3 Head be an APRA-regulated entity (including an authorised NOHC); however, the Head does not necessarily have to be the ultimate parent of the group. The Level 3 framework will not apply to entities upstream in an ownership sense from the Level 3 Head.

The Board of the Level 3 Head will be responsible for ensuring the group's compliance with the Level 3 supervision framework.

Group capital adequacy

As is the case for APRA's existing requirements, capital adequacy is an integral component of the proposed Level 3 supervision framework.

The primary concepts that APRA uses to assess capital adequacy (required capital, eligible capital, surplus capital and target surplus) will, in principle, apply to the management of capital within material unregulated entities, any sub-group of APRA-regulated entities, and the Level 3 group as a whole. However, APRA is not proposing to apply capital requirements directly to registrable superannuation entity (RSE) licensees or material unregulated entities in the group.

Under APRA's proposed approach, a Level 3 group must hold a surplus of eligible capital over required capital, net of any adjustments, to ensure adequate capital is held to cover risks within the group. A sufficient portion of the surplus must be readily transferable among group entities so that capital shortfalls within the group can be adequately addressed. The Board of the Level 3 Head will be responsible for ensuring the adequacy of capital (both level and quality) held by the group. APRA proposes to require a Level 3 Head to establish and maintain an appropriate capital management plan to manage and monitor its risks, capital requirements, group relationships and the disposition of capital across the group. The Level 3 Board must approve the group capital management plan and regularly monitor and review it.

The proposed Level 3 supervision framework provides the opportunity for greater flexibility in managing capital across the group, by allowing groups to determine where they will hold their capital.

For consistency, APRA is proposing an equity-equivalent approach to the definition of capital at Level 3. This approach focuses on the loss absorbency characteristics of capital. Equity-equivalent capital will comprise ordinary shares, reserves, retained earnings, eligible preference shares and certain hybrid capital instruments.

Measurement of Level 3 capital

APRA proposes to adopt a building block approach to determine *required capital* at Level 3. Required capital at Level 3 will be determined as the sum of the equity-equivalent requirements of all blocks within the group, including any Level 2 groups or other aggregation of entities as agreed with APRA. APRA may also impose additional requirements at Level 3 to ensure that capital held fully reflects the risks to the group.

APRA is considering two methods for measuring *eligible capital* at Level 3. One is a top-down method and the other, in parallel with the determination of required capital, is a building block approach. Both methods are expected to arrive at the same result, although this may not always be the case. APRA will be collecting data on both proposed methods and evaluating them before finalising how eligible capital at Level 3 is to be calculated.

Group governance and risk management requirements

Governance and risk management are integral components of group supervision. APRA is proposing to apply a number of existing prudential standards in these areas to the Level 3 Head. In some instances, APRA will also require the Level 3 Head to ensure that all material entities in the Level 3 group meet the requirements in these standards. The standards cover governance, group risk management, fit and proper, business continuity management, outsourcing, audit and related matters, risk concentrations and intra-group transactions and exposures.

Supervisory processes

Group supervision at Level 3 will involve not only assessing both capital adequacy and compliance with governance and risk management requirements, but also ensuring that the structure of the group does not give rise to excessive unmitigated risks. Supervision will take into account the individual structure and character of each group.

Where there are prudential reasons for doing so, APRA may impose, on a case-by-case basis, additional requirements on a Level 3 Head or other APRA-regulated entities in the group. These include additional capital, risk management or reporting requirements.

Glossary

ADI	An authorised deposit-taking institution under the <i>Banking Act 1959</i>
APRA	Australian Prudential Regulation Authority
APRA-regulated entities	ADIs, general insurers, life companies, RSE licensees and authorised NOHCs
Authorised NOHC	Non-operating holding company authorised under the <i>Banking Act 1959</i> , the <i>Insurance Act 1973</i> or the <i>Life Insurance Act 1995</i>
BCBS	Basel Committee on Banking Supervision
Eligible capital	Capital held by an entity or group that APRA recognises as eligible for capital adequacy purposes
General insurer	A general insurer authorised under the <i>Insurance Act 1973</i>
Level 1	Supervision that applies to individual operating entities authorised by APRA
Level 2	Group supervision that applies to groups headed by an ADI, general insurer or authorised NOHC
Level 3	Group supervision of conglomerate groups (containing APRA-regulated entities) with material operations across more than one APRA-regulated industry and/or in unregulated entities
Level 3 Head	An APRA-regulated entity determined by APRA to be the head of a Level 3 group
Life company	A company (including a friendly society) registered under the <i>Life Insurance Act 1995</i>
NOHC	Non-operating holding company
Required capital	The minimum capital that APRA requires an entity or group to hold
RSE licensee	Registrable superannuation entity licensee
Unregulated entities	Entities other than APRA-regulated entities

Chapter 1 – Introduction

This discussion paper describes proposals to extend APRA's current prudential supervision framework to conglomerate groups (containing APRA-regulated entities) that have material operations in more than one APRA-regulated industry and/or have one or more material unregulated entities.

APRA-regulated entities may operate in Australia under a variety of structures. They may operate as single stand-alone entities, as parts of a group operating predominantly within a single industry or as part of a conglomerate group that straddles different industries.

The range and nature of risks vary with these different structures. The contagion effects of a possible weakness of a member of a group may threaten the position of APRA-regulated entities within the group, even if these entities are prudentially sound. As group structures become larger, more complex and sometimes opaque, the risk of potential contagion within a group increases, as do the systemic impacts associated with a failure of the group.

APRA has, since its establishment, been conscious of the need to understand and assess the financial and operational aspects of conglomerate groups, as well as the individual APRA-regulated entities within them. APRA is already supervising banking and general insurance entities on a group basis. APRA issued prudential standards applying to groups containing one or more authorised deposit-taking institutions (ADIs) in 2000 and to groups that include one or more general insurers in 2009. Recent amendments to the *Life Insurance Act 1995* enable APRA to introduce supervision for life insurance groups.

History has demonstrated that the failure of one entity (regulated or not) within a conglomerate group may damage or even cause the failure of related entities as well. Hence, a narrow, stand-alone view of regulated entities is insufficient to obtain a full picture of the financial risks to which depositors and policyholders may be exposed.

Internationally, the need for a broader group-wide view has also been well recognised. The Basel Committee on Banking Supervision (BCBS) has long advocated consolidated supervision of banks: this is evident in both the Basel II Framework and the Core Principles for Effective Banking Supervision. Although international standards or guidelines that deal comprehensively with the supervision of conglomerate groups operating in multiple industries are yet to be published, both the International Association of Insurance Supervisors and the Joint Forum have emphasised the need for supervisors to adopt a broader view than stand-alone supervision can itself provide: 'Policymakers should ensure that all financial groups ... are subject to supervision and regulation that captures the full spectrum of their activities and risks'¹.

This discussion paper outlines APRA's proposed prudential framework to enhance the supervision of conglomerate groups that have significant cross-industry activities. Throughout this paper, this framework is referred to as the 'Level 3 supervision framework'.

The discussion paper covers the following topics:

- the factors that will determine the level at which a group is to be supervised (Chapter 2);
- group capital adequacy principles and their application to Level 3 groups (Chapters 3 and 4);
- group risk management and governance requirements at Level 3 (Chapter 5); and
- how APRA intends to supervise Level 3 groups (Chapter 6).

Information on the cost-benefit impacts of APRA's proposed approach is requested in Chapter 7.

¹ The Joint Forum, 'Review of the Differentiated Nature and Scope of Financial Regulation', www.bis.org/publ/joint24.htm, January 2010.

The purpose of group supervision

The purpose of group supervision is to ensure that a group is financially sound and that group activities, intra-group relationships and intra-group transactions do not jeopardise the financial soundness of APRA-regulated entities within the group. In other words, group supervision is designed to protect individual APRA-regulated entities from contagion risk.

Although operating within a group may provide benefits to APRA-regulated entities, group membership may also increase and change the risks they face. Possible risks arising from membership of a conglomerate group include:

- **financial risks**, stemming from transactions between group members or transactions involving both group members and third parties, such as intra-group investments and loans, insurance and reinsurance, guarantees, letters of comfort and cross-default provisions. Entities within the group that are not regulated by APRA ('unregulated entities' in this paper) might be undercapitalised or group treasury arrangements may oblige or encourage APRA-regulated entities to pass surplus capital to other members of the group;
- **reputation risks**, where adverse publicity about a group entity, whether accurate or not, may cause a loss of confidence in the integrity of an APRA-regulated entity within the group. Such damage may threaten its relationship with existing and potential customers and other stakeholders. A loss of trust and confidence on the part of investors in the group may also impair an APRA-regulated entity's access to funding. Reputation risk to APRA-regulated entities is increased with group practices such as common group branding, common funding and common management;
- **moral hazard risks**, which may arise where a group entity engages in excessive risk-taking activities on the assumption that, if a problem arises, another group entity will come to its assistance. Any group entity in financial stress that seeks support from a holding company or other group members may induce riskier behaviour than would otherwise occur;

- **operational risks**, associated with internal processes, people and systems or external events that originate in one part of the group and may adversely affect other parts of the group. This risk can be driven by the size and complexity of the group; and
- **governance and strategic risks**, which may arise from the legal structure, managerial structure or diversity of the group. Governance arrangements typically become more complicated where there are common directors and management across group entities. This can threaten the ability of individual APRA-regulated entities in the group to make strategic decisions and business judgments in the best interests of the regulated entity, with due consideration to the interests of depositors and policyholders.

These risks already affect APRA-regulated entities to varying degrees and are addressed to some extent through the prudential requirements of APRA's Level 1 supervision framework. However, this framework largely focuses on the individual APRA-regulated entities without full consideration of the group in which the entity may operate and the implications of group membership. The interaction of these risks within a group context requires more effective group-wide supervision beyond the existing stand-alone prudential frameworks and, in some cases, beyond the existing group supervision frameworks.

APRA's current supervision hierarchy

APRA supervises individual regulated entities as well as groups comprising these entities. The Level 1 supervision framework applies in some form to every APRA-regulated entity. The Level 2 supervision framework is designed to apply to specialist groups that operate primarily in one APRA-regulated industry. As already noted, Level 2 supervision is in place for ADI groups and general insurance groups. Recent amendments to the *Life Insurance Act 1995* enable APRA to register life insurance non-operating holding companies (NOHCs) although, at this stage, the prudential standards for life insurance NOHCs will extend only to governance and fit and proper, not to capital requirements.

Level 1

Every entity authorised by APRA to undertake financial activities is subject to supervision on a stand-alone basis. These entities could be ADIs, general insurers, life companies or RSE licensees.

Level 2

Level 2 group supervision applies to specialist groups operating primarily in one industry. It essentially treats the group on a consolidated basis and 'backs out' or deconsolidates any part of the group that operate in a different industry or are not regulated by APRA.

APRA applies Level 2 group supervision to groups headed by an ADI, general insurer or authorised non-operating holding company (authorised NOHC) and will be able to apply Level 2 supervision to groups headed by a life company under the recent amendments to the *Life Insurance Act 1995*.

APRA does not intend at present to supervise RSE licensees on a Level 2 group basis.

Throughout this discussion paper, groups supervised at Level 2 are referred to as **Level 2 groups**.

The proposed Level 3 supervision framework

The more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities, and the greater the danger of a supervisory 'blind spot' that may result in risks building up without adequate remediation.

Financial institutions are increasingly expanding beyond their traditional industry boundaries and using holding company structures to improve operational efficiency. Non-traditional activities can make up a sizeable proportion of earnings and can make a material contribution to a group's risk profile. Given the potential for these activities to impact on the financial health of APRA-regulated entities within a

group, APRA needs an overall view of the financial and operational soundness of the group. APRA must be confident that group risks are being measured within and across the group in its entirety and are being managed such that they are unlikely to materially affect the financial health of any APRA-regulated entities in that group.

For some conglomerate groups, Level 2 supervision will be adequate. The Level 2 framework has limitations, however, particularly within a conglomerate group that has material operations across more than one APRA-regulated industry and/or in one or more material unregulated entities.

The main limitations of the Level 2 framework are that:

- it may not properly account for double gearing or excessive leverage in those parts of the group that are deconsolidated for prudential purposes. Further, deconsolidation of subsidiaries that are not part of the primary industry of the Level 2 group can result in capital being held that does not adequately account for the risks to the APRA-regulated entities within the group;
- Level 2 supervision relies on aggregating or consolidating both the balance sheets of each entity within the group and their prudential capital requirements. This approach works well where each entity is in the same industry and is subject to the same capital adequacy framework, but not where entities are outside the consolidated group or operate under different capital regimes; and
- the Level 2 framework does not necessarily cover all material entities that could place APRA-regulated entities in the group at risk. This is particularly the case where large exposures might be held in parts of the group that are excluded from the Level 2 consolidation process, allowing the conglomerate group to exceed prudent limits on a consolidated basis.

APRA is therefore proposing an extension to its current supervision hierarchy that will enable it to assess the financial and operational condition of conglomerate groups that have material operations in more than one industry (financial or otherwise). The Level 3 supervision framework will be applied consistently regardless of:

- the primary industry within which the group operates;
- the corporate structure that the group employs to organise its activities; and
- the mix of business being undertaken.

The framework is designed to complement the existing industry-based Level 1 and Level 2 regimes. At the same time, it will provide common measures and tools through which group-wide risk profiles and supervisory assessments can be made.

The primary objective in extending APRA's group supervision framework is to ensure that APRA's supervision adequately captures the risks to which APRA-regulated entities within the conglomerate group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential arrangements at Level 1 and (where it applies) Level 2.

Throughout this discussion paper, groups to be supervised at Level 3 are referred to as **Level 3 groups**.

Chapter 2 outlines the guiding principles APRA will use to determine whether a group will be supervised as a Level 2 group or as well as a Level 3 group.

Figures 1 and 2 illustrate examples of conglomerate structures that might comprise Level 3 groups. In Figure 1, the head of the Level 3 group is an APRA-regulated operating entity (in this example, an ADI). This group comprises a Level 2 group designated in light blue (an ADI and an unregulated financial entity associated with the ADI), a life company, a RSE licensee and a material unregulated entity.

Figure 1 – Example of Level 3 group headed by an APRA-regulated operating entity (incorporating a Level 2 group)

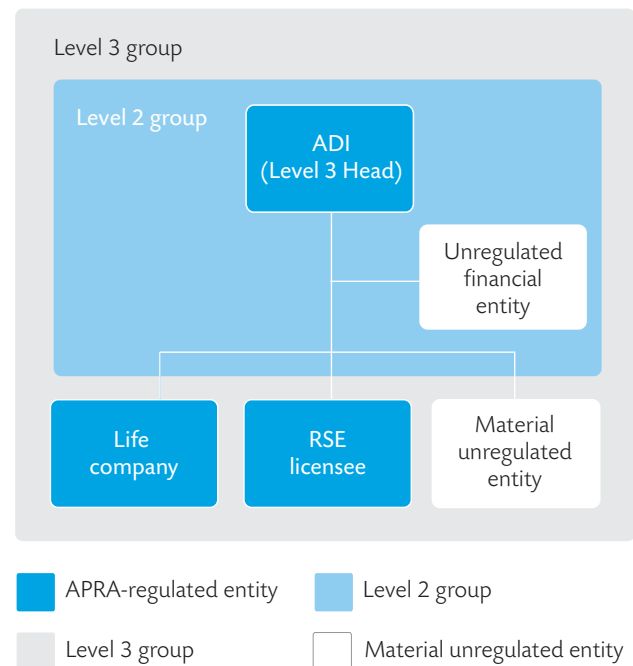
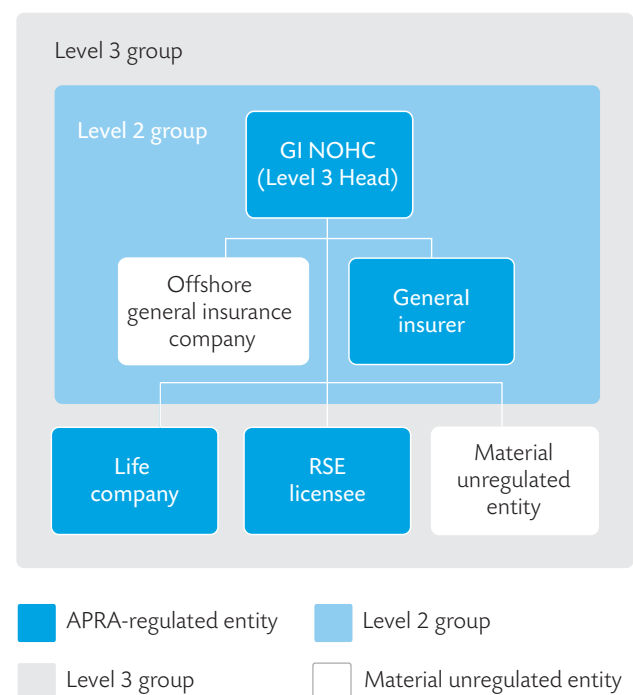


Figure 2 – Example of Level 3 group headed by an authorised NOHC (incorporating a Level 2 group)



In Figure 2, the head of the Level 3 group is an authorised general insurance NOHC. This group comprises a Level 2 group (a general insurance NOHC, a domestic general insurer and an offshore general insurance company), a life company, a RSE licensee and a material unregulated entity.

Where Level 3 groups contain material unregulated entities, APRA needs to seek information from and form risk assessments about these entities. These assessments might include undertaking quantitative and qualitative risk assessments covering areas such as business operations, capital, corporate governance, senior management and risk management systems and controls. APRA also needs to understand the nature and extent of intra-group transactions and exposures within the group. Although this information would not be collected as a matter of course, it is important that APRA can obtain the information if required.

The total capital of the Level 3 group must be sufficient to cover the risks arising out of all the activities undertaken by the group, including by unregulated entities. The group's arrangements must also ensure that this capital is readily available to unregulated entities where the need arises.

Group-wide capital management is an important mechanism to manage contagion risk within a group and this mechanism is a central aspect of the proposed Level 3 framework. APRA's capital adequacy requirements at Level 3 will be based on, but will differ to some extent from, those at Levels 1 and 2. Broadly speaking, the proposed Level 3 approach will require the Level 3 Head to ensure capital additional to the Level 1 and Level 2 requirements is held within the Level 3 group in those situations where APRA considers the total capital held in respect of material unregulated entities is not commensurate with the group's risk profile. Level 1 and Level 2 requirements will remain in place and should be considered as part of Level 3 capital management.

Details of the Level 3 capital proposals are set out in Chapters 3 and 4.

APRA is also proposing risk management and governance requirements at Level 3 that are based on similar principles to the Level 1 and Level 2 requirements. If a group has adequate governance arrangements at Level 3, for example, it will effectively comply with any existing Level 2 governance requirements. Some modification may be needed to address additional risks that can arise in conglomerate groups with material operations across more than one APRA-regulated industry. APRA intends to apply the risk management and governance requirements to the Level 3 Head and, in some instances, to require the head to ensure that the rest of the group complies with APRA's requirements. This approach is discussed in more detail in Chapter 5.

Benefits of the proposed framework

APRA's preliminary assessment of potential Level 3 groups suggests that between 10 and 15 groups, involving approximately 65 APRA-regulated entities, will be subject to the proposed group supervision framework at Level 3.

APRA believes there will be important benefits of the proposed group supervision framework at Level 3. It will ensure that group structures are not unduly restricted by supervisory intervention whilst giving both APRA and the group itself a better understanding of the risks that arise within the group and its entities. In particular, any risks that may arise from unregulated entities in the group will be identified and thus able to be better managed on a group-wide basis. The lessons of the global financial crisis, particularly the difficulties of the American International Group (AIG) and a number of European bancassurance groups, demonstrate that a failure to supervise conglomerate groups in a way that takes account of the risks to prudentially regulated entities can have serious consequences. The proposed framework will also improve the safety of the Australian financial system by reducing the likelihood that regulated entities within conglomerate groups, many of which are systemically significant, suffer financial failure.

APRA's capital management and risk management proposals for a Level 3 group reflect what APRA considers to be good practice and it is likely that the majority of APRA-regulated entities will already be in broad compliance with the proposals. Where adjustments to existing group-wide policies and procedures are required, APRA anticipates that these will be small in the context of the overall group.

As outlined in this discussion paper, capital adequacy under Level 3 is designed to supplement existing capital requirements at Levels 1 and 2. As a result, APRA anticipates that for the majority of affected groups, the impact of the proposed framework on capital is likely to be relatively small. However, when a Level 3 group includes unregulated entities that APRA considers to be undercapitalised, additional capital will be required to minimise the risk that any difficulties experienced by these entities flow through to the APRA-regulated entities in the group.

Chapter 2 – Determining whether a group is a Level 3 group

Under APRA's proposed group supervision framework, some conglomerate groups will be supervised at both Level 2 and Level 3.

APRA currently imposes Level 2 requirements on banking groups headed by an ADI or authorised NOHC and on insurance groups headed by a general insurer or authorised NOHC.

APRA will generally apply Level 3 supervision to conglomerate groups containing two or more material entities that are either APRA-regulated entities operating in different industries or a combination of at least one APRA-regulated entity and at least one material unregulated entity. APRA's decision to apply Level 3 supervision will have regard to whether the additional requirements of group supervision will enhance the protection of the depositors, policyholders and other beneficiaries of APRA-regulated entities.

In assessing whether a particular group should be subject to Level 3 supervision, APRA proposes to apply the following guiding principles:

Principle 1: If a group is concentrated within a single APRA-regulated industry and no material entities operate outside this industry, group supervision at Level 2 will apply without an extension to Level 3. In such cases, the capital of any APRA-regulated entities in a different industry from the primary business of the group, and of certain unregulated entities, is deducted from group capital.

Principle 2: If a group has material operations in two or more APRA-regulated industries (a cross-industry group), it may be supervised at Level 3 if:

- APRA wishes to undertake regular monitoring of the capital or risk position of the group as a whole; and/or
- the group has capital it wishes to have recognised as transferable within its group and APRA agrees to such recognition.

Principle 3: If a group contains material unregulated entities, APRA will normally apply group supervision at Level 3.

In applying these principles, APRA will consider whether the group's structure allows the effective supervision of the group or the assessment of risk to the APRA-regulated entities. Factors that APRA will take into account include whether:

- Level 1 and Level 2 supervision gives APRA sufficient information about the group; and
- existing prudential requirements allow APRA to satisfy itself that there is sufficient control of entities within the group that could influence the APRA-regulated entities.

The structure of any group should be sufficiently transparent, for example, to enable APRA to ascertain where the various business lines are conducted, the risk profile of the group and its individual parts, and the way in which internal risk management is organised and conducted for the group and for individual entities.

What is a material entity?

As part of its supervisory assessment (refer to Chapter 6), APRA will determine whether any particular entity or sub-group of entities is material.² Without imposing a strict definition, the factors that will affect APRA's assessment of materiality will include whether:

- any entity or sub-group of entities is significant to the group's capital position or its financial standing;
- an entity is operationally important to the rest of the group but does not currently form part of a Level 2 group. Examples may include entities such as a central hub that provides essential information technology services for the group; or
- any entity has the potential to create risks that, if realised, could produce significant losses for the group or the APRA-regulated entities within the group.

² A sub-group of entities refers to an aggregation of entities, for the purposes of capital calculations at Level 3, as agreed to by APRA.

APRA will not impose prudential requirements directly on unregulated entities that are part of a Level 3 group, material or otherwise. However, a Level 3 Head will be subject to reporting requirements in relation to all entities in the group, including unregulated entities. This will allow APRA to form risk assessments on the potential impact that unregulated entities might have on the activities and businesses of the group as a whole.

Some structural aspects

Each group supervised by APRA, whether at Level 2 or Level 3, will have an entity heading the group. In the Level 3 context, this entity is referred to as the Level 3 Head. This entity will generally play a pivotal role in the management and operations of the group as it will have control and influence over both APRA-regulated and unregulated entities in the group.

APRA is proposing that the Level 3 Head be an APRA-regulated entity (other than a RSE licensee). However, it does not necessarily have to be the ultimate parent of the group. Level 3 groups can be ultimately owned in a number of ways. For example, the Level 3 Head can be an Australian publicly listed company, a subsidiary of a listed or unlisted company or the Australian holding company for a foreign parent; in the last case, the remainder of the Level 3 group would be only those entities that fall under the Level 3 Head. Overseas-based entities and unregulated entities operating in Australia but directly owned and controlled by the foreign parent would not form part of the Level 3 group.

The Level 3 group will comprise the Level 3 Head and its subsidiaries. The Level 3 framework will not apply to entities upstream in an ownership sense from the Level 3 Head.

APRA will generally adopt a look-through approach in the determination of a Level 3 group. Some entities, such as special purpose vehicles and related parties, will not form part of the Level 3 group. However, if APRA considers that the Level 3 group is exposed to risks from the activities of such entities, it may adjust capital requirements at Level 3 to reflect these risks.

Where a Level 3 group is foreign-owned, APRA will define the group to include APRA-regulated entities and their domestic and offshore subsidiaries (both APRA-regulated entities and material unregulated entities) of the Level 3 Head.

Where the Level 3 Head is an authorised NOHC, a number of risks may arise that are not specifically covered at Level 1 or Level 2. APRA proposes, therefore, that an authorised NOHC that is a Level 3 Head:

- have the capacity to raise capital to support the APRA-regulated entities in the group; and
- only undertake limited activities as agreed with APRA (in line with APRA's existing approach at Level 2).

Chapter 3 – Group capital adequacy

This chapter discusses APRA's proposed approach to Level 3 capital adequacy and its relationship to existing capital adequacy requirements at Levels 1 and 2.

Capital adequacy is an integral component of the proposed Level 3 supervision framework. Ensuring that a conglomerate group is adequately capitalised limits the likelihood that difficulties in any entity in the group will have a detrimental impact on any APRA-regulated entity in the group.

The proposed capital adequacy requirements at Level 3 capture the risks and activities of all material entities within the group. APRA's proposed approach to capital adequacy at Level 3 builds on existing capital adequacy requirements at Levels 1 and 2 and includes scope for supervisory assessment for Level 3 groups.

Capital adequacy concepts

The primary concepts that APRA uses to assess capital adequacy are:

- *required capital*, which is the minimum capital that APRA requires a regulated entity or group to hold;
- *eligible capital*, which is the capital actually held by an entity or group that APRA recognises for capital adequacy purposes;
- *surplus capital*, which is the excess of eligible capital over required capital held; and
- *target surplus*³, which is the internal targeted amount of eligible capital in excess of required capital, as determined by the board of the entity or head of the group.

Under Level 1 supervision, required capital is the minimum capital required under APRA's prudential standards, including any additional capital that APRA may determine as necessary in certain cases. For general insurers, the minimum required capital is the Minimum Capital Requirement (MCR); for ADIs, it is the Prudential Capital Ratio (PCR).

Eligible capital at Level 1 is defined as the actual capital or net assets determined according to APRA's prudential standards. It includes ordinary equity (proceeds from ordinary shares), reserves, retained earnings, residual capital and certain hybrid capital instruments.

Surplus capital and target surplus are vital measures in monitoring capital adequacy at Level 1. These measures are designed to ensure that eligible capital does not fall below required capital, which would be a trigger for supervisory intervention.

Group-wide capital management involves the same capital adequacy principles that apply to individual entities. For example, group-wide required capital is compared with group-wide eligible capital.

For Level 2 groups, being single-industry groups, the required capital and eligible capital can be determined on a consolidated basis as if the individual APRA-regulated entities were aggregated into a single entity. Deconsolidation occurs where an entity in the group falls outside this single-industry assumption (refer to Chapter 1).

The Level 3 capital adequacy regime is designed to capture the full spectrum of risks associated with groups. The capital adequacy concepts of required and eligible capital, surplus capital and target surplus at Level 1 and Level 2 are similarly extended to the Level 3 framework. These measures of capital will, in principle, apply to the management of capital within material unregulated entities, any sub-group of entities and the group as a whole. While the principles of capital management will apply to the Level 3 group as a whole, APRA is not proposing to apply capital requirements directly to RSE licensees or material unregulated entities.

³ The concept of target surplus is used widely in the general and life insurance industries. This concept is similar to the Board-approved internal target capital ratios established by many ADIs.

Level 3 capital adequacy proposals

Under APRA's proposed approach, a Level 3 group must hold a surplus of eligible capital over required capital, net of any adjustments, to ensure adequate capital is held to cover risks within the group. A sufficient portion of the surplus must be readily transferable among group entities so that capital shortfalls within the group can be adequately addressed.

The Board of the Level 3 Head (Level 3 Board) will ultimately be responsible for ensuring there is an appropriate level and quality of capital held by the group commensurate with the risks associated with its activities. Essential to the Level 3 Board's assessment of group capital adequacy will be the establishment of a group capital management plan.

The group capital management plan

Under Level 1 and Level 2 supervision, APRA-regulated entities and groups are required to maintain business plans that incorporate their approach to capital management.⁴

APRA proposes to extend the requirement for a capital management plan to the Level 3 Head for application to the Level 3 group. As such, APRA intends to require a Level 3 Head to establish and maintain an appropriate capital management plan to manage and monitor the group's risks, capital requirements, group relationships and the disposition of capital across the group. The Level 3 Board would approve the group capital management plan and regularly monitor and review it.

This requirement is consistent with APRA's principles-based approach and provides scope for groups to tailor their capital management planning to the nature, size and complexity of their businesses.

APRA proposes that the Level 3 group capital management plan include, as a minimum:

- systems and procedures to identify, measure, monitor and manage the risks arising from the group's activities to ensure that capital is commensurate with the group's risk profile. This process corresponds to the Internal Capital Adequacy Assessment Process required of ADIs at Level 1 and Level 2;
- the group's regime for determining and maintaining a group target surplus or target capital under both normal and stressed conditions, including the setting of trigger points to alert management and avert potential breaches of these targets;
- the remedial actions the group will take when it deviates from its group target surplus;
- the steps the group will take to ensure that every APRA-regulated entity within the group meets its Level 1 and Level 2 capital adequacy requirements;
- the group's understanding of the nature of capital which is considered freely available to be transferred amongst group entities and how it is transferable; and
- the group's arrangements to ensure that unregulated entities hold sufficient capital or have ready access to sufficient capital.

APRA-regulated entities within a group would continue to meet Level 1 and Level 2 capital requirements. APRA is not proposing to establish capital requirements for unregulated entities on a stand-alone basis. The group, however, would have to ensure that unregulated entities can readily access capital within the group to address potential shortfalls in capital. APRA does not intend to dictate where this capital should be held within the group.

⁴ ADIs are required under *Prudential Standard APS 110 Capital Adequacy* (APS 110) to have a separate capital management plan.

Capital flexibility and transferability

As part of its overall capital management, a Level 3 Head must ensure that eligible capital in excess of required capital is held within the Level 3 group. Within this surplus capital, there is typically an amount of capital that can be moved or transferred within the group without affecting the capital adequacy of any one member. At Level 3, APRA expects this transferable amount to be determined by the group on a regular basis using a transferability assessment that identifies those components of surplus capital that may not be freely transferable due to legal, regulatory or other impediments.

As a result, the proposed Level 3 supervision framework provides the opportunity for flexibility in managing capital across the group, by allowing groups to determine where they will hold their capital. However, APRA expects that in developing its capital management plan, the group will not hold less capital than would be considered prudent in light of the nature and risks of the group.

In conducting its transferability assessment, the Level 3 Head would be expected to take the following considerations into account:

- any regulatory or market limitations or restrictions not already accounted for in measuring surplus capital at Level 3. These might include:
 - regulatory or market restrictions on capital;
 - prudential requirements on the quality of capital;
 - any prudential limits on equity holdings and/or capital contributions to unregulated entities; or
 - restrictions imposed by regulators other than APRA;
- where capital requirements for a Level 2 group are less than the sum of the capital requirements of Level 1 APRA-regulated entities, possibly due to diversification benefits or intra-group eliminations, the difference will be considered as non-transferable for purposes of the Level 3 group;
- where APRA-regulated entities choose to meet their capital requirements at Level 1 or Level 2 with a higher proportion of Tier 1 capital than the minimum (50 per cent of total capital), the Tier 1 capital held will be greater than the required capital at Level 3. This difference will be considered non-transferable as it is needed to meet capital adequacy requirements at Level 1 or Level 2⁵;
- minority interests that are considered part of shareholders' equity under APRA's existing standards but may not, in practice, be readily transferable across the group;
- policyholder retained profits within participating statutory funds of a life company are not normally available for distribution to shareholders and will therefore be considered non-transferable for Level 3 purposes;
- any legal restrictions on transfers between entities such as exchange or currency controls, shareholder rights or policyholder rights;
- taxation (e.g. income, capital gains or withholding tax) on amounts ultimately available to fund capital contributions to other entities in the Level 3 group; and
- capital that the individual entities in the Level 3 group must hold to meet their internal capital targets.

⁵ For example, an ADI has a total capital requirement at Level 1 of \$100 million of which 50 per cent (\$50 million) must be held as Tier 1 capital. The ADI meets its capital requirement with \$70 million of Tier 1 capital and \$30 million of Tier 2 capital. The required capital at Level 3 for the ADI is \$50 million (refer to Chapter 4). In this case, the difference of \$20 million between the actual Tier 1 capital held and the \$50 million required at Level 3 will be considered non-transferable. The additional \$20 million of Tier 1 capital is necessary to meet capital adequacy requirements at Level 1.

Defining eligible capital at Level 3

In defining Level 3 group capital adequacy requirements, APRA's objective is to ensure the group has sufficient high quality capital to absorb losses under all reasonable circumstances, including periods of financial stress.

Currently, the definition of eligible capital is not fully consistent across APRA-regulated industries or in unregulated entities. ADIs and general insurers are subject to a tiered definition of capital. Tier 1 capital is of a higher quality than Tier 2 capital and is characterised by a permanent and unrestricted commitment of funds that are freely available to absorb losses and do not impose unavoidable servicing charges against earnings. Tier 2 capital includes other components of capital that fall short of the quality of Tier 1 capital to varying degrees as they are, for example, non-permanent in character. In contrast, APRA-regulated entities in the life insurance and superannuation industries are not subject to a tiered definition of capital and capital requirements are not defined in the same way as for ADIs and general insurers.

Equity-equivalent (Tier 1) proposal

APRA proposes an equity-equivalent approach to the definition of capital at Level 3. This approach focuses on capital with key loss absorbency characteristics. Equity-equivalent capital mainly comprises ordinary shares, reserves, retained earnings, eligible preference shares and certain hybrid capital instruments. These are the highest quality forms of capital that are generally freely available to absorb losses. These instruments are broadly similar across APRA-regulated industries and are easily identifiable in the case of unregulated entities.

For APRA-regulated entities in the ADI and general insurance industries, equity-equivalent eligible capital corresponds with Tier 1 capital. For life companies, the total balance sheet approach to the calculation of capital requirements⁶, and the absence of a tiered definition of capital, mean that it is not straightforward to derive an equity-equivalent capital requirement. APRA proposes to develop such a requirement prior to the implementation of the Level 3 framework in the context of its current review of life and general insurance capital. In the interim, APRA proposes that proxies be used. Appendix 3 provides further details.

The equity-equivalent capital in respect of the activities of the other entities in a Level 3 group would broadly correspond to ordinary shares, retained earnings and reserves, subject to the relevant definitions in the ADI prudential standards.

This equity-equivalent approach is broadly consistent with the basis on which market judgments of capital adequacy of most financial services entities and groups are made. It will ensure that capital is easily identifiable across both APRA-regulated and unregulated entities; it will also minimise unnecessary complexity in the calculation of capital at Level 3 and has the benefits of:

- avoiding the detailed tiered definitions used for Level 1 and Level 2. A more uniform definition of capital at Level 3 will facilitate the aggregation of individual capital amounts for entities within groups and will limit the opportunities for regulatory arbitrage; and
- focusing on the highest quality and most fungible form of capital available to a group, which is particularly important for managing risks during times of financial stress.

⁶ Refer to *Prudential Standards No 3 Prudential Capital Requirement (PS 3)*, *Prudential Standard LPS 3.04 Capital Adequacy Standard (LPS 3.04)*, *Prudential Standard LPS 6.03 Management Capital Standard (LPS 6.03)* and *Prudential Standard LPS 2.04 Solvency Standard (LPS 2.04)*.

Floors and limits on equity-equivalent capital

For the ADI and general insurance industries, APRA currently applies floors and limits to the composition of Tier 1 capital at Level 1 and Level 2. This is consistent with international practice and is an appropriate means of ensuring entities hold a sufficient quality of capital. APRA proposes to extend the same approach to capital at Level 3.

Accordingly, at this stage, APRA proposes the following floors and limits:

- ordinary equity must constitute at least 75 per cent of eligible capital at Level 3;
- residual capital will be limited to a maximum of 25 per cent of eligible capital at Level 3; and
- hybrid capital⁷ will be limited to a maximum of 15 per cent of eligible capital at Level 3.

Where there are prudential reasons for doing so, APRA may require a Level 3 Head to hold more than 75 per cent of eligible capital for the Level 3 group in the form of ordinary equity.

In December 2009, the BCBS issued new proposals on the definition of capital in their consultative document, *Strengthening the resilience of the banking sector*. Some key proposals include:

- a general strengthening of those components of the Tier 1 capital base that are available to absorb losses fully on a going-concern basis;
- a harmonised approach to deductions from capital, ensuring that deductions are generally applied at the ordinary equity level (or equivalent); and
- a phasing-out of innovative hybrid capital instruments.

APRA supports the broad set of proposals contained in this consultative document. Once the BCBS proposals are finalised, APRA will modify its capital requirements at Levels 1, 2 and 3 accordingly.

⁷ Hybrid capital instruments are those that correspond with the definitions of Innovative and non-Innovative Tier 1 capital instruments as defined in *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital (APS 111)*, *Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups (GPS 111)* and *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (GPS 112)*.

Chapter 4 – Measurement of Level 3 capital

Required capital at Level 3

‘Building block’ approach

APRA proposes to adopt a building block approach to determine required capital at Level 3. Required capital at Level 3 for every ‘block’ in the Level 3 group will be determined and added together to give the required capital for the group. A block may be a single entity or a sub-group of entities. Where there is a Level 2 capital requirement, this will form the basis of the Level 3 capital requirement; otherwise, the required capital at Level 1 will be the basis for the required capital at Level 3 for each Level 1 entity.

Measurement of required capital at Level 3

The required capital of a Level 3 group will be determined as the sum of the equity-equivalent requirements of all blocks within its group, including any Level 2 groups or other aggregation of entities as agreed with APRA.

APRA may also impose additional requirements on a Level 3 group on a case-by-case basis to ensure that Level 3 capital fully reflects the risks of the group (refer to Chapter 6).

Required capital at Level 3 will be subject to adjustments that are outlined later in this chapter.

Table 1 sets out APRA’s proposals for determining required capital at Level 3. The required capital for APRA-regulated entities (other than RSE licensees) will be determined as the equity-equivalent capital requirement based on the industry-specific prudential standards, using the Tier 1 (equity-equivalent) requirements at Levels 1 or 2 (as appropriate). The required capital for other entities and RSE licensees will be based on the group’s internal capital allocations or capital levels determined by APRA.

Further details of proposed calculations and formulae are outlined in Table 4 of Appendix 3.

Table 1 – Summary of proposed required capital calculations at Level 3

Industry	Proposal
ADI	The Tier 1 capital requirement as determined by APRA for a Level 2 group or, where there is no Level 2 group, for the ADI. ⁸
General insurance	The Tier 1 capital requirement as determined by APRA for a Level 2 group or, where there is no Level 2 group, for the general insurer. ⁹
Life insurance	To be specified by APRA at a later date; an interim proxy is proposed in Appendix 3.
Funds management entities (including RSE licensees and material unregulated entities engaged in funds management)	Consistent for all entities (excluding life companies) regardless of the vehicle undertaking the activities. Required capital will be calculated as the greatest of: <ul style="list-style-type: none"> • 0.25 per cent of funds under management on account balances not invested in life insurance policies or bank deposits of a related party; or • any regulatory capital requirement of the entity; or • the capital requirement as calculated by the entity’s (or Level 3 group’s) internal capital allocation.
Material unregulated entities (not engaged in funds management activities) and authorised NOHCs	The group’s internal capital allocation or, where APRA considers this is inadequate, a capital level determined by APRA. For foreign unregulated entities in the Level 3 group engaged in banking, insurance or superannuation activities, capital requirements in the first instance will be based on those imposed by their home regulator (refer to Appendix 3).

⁸ 50 per cent (or a higher percentage as determined by APRA) of capital required to meet the prudential capital requirement: refer to APS 110 and APS 111.

⁹ 50 per cent of total capital or as determined by APRA: refer to GPS 111 or GPS 112.

Measurement of eligible capital at Level 3

APRA is considering two methods for measuring eligible capital at Level 3. It is expected that both methods will arrive at the same result, although this may not always be the case. While APRA recognises the benefits in establishing a single method of calculation, particularly for comparison and consistency across different groups, it is not clear at this stage which method will result in the most appropriate measure of a Level 3 group's eligible capital. APRA will be collecting data on both proposed methods and evaluating them before finalising how eligible capital at Level 3 is to be calculated.

Method 1 (top down): Eligible capital at Level 3 will be based on the consolidated accounts of the Level 3 group net of all adjustments.

Method 2 ('building block'): Eligible capital at Level 3 will be based on the sum of the eligible capital for each block of the Level 3 group, net of all adjustments, in the same way as required capital is measured for the group.

Table 2 sets out APRA's proposals for determining eligible capital at Level 3 under Method 2. For APRA-regulated entities, industry-specific definitions of capital will generally flow through to the calculation of eligible capital at Level 3, irrespective of the capital measurement method. APRA considers this the most appropriate way to avoid distortions between eligible capital at Level 1 and Level 2 on the one hand, and eligible capital at Level 3 on the other.

Further details of the formulae to be used are set out in Table 11 of Appendix 3.

Table 2 – Summary of proposed components for eligible capital at Level 3 (Method 2)

Industry	Proposal
ADI	Level 3 ordinary equity: Fundamental Tier 1 capital (paid-up ordinary shares, retained earnings and current year earnings, certain reserves and other items as defined in APS 111). Level 3 residual capital: Residual Tier 1 capital (refer to APS 111).
General insurance	Level 3 ordinary equity: Fundamental Tier 1 capital (paid-up ordinary shares, retained earnings and current year earnings, certain reserves and other items as defined in GPS 111 and GPS 112). Level 3 residual capital: Residual Tier 1 capital (refer to GPS 111 and GPS 112).
Life insurance	Eligible capital for a life company will be specified by APRA in the future. In the interim, the following proxies are proposed: <ul style="list-style-type: none"> • for the shareholders' fund, eligible capital will be the shareholder' fund net assets as reported under <i>Reporting Standard LRS 300.0 Statement of Financial Position</i>; and • for statutory funds, eligible capital will be the sum of: <ul style="list-style-type: none"> – life insurance net assets; – surplus or deficit (if any) of net policy liability relative to net minimum termination value (MTV); and – policy owner retained profits at the end of the period.
RSE licensees, material unregulated entities and authorised NOHCs	Ordinary equity: proceeds from paid-up ordinary shares, retained earnings (including current year earnings) and reserves (excluding asset revaluation reserves and any other Tier 2 equivalent reserves). Residual capital: eligible preference shares (refer to Non-innovative Residual Tier 1 capital definition in APS 111) and hybrid capital (refer to Innovative Tier 1 capital definition in APS 111).

Level 3 capital adjustments

Various industry-specific deductions are required from total Tier 1 and Tier 2 capital when measuring capital adequacy for ADIs and general insurers. These deductions reduce the amount of eligible capital. Life companies do not have analogous capital requirements but are required to create an inadmissible asset reserve that effectively increases the required capital.

APRA intends that all industry-specific adjustments to capital will flow through to the calculation of eligible capital at Level 3. Regardless of which capital measurement method is used, eligible capital at Level 3 is to be calculated net of all adjustments that apply at Level 1 or Level 2. Where goodwill and other intangible assets are not otherwise treated as deductions at Level 1 or Level 2, they will be treated as deductions at Level 3. This approach will also apply to unregulated entities; intangible assets in those entities will be deducted from equity for Level 3 eligible capital calculations.

APRA's proposals for capital adjustments are intended to be consistent with international developments, including the BCBS proposals in their final form.

Adjustments for intra-group exposures

APRA proposes that, in determining capital adequacy at Level 3, all intra-group transactions be eliminated. This will ensure that only those balances or transactions resulting from dealings with entities outside of the Level 3 group are included. APRA proposes that:

- transactions with entities that form part of the Level 3 group against which capital may be required under the current Level 1 or Level 2 frameworks be eliminated at Level 3; this may result in a reduction in the required capital of the Level 3 group;

- all forms of capital contributions or contingent capital support by each entity in the Level 3 group to other Level 3 group entities (including debt, equity and guarantees) be eliminated from the entity's eligible capital at Level 3, if not already netted out through the accounting or APRA's consolidation process;
- internal profits or goodwill arising from the sale of a subsidiary to another entity in the Level 3 group be eliminated from eligible capital where this sale is funded from within the group;
- where an entity in the Level 3 group provides funds to third parties and those third parties then invest the capital in any entity within the group (known as circular funding), these funds are treated as a deduction; and
- any capital generated through structures or methods that, in APRA's view, artificially inflate a Level 3 group's capital be disallowed for eligible capital calculation purposes.

Treatment of the value of equity in subsidiaries

The treatment of the value of equity investments in subsidiaries differs, to varying degrees, under the existing industry-specific capital adequacy frameworks. These differences result in potentially inconsistent capital outcomes at Level 3, depending on the nature and activities of the subsidiaries and the way a Level 3 group is structured. APRA proposes that:

- in all circumstances, intangible assets in subsidiaries (including the value of business in force and the value of future new business in a subsidiary) be excluded as assets (and capital) for capital adequacy purposes; and
- adjustments be made to eligible capital at Level 3 for any under-capitalisation of subsidiaries.

Capital upgrading

APRA proposes that, as a general rule, any instances of capital upgrading and/or double gearing be eliminated in calculating eligible capital at Level 3.

Chapter 5 – Group governance and risk management requirements

Governance and risk management are integral components of group supervision. APRA has a number of behavioural prudential standards addressing these components that are applied at Levels 1 and 2. Accordingly, APRA is proposing to extend its governance and risk management requirements to the Level 3 Head only in cases where:

- the Level 3 Head is not currently an APRA-regulated entity. APRA intends that a NOHC that is to be a Level 3 Head and is not already the head of a Level 2 group will have to be authorised; or
- the Level 3 Head is currently an APRA-regulated entity but the proposed requirements at Level 3 do not currently apply to this entity at Levels 1 or 2.

In some instances, APRA will also require the Level 3 Head to ensure that all material entities in the Level 3 group meet the requirements in APRA's risk management standards.

The proposals

Governance

The existing governance prudential standards are aimed at ensuring a sound governance framework.¹⁰ These standards include, for example, specific requirements relating to board size and composition, remuneration and audit. APRA proposes that the requirements of the existing governance prudential standards be applied to the Level 3 Head only, noting that all other APRA-regulated entities within the group must comply with these standards at Level 1 or Level 2 (as appropriate). APRA does not intend to require the Level 3 Head to ensure that these requirements are met by material unregulated entities within the Level 3 group.

Risk management

APRA proposes that group risk management requirements be applied to the Level 3 Head and that the Level 3 Head ensure that material unregulated entities are embraced by an overarching risk management framework across the group that addresses the risks within the group.

These requirements would be a core tool for managing group risk at Level 3. They would be principles-based and consistent with existing standards in this area.¹¹ The requirements are unlikely to prescribe the manner in which a particular risk must be dealt with other than as required under the existing prudential standards at Level 1 and Level 2.

Fit and proper

APRA's fit and proper prudential standards set out minimum requirements for APRA-regulated entities when determining the fitness and propriety of individuals to hold positions of responsibility.¹² APRA proposes that the existing fit and proper prudential standards be applied to the Level 3 Head. The Level 3 Head would also be required to ensure that the standards are met by persons whose activities for group entities may materially affect the whole, or a substantial part, of the business of a Level 3 group or its financial standing, either directly or indirectly.

Business continuity management

The business continuity management (BCM) prudential standards aim to ensure that a whole-of-business approach to BCM is taken that is appropriate to the nature and scale of an entity's operations.¹³

¹⁰ Refer to *Prudential Standard APS 510 Governance* (APS 510), *Prudential Standard GPS 510 Governance* (GPS 510) and *Prudential Standard LPS 510 Governance* (LPS 510).

¹¹ These requirements will take the following prudential standards into consideration: *Prudential Standard APS 222 Associations with Related Entities* (APS 222), *Prudential Standard GPS 220 Risk Management* (GPS 220), *Prudential Standard GPS 221 Risk Management: Level 2 Insurance Groups* (GPS 221) and *Prudential Standard LPS 220 Risk Management* (LPS 220).

¹² Refer to *Prudential Standard APS 520 Fit and Proper* (APS 520), *Prudential Standard GPS 520 Fit and Proper* (GPS 520) and *Prudential Standard LPS 520 Fit and Proper* (LPS 520).

¹³ Refer to *Prudential Standard APS 232 Business Continuity Management* (APS 232), *GPS 221, Prudential Standard GPS 222 Business Continuity Management* (GPS 222), *Prudential Standard LPS 232 Business Continuity Management* (LPS 232).

APRA proposes that the existing BCM standards be applied to the Level 3 Head and that the Level 3 Head ensure that material unregulated entities conform to key elements, including requirements to implement and maintain a BCM policy and business continuity plan. The intention behind the requirements is to increase a Level 3 group's resilience to business disruption arising from internal and external events and hence reduce the impact on the group's business operations, reputation and profitability.

Outsourcing

The existing outsourcing prudential standards aim to ensure that all outsourcing arrangements involving material business activities are subject to appropriate due diligence, approval and on-going monitoring.¹⁴ APRA proposes that these standards be applied to the Level 3 Head and that the Level 3 Head ensure that material unregulated entities conform to key elements, which include requirements that APRA-regulated entities have in place a policy relating to the outsourcing of material business activities, to monitor outsourcing activities and to ensure that outsourcing arrangements are in the form of a legally binding agreement. Where the Level 3 Head is engaged in activities such as treasury operations and material aspects of these activities are outsourced, the outsourcing arrangements would be captured by the requirements.

Audit-related requirements

APRA's audit requirements specify the role of an independent auditor in ensuring that high-quality information in relation to an entity's operations and internal controls is produced and provided to the board, senior management and APRA. APRA proposes that, for Level 3, audit-related requirements be developed from the existing industry prudential standards and other statutory arrangements covering audit and be applied to the Level 3 Head and prudential reporting by the Level 3 group.¹⁵

Risk concentration

APRA proposes risk concentration requirements at Level 3 that draw on the key qualitative elements of the existing industry standards.¹⁶ The aim will be to ensure that a concentration of risk in one part of, or across, the Level 3 group does not pose a threat to the APRA-regulated entities in the group. The prudential standards will require the Level 3 Board to identify and manage risk concentrations across the Level 3 group. APRA does not propose to include quantitative limits or thresholds on a Level 3 basis as the existing requirements at Levels 1 and 2 will continue to apply.

The qualitative, principles-based aspects of existing prudential standards relating to risk concentration may be used as an indication of APRA's likely approach at Level 3. These include the need for explicit policies for managing risk concentrations and a requirement to report to APRA on such concentrations.

There will be a wide diversity in the types of risk concentrations that a Level 3 group must consider which are likely to be unique to each group. The proposed requirements will define minimum areas for the Level 3 Board to consider when identifying risk concentrations and will require the group to have in place policies and systems for identifying and managing risk concentrations.

¹⁴ Refer to *Prudential Standard Outsourcing APS 231 (APS 231)*, *Prudential Standard GPS 231 Outsourcing (GPS 231)*, *GPS 221* and *Prudential Standard LPS 231 Outsourcing (LPS 231)*.

¹⁵ Refer to *Prudential Standard APS 310 Audit and Related Matters (APS 310)*, *Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation (GPS 310)*, *Prudential Standard GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups (GPS 311)* and *Prudential Standard LPS 310 Audit and Related Matters (LPS 310)*.

¹⁶ Refer to *Prudential Standard APS 221 Large Exposures (APS 221)*, *Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge (GPS 114)*, *Prudential Standard GPS 116 Capital Adequacy: Concentration Risk Capital Charge (GPS 116)*, *GPS 111*, *LPS 2.04* and *LPS 3.04*.

Intra-group transactions and exposures

APRA proposes requirements for intra-group transactions and exposures (ITEs) at Level 3 that are based on the key qualitative elements of the existing industry prudential standards relating to ITEs, which include the requirement to have policies and procedures for the management of ITEs and to report to APRA on such exposures.¹⁷ The existing quantitative requirements at Level 1 and Level 2 will continue to apply. The aim will be to ensure that the Level 3 Board manages the risk that problems in one entity in the Level 3 group may compromise the financial or operational position of another entity (particularly APRA-regulated entities), because of links through ITEs.

The proposed requirements will cover a range of matters addressing quantifiable ITEs as well as a range of non-quantifiable areas for the proper management of ITEs across the Level 3 group. The proposed requirements will address explicit as well as implicit arrangements but will not include quantitative limits or thresholds.

¹⁷ Refer to APS 222, GPS 114, GPS 116, GPS 111, LPS 2.04 and LPS 3.04.

Chapter 6 – Supervisory processes

Group supervision at Level 3 will involve assessing capital adequacy and compliance with governance and risk management requirements, and ensuring that the structure of the group does not give rise to excessive unmitigated risks. Supervision will take into account the individual structure and character of each group.

An assessment of whether a Level 3 Head is ensuring appropriate compliance with prudential requirements will generally involve:

- an assessment of the group's capital adequacy and capital planning and of its identification and management of specific risks that are not completely captured at Levels 1 and/or 2. APRA does not intend to formally approve group capital management plan for a Level 3 group. It is the responsibility of the Level 3 Board to sign off the group capital management plan as appropriate for the capital adequacy requirements of the group;
- an assessment of the group's surplus capital management. The Level 3 Head will be required to develop a surplus capital policy, detailing how the group intends to meet APRA's overall capital adequacy requirements. In any instance where a fall in capital threatens the target surplus, APRA would expect remedial action to restore capital levels to the target surplus as soon as is reasonable; and
- consideration of the adequacy of the risk management systems of the Level 3 Head and whether they comply with APRA's risk management requirements.

Underpinning the Level 3 supervision framework is the concept of minimum requirements for capital adequacy, as outlined in Chapter 3, enhanced by the supervisory review process of the group's own capital adequacy assessments.

Based on the supervisory review process for the current Basel II Framework for banking institutions, APRA will consider how well the Level 3 Head is assessing the capital adequacy of the Level 3 group relative to risks under its internal capital assessment process and strategy.¹⁸ This is intended to encourage groups to develop and adopt better risk management techniques in monitoring and managing their risks, and to ensure that they have adequate capital to support all the risks in their businesses. It also has the advantage of promoting a more consistent and structured approach in setting out APRA's expectations of a group's capital management.

Where there are prudential reasons for doing so, APRA may impose additional requirements on a Level 3 Head or APRA-regulated entities in the group on a case-by-case basis. These include, but are not limited to, additional capital, risk management or reporting requirements. Where APRA considers that there is a prudential issue, it will typically seek to have its concerns addressed in the first instance in consultation with the senior management and Board, as appropriate, of the Level 3 Head.

¹⁸ For banking institutions, the Basel II Framework describes minimum requirements for capital adequacy as Pillar 1 minimum capital requirements and the supervisory review process as Pillar 2.

Chapter 7 – Request for cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a Preliminary Assessment to establish whether it is likely that there will be business compliance costs associated with the proposals. In order to perform a cost-benefit analysis, APRA welcomes information from interested parties.

As part of the consultation process, APRA requests respondents to provide an assessment of the impact of the proposed changes and, specifically, any marginal compliance costs that APRA-regulated entities are likely to face. APRA will also be undertaking an impact study of its proposals.

Given that APRA's proposed requirements may impose some compliance costs, respondents may also indicate whether there are any other relevant regulations relating to conglomerate group supervision that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input parameters to the BCC as well as the final result. The BCC can be accessed at: www.finance.gov.au/obpr/bcc/index.html.

Appendix 1 – Summary of proposals

The following table summarises proposals discussed in this paper.

Proposal	Description
Scope of application	The Level 3 supervision framework will not apply to all groups. APRA will determine on a case-by-case basis which groups will be subject to Level 3 supervision.
Level 3 group structure	<p>The Level 3 group will comprise the Level 3 Head and its subsidiaries. The Level 3 framework will not apply to entities upstream in an ownership sense from the Level 3 Head.</p> <p>APRA will determine an APRA-regulated entity to be the Level 3 Head. A Level 3 Head that is a NOHC will be required to be authorised by APRA.</p>
Capital management	<p>The Level 3 Board will be responsible for ensuring appropriate capital management of the Level 3 group and for establishing and maintaining an appropriate level of surplus capital.</p> <p>The Level 3 Board will be required to ensure that there is an appropriate group capital management plan.</p>
Minimum capital adequacy requirements at Level 3	A Level 3 Head will be required to hold, at all times, an excess of eligible capital above its required capital for the Level 3 group and to ensure that the group has determined a group target surplus.
Definition of capital	Capital adequacy at Level 3 will be based on an equity-equivalent approach that broadly corresponds to Tier 1 capital for the ADI and general insurance industries.
Floors and limits on equity-equivalent capital	<p>Ordinary equity must constitute at least 75 per cent of eligible capital at Level 3.</p> <p>Residual capital will be limited to a maximum of 25 per cent of eligible capital at Level 3.</p> <p>Hybrid capital will be limited to a maximum of 15 per cent of eligible capital at Level 3.</p> <p>These floors and limits must be calculated net of all applicable adjustments.</p> <p>APRA may require a Level 3 Head to hold more than 75 per cent of eligible capital for the group at Level 3 in the form of ordinary equity in cases where APRA considers there are prudential reasons for doing so.</p>
Measurement of required capital	<p>APRA proposes a ‘building block’ approach for determining required capital at Level 3, which involves a summation of the various blocks across the group. Where there is a Level 2 capital requirement, this will form the basis for determining the capital requirement at Level 3; otherwise, the capital requirements at Level 1 will form the basis of the group calculation.</p> <p>APRA may agree to other entities in the Level 3 group to be aggregated for the purposes of calculating capital requirements.</p>
Required capital at Level 3	<p>Required capital at Level 3 comprises equity-equivalent capital requirements of the entities of the group plus any additional group requirements and any group capital adjustments required by APRA.</p> <p>Capital requirements will vary according to the type of entity involved; details of the requirements to apply to each industry are contained in Appendix 3.</p> <p>The Level 3 group will be required to hold capital in respect of material unregulated entities, RSE licensees and authorised NOHCs that are not part of a Level 2 calculation.</p> <p>The location of required capital in respect of these entities will be left to the discretion of the Level 3 Head.</p>

Proposal	Description
Capital in respect of NOHCs	<p>For authorised NOHCs whose activities are not fully reflected in the capital requirement of a Level 2 group, the capital requirement will be consistent with that which would apply to an APRA-regulated entity engaged in those activities.</p> <p>Where a NOHC is not authorised it will be treated consistently with unregulated financial entities. Capital in respect of the NOHC will not need to be held in the NOHC itself.</p> <p>Where a NOHC only holds investments in subsidiaries funded by equivalent capital issued by the NOHC it is unlikely to be subject to capital requirements.</p>
Capital in respect of material unregulated entities	<p>The group's capital requirements in respect of unregulated entities will be based on its internal capital allocation. Where APRA considers that the capital allocation is inadequate, it may determine a capital level for the unregulated entities that the group will be required to hold.</p>
Measurement of eligible capital	<p>Eligible capital at Level 3 comprises ordinary equity and residual capital.</p> <p>APRA proposes two methods for the measurement of eligible capital at Level 3:</p> <ul style="list-style-type: none"> • Method 1 – a top-down approach using the consolidated accounts of the group; or • Method 2 – 'building block' approach using the sum of eligible capital of blocks within the Level 3 group. <p>The definition of eligible capital at Level 3 will vary according to the type of entity involved; details of the requirements to apply to each industry are contained in Appendix 3.</p>
Level 3 capital adjustments	<p>APRA may require adjustments to be made to required or eligible capital at Level 3 in respect of:</p> <ul style="list-style-type: none"> • industry-specific adjustments that currently apply at Level 1 or Level 2; • intra-group transactions; • value of equity in subsidiaries; and • capital upgrading and double gearing. <p>APRA may also require additional adjustments to capital on a case-by-case basis.</p>
Risk management and governance	<p>APRA proposes a range of risk management requirements to apply to the Level 3 Head. In some instances, the Level 3 Head will be required to ensure that all material entities in the Level 3 group meet the requirements. The requirements cover group risk management, governance, fit and proper, business continuity management, outsourcing, audit and related matters, risk concentration and intra-group transactions and exposures.</p>

Appendix 2 – International developments

There has been a concerted effort by regulators over recent times to address the challenges and risks created by groups with activities in more than one financial industry or with a mix of activities across financial and non-financial industries. The global financial crisis, in particular, has highlighted the need for enhanced supervision of financial conglomerates.

The Joint Forum (previously the Joint Forum on Financial Conglomerates) is a key international group focused on the supervision of financial conglomerates. It has published a series of papers setting out principles and other guidance for the supervision and prudential regulation of financial groups. The Joint Forum undertook a project in response to the call from the G-20 Leaders in March 2009 for a review of the differentiated nature and scope of regulation.¹⁹ A paper was released in January 2010 which, among other areas, considers key differences across the banking, insurance and securities sectors, and the supervision and regulation of financial groups.²⁰ To strengthen supervision and regulation of financial groups, the Joint Forum recommended that:

- policymakers should ensure that all financial groups (particularly those providing cross-border services) are subject to supervision and regulation that captures the full spectrum of their activities and risks;
- the 1999 Joint Forum principles on the *Supervision of Financial Conglomerates* should be reviewed and updated; and

- the BCBS, the International Organization of Securities Commissions and the International Association of Insurance Supervisors should work together to enhance the consistency of supervisory colleges across sectors and ensure that cross-sectoral issues are effectively reviewed within supervisory colleges, where needed and not already in place.²¹

While the publications of the Joint Forum have assisted the supervision of financial groups, there is as yet no internationally agreed comprehensive framework for the regulation and supervision of financial conglomerates.

In the European Union, the Financial Conglomerates Directive (FCD) provides specific legislation for the prudential supervision of financial conglomerates and financial groups involved in cross-industry activities.²² The FCD's objectives are to ensure financial conglomerates are adequately capitalised, to introduce calculation methods for determining a group's overall solvency position and to facilitate the establishment of a single lead regulator for financial conglomerates.

The FCD is currently under review.²³ In November 2009, a public consultation paper on the FCD was released, incorporating a questionnaire and requesting contributions by mid-January 2010. Previously, the European Commission had indicated that it expects a legislative simplification to result from the review.

In the United States, the regulatory system is based around a number of industry-specific federal supervisors with additional supervision at the state level. This results in diversified financial groups being subject to the oversight of several different regulators, with a small amount of coordination.²⁴

19 G-20, 'Enhancing Sound Regulation and Strengthening Transparency', www.g20.org/Documents/g20_wg1_010409.pdf, March 2009.

20 The Joint Forum, 'Review of the Differentiated Nature and Scope of Financial Regulation', www.bis.org/publ/joint24.htm, January 2010.

21 *op. cit.*, pp13-14

22 <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=CELEX:32002L0087:EN:NOT>

23 The Joint Committee of Financial Conglomerates provided advice as part of the review: 'The review of the Financial Conglomerates Directive', www.ceiops.eu/index.php?option=content&task=view&id=589, May 2009 and 'Advice to the European Commission on the review of the Financial Conglomerates Directive', www.c-ebs.org/Publications/Advice/2009/CEBS-and-CEIOPS-todaypublish-their-advice-to-the-E.aspx, October 2009.

24 Coordination mechanisms include the Federal Financial Institutions Examination Council (for federal banking supervisors) and the National Association of Insurance Commissioners (for insurance supervisors). In recent years, the Federal Reserve has been appointed as the umbrella supervisor for financial holding companies and the Office of Thrift Supervision and the Securities and Exchange Commission have powers to supervise thrift and certain holding companies predominantly engaged in broker-dealer activities.

In March 2008, the Department of the Treasury released a blueprint for an improved financial regulatory structure in the United States, centering on an objectives-based regulatory framework.²⁵ In March 2009, the Federal Reserve also proposed reforms to the current financial regulatory system. These will include an increased emphasis on 'systemically important financial institutions' through a more intense and consolidated approach to their supervision.²⁶ In June 2009, the Department of the Treasury released the Regulatory Reform White Paper which further highlights the need for stronger standards for large, interconnected firms.²⁷

25 The Department of the Treasury, 'Blueprint for a Modernized Financial Regulatory Structure', www.ustreas.gov/press/releases/hp896.htm, March 2008.

26 Bernanke, B.S., 'Financial Reform to Address Systemic Risk', www.federalreserve.gov/newsevents/speech/bernanke20090310a.htm, March 2009.

27 The Department of the Treasury 'Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation' www.financialstability.gov/docs/regs/FinalReport_web.pdf, June 2009.

Appendix 3 – Methodology – Measurement of Level 3 capital adequacy

Minimum Level 3 capital adequacy requirements

This appendix sets out the calculations behind the proposed Level 3 capital adequacy assessment. It should be read in conjunction with Chapter 4.

Surplus capital

The Level 3 Head must ensure that the Level 3 group meets its minimum capital requirements at all times. In addition, it must ensure that the Level 3 group holds eligible capital over and above its required capital, which is referred to as surplus capital at Level 3.

Table 3 – Group surplus capital (SC_g)

$SC_g = EC_g - RC_g$ (where $EC_g - RC_g > 0$)	
where	
EC_g	= eligible capital at Level 3
RC_g	= required capital at Level 3

Measurement of required capital

The required capital of a Level 3 group is the sum of the capital requirements of entities in the Level 3 group²⁸, any additional requirements at Level 3 set by APRA and any adjustments to required capital at Level 3. Required capital at Level 3 is to be calculated net of any industry-specific adjustments at Level 1 or Level 2.²⁹

Table 4 – Required capital for Level 3 group (RC_g)

$RC_g = RC_{ADI} + RC_{GI} + \Sigma RC_{LI} + \Sigma RC_{RSE} + \Sigma RC_{A-NOHC} + \Sigma RC_{Unreg\ Funds\ Mgt} + \Sigma RC_{Unreg\ other} + AR \pm RA$	
where	
RC_{ADI}	= Required capital for the ADI Level 2 group or the sum of the required capital for ADI entities where Level 2 does not apply
RC_{GI}	= Required capital for the general insurance Level 2 group or the sum of the required capital for general insurance entities where Level 2 does not apply
RC_{LI}	= Required capital for a life company
RC_{RSE}	= Required capital in respect of the activities of a RSE licensee
RC_{A-NOHC}	= Required capital for any authorised NOHC, to the extent that the activities of the NOHC are not already incorporated in the capital requirement of a Level 2 group
$RC_{Unreg\ Funds\ Mgt}$	= Required capital in respect of the activities of any unregulated entity engaged in funds management activities
$RC_{Unreg\ other}$	= Required capital in respect of the activities of any other material unregulated entity, including NOHCs that are not authorised by APRA, but excluding unregulated entities engaged in funds management activities
AR	= Additional requirements – any additional capital requirement set by APRA at Level 3
RA	= Required capital adjustments – any adjustments to required capital at Level 3

28 Or a Level 2 group or other sub-group of entities as agreed with APRA.

29 In this paper the term 'adjustments' refers to both additions to and subtractions from required capital.

ADIs

APRA proposes that the required capital at Level 3 for an authorised deposit-taking institutions (ADI) Level 2 group or an ADI entity (if Level 2 does not apply) be calculated as the Tier 1 capital requirement for the ADI block.

Under the existing capital adequacy framework for ADIs³⁰, an ADI at Levels 1 and 2 has a minimum capital requirement of its PCR times its total risk-weighted assets, of which 50 per cent must be held in the form of Tier 1 capital. APRA may also require the ADI to hold more than 50 per cent of its minimum capital requirement in the form of Tier 1 capital.

Table 5 – Required capital for ADI entity or Level 2 group (RC_{ADI})

$RC_{ADI} = T1C$	
$T1C = 50\% \text{ (or a higher per cent as specified by APRA)} \times PCR \times RWA$	
where	
T1C	= Tier 1 capital requirement
PCR	= Prudential Capital Ratio
RWA	= Risk-weighted assets

General insurers

APRA proposes that the required capital at Level 3 for a Level 2 general insurance group or a general insurance entity (if Level 2 does not apply) be calculated as the Tier 1 capital requirement for the general insurance block.

Under the existing general insurer capital adequacy framework³¹, a general insurer at Levels 1 and 2 must maintain, at all times, a capital base in excess of its minimum capital requirement (MCR) and hold Tier 1 capital at 50 per cent of MCR. APRA may also require a general insurer to hold more than 50 per cent of its required MCR in the form of Tier 1 capital at Levels 1 or 2. The Tier 1 capital requirement is, generally, the Tier 1 capital ratio (either 50 per cent or higher as determined by APRA) of the MCR (or the requirement as specified by APRA).

Table 6 – Required capital for a general insurer entity or Level 2 group (RC_{GI})

RC_{GI}	=	T1C
T1C	=	50% (or a higher per cent as specified by APRA) of the MCR
MCR	=	The higher of: <ul style="list-style-type: none"> the MCR as calculated in accordance with the prudential standards; or the MCR as adjusted by APRA, including any adjustment by a specified proportion of MCR.
where		
MCR	=	Minimum Capital Requirement

Life companies

For life companies³², the total balance sheet approach to the calculation of the capital requirements and the absence of a tiered definition of capital make the derivation of an equity-equivalent capital requirement less straightforward than for ADIs and general insurers.

The Level 1 capital adequacy framework that applies to a life company pertains separately to its shareholders' fund and to each of its statutory funds.

30 Refer to APS 110 and APS 111.

31 Refer to GPS 110, GPS 112, GPS 111 and *Prudential Practice Guide GPG 110 Capital Adequacy: Capital Management*.

32 Refer to PS 3, LPS 3.04 and LPS 6.03.

For the purposes of Level 3, APRA proposes that the equity-equivalent capital requirement for a life company be calculated as the sum of the equity-equivalent capital requirements for the shareholders' fund and for each of the statutory funds. APRA proposes to harmonise its approach to life insurance capital with the ADI and general insurance industries prior to the implementation of the Level 3 supervision framework, in the context of the life and general insurance capital review that APRA is currently undertaking.

In the interim, for the purposes of estimating potential capital requirements at Level 3, APRA proposes the following proxy calculations for the equity-equivalent capital requirement for the shareholders' fund and statutory funds.

1. Shareholders' fund

For the shareholders' fund, a life company is subject to two capital requirements that make up the 'prudential capital requirement', which is the greater of a management capital requirement and a minimum capital amount.³³

APRA proposes that the interim equity-equivalent capital requirement for the shareholders' fund be the prudential capital requirement as defined in the reporting standards. *Reporting Standard LRS 120.0 Management Capital* (LRS 120.0) calculates the management capital reserve as the total management capital requirement less the total liabilities of the shareholders' fund. This reporting standard defines the prudential capital requirement as the greater of the management capital reserve and the minimum capital amount.

2. Statutory funds

For statutory funds, the different capital requirements for solvency and capital adequacy provide capital requirements under different circumstances. The 'solvency' requirement is intended to cover a run-off of existing business. The 'capital adequacy' requirement is intended to cover the operations of the statutory fund on a going-concern basis.

Consistent with the approach taken with other industries, capital assessments at Level 3 should not be based solely on a minimum capital requirement; hence, APRA proposes to use the capital adequacy requirement (not the solvency requirement) as the base for building the capital requirement at Level 3.

The capital adequacy reserve, as reported under *Reporting Standard LRS 110.0 Capital Adequacy*, represents the excess of the total capital adequacy requirement over the total minimum liabilities for the fund. As an interim proxy, APRA proposes that the equity-equivalent capital requirement for a statutory fund be equal to the fund's capital adequacy reserve as defined in the reporting standards less:

- eligible amounts of approved subordinated debt; and
- seed capital (only applicable to friendly societies).

33 Refer to PS 3.

Table 7 – Interim required capital for life companies (RC_{LI})

RC_{LI}	=	$T1C_{SHARE} + \Sigma T1C_{STAT}$
where:		
$T1C_{SHARE}$	=	prudential capital requirement
$T1C_{STAT}$	=	CAR – SUB – SEED
CAR	=	capital adequacy reserve
SUB	=	eligible amounts of approved subordinated debt
SEED	=	seed capital (only applicable to friendly societies)

Entities engaged in funds management

Many different legal entities engage in funds management activities and the risks involved are generally not driven by the legal status of the entity through which they are undertaken.

Funds management activities undertaken by life companies are covered by the existing Level 1 prudential framework.

Capital requirements exist in the *Superannuation Industry (Supervision) Act 1993* and the *Superannuation Industry (Supervision) Regulations 1994* for RSE licensees.³⁴ However, these capital requirements are not risk-based. Unregulated entities engaged in funds management are not subject to any prudential capital requirements.

At Level 3, APRA proposes a consistent approach to the calculation of capital requirements in respect of the activities of RSE licensees and of unregulated entities engaged in funds management. This approach is broadly based on the current APRA requirements for the life insurance industry. The life insurance regime is a risk-based one specifically designed to cover the risks arising from funds management activities, which are a major activity for many life companies. It is therefore proposed as a suitable basis for life insurance capital requirements at Level 3 and, in a simplified form, for funds management activities conducted by other entities in the Level 3 group.

APRA proposes to base the calculation of required capital at Level 3, in respect of any funds management entity (other than a life company), on the funds under management of the entity, excluding account balances invested in life insurance policies or bank deposits of a related life company or ADI. These exclusions recognise that capital is already held by the group against this business (albeit not in relation to any risk specific to the funds manager). As such, the exclusion provides broad capital neutrality and lessens the incentive within a group to move business out of the life company or ADI environment simply to reduce Level 3 group capital requirements.

RSE licensees

APRA proposes that the Level 3 group capital required to cover the risks of RSE licensees be calculated as the greater of:

- 0.25 per cent of funds under management or account balances not invested in life insurance policies or bank deposits of a related party;
- any regulatory capital requirement of the entity; or
- the capital requirement as calculated by the entity's (or Level 3 group's) internal capital allocation.

³⁴ Refer to subsection 29DA(2) and paragraphs 29DA(3)(a) and (4)(b) of the *Superannuation Industry (Supervision) Act 1993* and subsection 3A.04(1) and (2) of the *Superannuation Industry (Supervision) Regulations 1994*.

Table 8 – Required capital for RSE licensees (RC_{RSE})

RC_{RSE}	=	[Greater of {(FUM x 0.25%), RC, ECM}]
where		
FUM	=	Funds under management or account balances not invested in life insurance policies or bank deposits of a related party
RC	=	the regulatory capital requirement of the RSE licensee
ECM	=	the capital allocation as calculated by an entity's (or Level 3 group's) internal capital model
Where an RSE licensee also conducts non-funds management activities, additional capital may be required. Such a requirement would be agreed on a case-by-case basis in consultation with APRA.		

Unregulated entities engaged in funds management

APRA proposes that the Level 3 group capital required to cover the risks of unregulated entities engaged in funds management be calculated as the greater of:

- 0.25 per cent of funds under management or account balances not invested in life insurance policies or bank deposits of a related party;
- any regulatory capital requirement of the entity; or
- the capital requirement as calculated by the entity's (or Level 3 group's) internal capital allocation.

Other material unregulated entities (not engaged in funds management)

APRA proposes that the capital required within a Level 3 group to cover the risks of material unregulated entities be based, in the first instance, on the group's internal capital allocation. In the absence of such an allocation, or where APRA considers that the allocation for one or more unregulated entities is inadequate, it may determine an amount of capital that the Level 3 group will be required to hold against these risks.

Table 9 – Required capital in respect of the activities of unregulated entities (engaged in funds management) ($RC_{Unreg\ Funds\ Mgt}$)

$RC_{Unreg\ Funds\ Mgt}$	=	Greater of [(FUM x 0.25%), RC, ECM]
where		
FUM	=	Funds under management or account balances not invested in life insurance policies or bank deposits of a related party
RC	=	any regulatory capital requirement of the entity
ECM	=	the capital allocation as calculated by an entity's internal capital model
Where an entity that is engaged in funds management business also conducts non-funds management activities, an additional capital requirement may be required. Such a requirement would be agreed on a case-by-case basis in consultation with APRA.		

For unregulated financial entities, prudential requirements that would apply to APRA-regulated entities engaged in similar activities would be used as a starting point in assessing the reasonableness of the group's capital allocation and/or determining an appropriate capital level. APRA will consider the nature and activities of the unregulated financial entities and the Level 3 group on a case-by-case basis. APRA will also consider the views of the group when assessing the appropriateness of the capital allocation.

In certain cases, subsidiaries engaged in banking, insurance or superannuation industries outside Australia will be classified for Level 3 purposes as unregulated financial entities. The capital requirement in respect of these entities will, in the first instance, be based on the requirements of their home regulator. If APRA considers that the requirements of the home regulator do not adequately capture the risks of entities to the Level 3 group, APRA may require the Level 3 Head to hold a higher capital amount in the group. To the extent that the activities of any unregulated financial entity are comparable to the activities of APRA-regulated entities, APRA's requirements will be based on relevant existing standards.

For unregulated commercial entities, peer group comparison using market benchmarks and industry ratios may be used in assessing the reasonableness of a group's capital allocation and/or determining an appropriate capital level. Again, APRA will consider on a case-by-case basis the nature and activities of the unregulated commercial entity and the Level 3 group, as well as the views of the group, when assessing the appropriateness of the capital allocation.

Table 10 – Required group capital in respect of unregulated entities (not engaged in funds management) ($RC_{Unreg\ other}$)

$RC_{Unreg\ other}$	=	T1C
where:		
T1C	=	The higher of: <ul style="list-style-type: none"> • internal capital allocation by the Level 3 group; and • capital level determined by APRA.

NOHCs

For Level 3 purposes, APRA proposes that risks associated with activities undertaken by NOHCs (including intermediate holding companies) in the Level 3 group be captured in the group capital adequacy assessment.

Where an authorised NOHC (such as the Level 3 Head or an intermediate holding company) undertakes activities on behalf of the Level 3 group (e.g. treasury, managing capital or provision of capital support), it is possible that group risk (e.g. market, operational, liquidity risks) may be transferred from subsidiaries to the authorised NOHC itself.

This transfer of risk to the NOHC may already be included as part of the capital adequacy assessment at Level 2. To the extent that it is not, APRA proposes that the authorised NOHC be subject to capital requirements on a stand-alone basis. Where such activities are broadly similar to those carried out by other APRA-regulated entities, the authorised NOHC will be subject, at a minimum, to the capital requirement that would apply to an APRA-regulated entity engaged in such activities.

An authorised NOHC is not likely to be subject to capital requirements on a stand-alone basis where it only holds investments in subsidiaries that are funded by equivalent capital issued by the NOHC.³⁵

35 Where a non-operating holding company (NOHC) is included in a Level 2 capital adequacy assessment, it will be subject to the capital adequacy rules applicable to the industry in which they are authorised.

Where a NOHC that is not authorised by APRA undertakes activities on behalf of the Level 3 group, the Level 3 Board will be required to ensure that the group holds capital commensurate with the risks associated with these activities. In this respect, a NOHC that is not authorised will be treated like an unregulated financial entity; the capital will not need to be held within the NOHC itself but may be held elsewhere within the Level 3 group, so long as it is transferable to the NOHC when needed.

Where a NOHC funds its investments in subsidiaries from debt and APRA considers such leverage excessive, the Level 3 Board may be required to ensure that the group holds additional capital to cover the risk associated with such leverage. This requirement would be determined on a case-by-case basis.

Measurement of eligible capital at Level 3

APRA is proposing two methods for the calculation of eligible capital at Level 3 (refer to Chapter 4).

For APRA-regulated entities, APRA's industry-specific definitions of capital will generally flow through to the calculation of eligible capital at Level 3, irrespective of whether Method 1 or Method 2 is used.

Table 11 – Eligible capital for Level 3 group (EC_g)

Method 1: the consolidated equity-equivalent capital of the Level 3 group net of all adjustments.	
EC_g	$= EC_c \pm EA$
Method 2: the sum of the eligible equity-equivalent capital of all entities of the Level 3 group net of all adjustments to eligible capital at Level 3.	
EC_g	$= EC_{ADI} + EC_{GI} + \sum EC_{LI} + \sum EC_{RSE} + \sum EC_{A-NOHC} + \sum EC_{Unreg\ Funds\ Mgt} + \sum EC_{Unreg\ other} \pm EA$
where:	
EC_c	= Eligible capital from the group consolidated accounts
EA	= Eligible capital adjustments – any adjustments to eligible capital at Level 3 ³⁶
EC_{ADI}	= Eligible capital for the ADI Level 2 group or the sum of the eligible capital for ADI entities where Level 2 does not apply
EC_{GI}	= Eligible capital for the Level 2 general insurance group or the sum of the eligible capital for general insurance entities where Level 2 does not apply
EC_{LI}	= Eligible capital for a life company
EC_{RSE}	= Eligible capital for a RSE licensee
EC_{A-NOHC}	= Eligible capital for any authorised NOHC not already incorporated in a Level 2 group eligible capital calculation
$EC_{Unreg\ Funds\ Mgt}$	= Eligible capital for unregulated entities engaged in funds management activities
$EC_{Unreg\ other}$	= Eligible capital for unregulated entities including NOHCs that are not authorised by APRA but excluding entities engaged in funds management activities

36 The term 'adjustments' refers to both additions to and subtractions from eligible capital. Adjustments will be different under Method 1 and Method 2. Where industry-specific deductions or adjustments are made in calculating the eligible capital of a Level 2 group (i.e. ADIs and general insurers), EA under Method 2 will only include Level 3 specific deductions or adjustments.

ADIs

Eligible capital for an ADI entity or an ADI Level 2 group will be calculated as:

- Level 3 ordinary equity, which equals Fundamental Tier 1 capital. This includes paid-up ordinary shares, retained earnings and current year earnings, certain reserves and other items as defined in APS 111; and
- Level 3 residual capital, which equals Residual Tier 1 capital as defined in APS 111.

General insurers

Eligible capital for a general insurance entity or a Level 2 general insurance group will be calculated as:

- Level 3 ordinary equity, which equals Fundamental Tier 1 capital. This includes paid-up ordinary shares, retained earnings and current year earnings, certain reserves and other items as defined in GPS 111 and GPS 112; and
- Level 3 residual capital, which equals Residual Tier 1 capital as defined in GPS 111 and GPS 112.

Life companies

Eligible capital for a life company (EC_{LP}) will be:

- for the shareholders' fund, the shareholders' fund net assets as reported under *Reporting Standard LRS 300.00 Statement of Financial Position*; and
- for the statutory fund, the sum of:
 - life insurance net assets;
 - surplus or deficit (if any) of net policy liability relative to net minimum termination value (MTV); and
 - policy owner retained profits at the end of the period.

RSE licensees, authorised NOHCs and all material unregulated entities

For the purposes of defining eligible capital for material unregulated entities, authorised NOHCs and any additional capital requirements at Level 3³⁷, APRA proposes an approach consistent with ADIs at Levels 1 and Level 2. That is, ordinary equity for unregulated entities, authorised NOHCs and Level 3 specific capital requirements would comprise proceeds from paid-up ordinary shares, retained earnings (including current-year earnings) and reserves (excluding asset revaluation reserves and any other Tier 2 equivalent reserves).

Residual capital for authorised NOHCs and all material unregulated entities will be defined as eligible preference shares and hybrid capital such that:

- the eligible preference shares component of the eligible capital at Level 3 has the same meaning as Non-innovative Residual Tier 1 capital as defined in APS 111; and
- hybrid capital will have the same meaning as Innovative Tier 1 capital as defined in APS 111.

37 Where a NOHC forms part of a Level 2 group, the relevant industry requirements will apply.



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