Prudential Standard GPS 110

Capital Adequacy

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that general insurers and Level 2 insurance groups maintain adequate capital against the risks associated with their activities. This Prudential Standard outlines the overall framework adopted by APRA for assessing the capital adequacy of a general insurer and a Level 2 insurance group.

This Prudential Standard forms part of a comprehensive set of prudential standards that deal with the measurement of the capital adequacy of a general insurer and a Level 2 insurance group.

This Prudential Standard applies to all general insurers and Level 2 insurance groups.

The key requirements of this Prudential Standard are that a general insurer and a Level 2 insurance group must:

- have an Internal Capital Adequacy Assessment Process;
- maintain required levels of capital;
- determine its prescribed capital amount having regard to a range of risk factors that may adversely impact a general insurer or Level 2 insurance group's ability to meet its obligations. These factors include insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk.
- comply with any supervisory adjustment to capital imposed by APRA;
- make certain public disclosures about the capital adequacy position of the general insurer or Level 2 insurance group;
- seek APRA's consent for certain planned capital reductions of the general insurer or Level 2 insurance group; and
- inform APRA of any significant adverse changes in the general insurer or Level 2 insurance group's capital position.

Authority

1. This Prudential Standard is made under section 32 of the *Insurance Act 1973* (**the Act**).

Application

2. This Prudential Standard applies to each:

   (a) **general insurer** authorised under the Act (**insurer**); and

   (b) **Level 2 insurance group** as defined in *Prudential Standard GPS 001* (**GPS 001**).

   Where a requirement applies to a Level 2 insurance group, the requirement is imposed on the **parent entity** of the Level 2 insurance group.

3. Subject to any specific transition rules, this Prudential Standard applies to insurers and Level 2 insurance groups (**regulated institutions**) from 1 January 2013 (effective date).

Interpretation

4. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in GPS 001.

Objective

5. The **prescribed capital amount** in respect of a regulated institution is intended to be sufficient, such that if a regulated institution was to start the year with a **capital base** equal to the prescribed capital amount, and losses occurred at the 99.5 per cent confidence level then the assets remaining would be at least sufficient to provide for the central estimate of the insurance liabilities and other liabilities at the end of the year. The other liabilities to be provided for exclude those liabilities that satisfy the criteria for inclusion in the capital base.

Responsibility for capital management

6. Capital is the cornerstone of a regulated institution's financial health. It supports a regulated institution's operations by providing a buffer to absorb unanticipated losses from its activities and, in the event of such losses, enables the regulated institution to continue to meet its insurance obligations.

7. As a consequence of the key role played by capital in the financial health of a regulated institution, the Board of directors (**Board**) of a regulated institution must ensure that the regulated institution has capital that is adequate for the scale, nature and complexity of its business and risk profile, such that it is able to meet its obligations under a wide range of circumstances.

8. In addition to the requirements in paragraph 7, the Board of the parent entity of a Level 2 insurance group must also have regard to:

   (a) the potential for risk to compound across the insurance group;

   (b) concentration of capital and risk within individual entities in the insurance group;

   (c) guarantees and other commitments between entities in the group;

   (d) the capital needs of individual entities in the group;

   (e) the nature of capital held by the insurance group, including its maturity, servicing costs and any double counting of capital within the insurance group; and

   (f) the ability to readily transfer surplus or free capital within the insurance group and the type of capital that may be available to individual entities from other entities in the Level 2 insurance group if required.

Internal Capital Adequacy Assessment Process

9. A regulated institution (except regulated institutions in run-off) must have in place an **Internal Capital Adequacy Assessment Process** (**ICAAP**) that must:

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

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

10. A regulated institution that is part of a Level 2 insurance group may rely on the ICAAP of the Level 2 insurance group provided that the Board of the regulated institution is satisfied that the group ICAAP meets the criteria in paragraph 11 of this standard in respect of the regulated entity.

11. The ICAAP must include at a minimum:

   (a) adequate systems and procedures to identify, measure, monitor and manage the risks arising from the regulated institution's activities on a continuous basis to ensure that capital is maintained at a level consistent with the regulated institution's risk profile and the Board's risk appetite;

   (b) a strategy for ensuring adequate capital is maintained over time, including specific capital targets set out in the context of the regulated institution's risk profile and the Board's risk appetite, plans for how the target level of capital is to be met and the means available for sourcing additional capital where required;

   (c) actions and procedures for monitoring the regulated institution's compliance with its capital requirements and against capital targets, including the setting of triggers to alert management to, and avert, potential breaches of these requirements;

(d) processes for reporting on the ICAAP and its outcomes to the Board and senior management of the regulated institution; and

(e) an **ICAAP summary statement** as defined in paragraph 12.

12. The ICAAP summary statement is a high level document that describes and summarises the capital assessment and management processes of the regulated institution. It must outline at a minimum the aspects of the ICAAP listed in paragraphs 11 (a) to (d) and paragraph 13.

13. A regulated institution must ensure its ICAAP is subject to robust independent review at regular intervals. The frequency and scope of the review must be appropriate to the regulated institution, having regard to the size, business mix and complexity of its operations and the nature and extent of any changes that have occurred or are likely to occur in its business profile or its risk appetite. In any event, the review must not be any less frequent than every three years. The regulated institution's policy for review of its ICAAP must be documented in the ICAAP summary statement, including the responsibility for the review, frequency and scope of the review, and reporting of the review to the Board and senior management.

14. A regulated institution must, on an annual basis, provide a report on the implementation of its ICAAP to APRA (**ICAAP report**). The ICAAP report must be provided to APRA within four months from the end of the **financial year** of the regulated institution. The ICAAP report must include:

(a) detailed information on current and three-year projected capital levels relative to minimum requirements and target levels;

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

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

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

Capital base

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

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

(b) is freely available to absorb losses;

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

(d) ranks behind the claims of policyholders and creditors in the event of the winding-up of the regulated institution.

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

17. A regulated institution's balance sheet may contain certain assets (such as deferred tax assets, goodwill and other intangibles) that are acceptable from an accounting perspective. However, for supervisory purposes, such assets are either generally not available, or of questionable value, should the regulated institution encounter difficulties. A regulated institution is therefore required to make certain adjustments in determining the capital base. Details of these adjustments are provided in GPS 112.

Prudential Capital Requirement (PCR)

18. This Prudential Standard establishes a risk-based approach to measure the capital adequacy of a regulated institution. The required level of capital for regulatory purposes is referred to as the **Prudential Capital Requirement** (**PCR**). The PCR is intended to take account of the full range of risks to which a regulated institution is exposed.

19. A regulated institution must ensure that it has a capital base, at all times, in excess of its PCR.[1]

20. The PCR for a regulated institution equals:

(a) a prescribed capital amount determined either:

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

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

[1] However, this does not apply to Category C insurers: refer to paragraphs 34 to 36.

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

(b) any **supervisory adjustment** determined by APRA under paragraph 33.

21. Regardless of the outcome of the method used for determining the prescribed capital amount, a regulated institution's prescribed capital amount cannot be:

(a) in the case of a regulated institution other than a **Category D insurer** or **Category E insurer**, less than $5 million; and

(b) in the case of a Category D insurer or Category E insurer, less than $2 million.

Standard Method

22. For regulated institutions using the Standard Method, the prescribed capital amount is determined as:

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

(b) the **Insurance Concentration Risk Charge**; plus

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

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

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

(f) an aggregation benefit.

Insurance Risk Charge

23. The Insurance Risk Charge relates to the risk that the actual value of net insurance liabilities is greater than the value determined in accordance with *Prudential Standard GPS 320 Actuarial and Related Matters* (**GPS 320**). The method for determining the Insurance Risk Charge is set out in *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge*.

Insurance Concentration Risk Charge

24. The Insurance Concentration Risk Charge for a regulated institution represents the net financial impact on the regulated institution from either a single large event, or a series of smaller events, within a one year period. The determination of the net financial impact is based on the formulae and requirements set out in *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* (**GPS 116**). For lenders mortgage insurers, additional requirements for calculating the Insurance Concentration Risk Charge are also set out in GPS 116.

Asset Risk Charge

25. The Asset Risk Charge relates to the risk of adverse movements in the value of a regulated institution's on-balance sheet and off-balance sheet exposures. The method for determining the Asset Risk Charge is set out in *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* (**GPS 114**). Asset risk can be derived from a number of sources, including market risk and credit risk. For the purposes of this Prudential Standard and GPS 114, assets and exposures must be valued in accordance with the relevant reporting standards made under the *Financial Sector (Collection of Data) Act 2001* (**Collection of Data Act**)[2].

Asset Concentration Risk Charge

26. The Asset Concentration Risk Charge relates to the risk resulting from investment concentrations in individual assets or large exposures to individual counterparties or groups of related counterparties. The method for determining Asset Concentration Risk Charge is set out in *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge*.

Operational Risk Charge

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

Aggregation benefit

28. The aggregation benefit makes an explicit allowance for diversification between asset risk and the sum of insurance risk and insurance concentration risk in the calculation of the prescribed capital amount.

29. The aggregation benefit formula is:

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

where:

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

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

(c) 'correlation' is:

(i) 20 per cent for all insurers except lenders mortgage insurers; or

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2 For the purpose of calculating the prescribed capital amount of a Category C insurer, the Asset Risk Charge is to be applied only to the assets in Australia of the insurer consistently with reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

(ii) 50 per cent for lenders mortgage insurers; or

(iii) the weighted average of the factors in sub-paragraphs (i) and (ii) for Level 2 insurance groups. The weighting of the factors must be by the size of the insurance risk charges for the non-lenders mortgage insurance and lenders mortgage insurance business, respectively.

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

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

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

Internal Model-based Method

32. A regulated institution may use its own internal capital measurement model to calculate the prescribed capital amount. Use of the IMB Method is conditional on APRA's approval.[3] APRA approval requires a regulated institution to satisfy a range of criteria, as set out in *Prudential Standard GPS 113 Capital Adequacy: Internal Model-based Method* (**GPS 113**). Regulated institutions which do not use an internal model that meets the criteria specified in GPS 113 must use the Standard Method described in this Prudential Standard.

Supervisory adjustment to capital

33. APRA recognises that any measure of the adequacy of a regulated institution's capital involves judgement and estimation, including quantification of risks that may be difficult to quantify. If APRA is of the view that there are prudential reasons for doing so, APRA may, in writing, determine a supervisory adjustment to be included in the PCR[4] of the regulated institution.

Category C insurers

34. By the nature of its Australian balance sheet, a **Category C insurer** will not typically have capital instruments of the type specified in GPS 112. Category C insurers are nevertheless required to meet a variant of the PCR. Specifically,

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[3] Approval will take the form of a modification to this Prudential Standard pursuant to subsection 32(3A) of the Act, which permits APRA to modify a prudential standard to replace particular requirements in the standard with an in-house capital adequacy model.

[4] Under subsection 32(3D) of the Act, prudential standards may include a power for APRA to approve, impose, adjust or exclude prudential requirements in the prudential standard in relation to a particular regulated institution.

Category C insurers are required to maintain assets in Australia[5] that exceed their liabilities in Australia (adjusted for any surplus or deficit of technical provisions as required by GPS 320) (**Net assets in Australia**) by an amount that is greater than the PCR determined by this Prudential Standard.

35. References to the capital base of a regulated institution elsewhere in this Prudential Standard are, where they are being applied to a Category C insurer, to be read as referring to 'net assets in Australia'[6] of that insurer.

36. For further detail regarding the treatment of Category C insurers, refer to *Prudential Standard GPS 120 Assets in Australia*.

Disclosure

37. To improve the understanding of its capital adequacy position by policyholders and other market participants, a regulated institution must publish, at least annually, the following items:

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

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

    (c) the amount of its **Additional Tier 1 capital**;

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

    (e) the amount of its **Tier 2 capital**;

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

    (g) its total capital base derived from the items (a) to (f);

    (h) its prescribed capital amount;

    (i) the components of its prescribed capital amount; and

    (j) its capital adequacy multiple (item (g) divided by item (h)).

38. A regulated institution must publish the information specified in paragraph 37 so that it is readily accessible to both policyholders and other market participants.

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5 An asset will not be counted as an asset in Australia for the purpose of this paragraph if *Prudential Standard GPS 120 Assets in Australia* excludes it from being an asset in Australia for the purpose of paragraph 28(a) of the Act, or it is not otherwise an asset in Australia within the meaning of paragraph 28(a) of the Act.

6 As provided for in paragraph 34, 'net assets in Australia' is the amount of assets in Australia that exceeds the liabilities in Australia (adjusted for any surplus or deficit of technical provisions relative to those required by GPS 320).

39. A regulated institution must not disclose any supervisory adjustment included in the PCR.

40. Compliance with paragraphs 37 and 38 by Level 2 insurance groups does not replace the obligation of insurers to comply with the disclosure requirements of this Prudential Standard. However, the parent entity of the Level 2 insurance group may make the disclosures required by this Prudential Standard on behalf of each insurer within the group.

Reductions in capital base

41. A regulated institution must obtain APRA's written consent prior to making any planned reduction in its capital base. APRA's consent may be subject to conditions.

42. A reduction in a regulated institution's capital base includes, but is not limited to:

    (a) a share buyback;

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

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

    (d) payment of dividends on paid-up ordinary shares that exceed a regulated institution's after-tax earnings (as reported to APRA in the regulated institution's **statutory accounts**), after including any payments on more senior capital instruments, in the financial year[7] to which they relate; and

    (e) dividend or interest payments (whether whole or partial) on Additional Tier 1 or Tier 2 capital that exceed a regulated institution's after-tax earnings (as reported to APRA in the regulated institution's statutory accounts), including any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year[8] to which they relate.

43. A regulated institution proposing a capital reduction must provide APRA with an updated ICAAP report incorporating the proposed reduction. The regulated institution must satisfy APRA that its capital base, after the proposed reduction, will remain adequate for its future needs.

Reductions in capital for run-off insurers

44. This paragraph applies to **run-off insurers** planning a reduction in capital. The insurer must submit to APRA:

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7 As defined in GPS 112.

8 As defined in GPS 112.

(a) documents clearly setting out and evidencing its current financial position; and

(b) documents setting out the projected capital position with insurance liabilities valued in accordance with the methodology set out in GPS 320, except that the valuation must demonstrate that the tangible assets of the insurer, after the proposed capital reduction, are sufficient to cover its insurance liabilities to a 99.5 per cent level of sufficiency, plus any other liabilities, as calculated by its **Appointed Actuary**.[9]

Category C insurers

45. Any repatriation of assets in Australia, whether direct or indirect, by a Category C insurer that will result in a reduction in its net assets in Australia must be subject to APRA's prior consent consistent with the requirements of paragraphs 41 to 43.[10]

46. Paragraph 45 does not apply to any repatriation of assets in Australia out of the current year profits of a Category C insurer where the assets being repatriated to the head office of the Category C insurer or any other branch or related entity[11] of the Category C insurer do not exceed the Category C insurer's after-tax earnings in the year to which they relate (i.e. a repatriation of assets not wholly or partly funded from retained earnings).

Materiality

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

Notification requirements

48. A regulated institution must inform APRA as soon as practicable of:

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

(b) any significant departure from its ICAAP; or

(c) any significant adverse changes in the capital base or PCR.

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9 Where an insurer does not have an Appointed Actuary, the insurer must ensure that the actuary engaged to provide this valuation meets the fit and proper criteria applicable to an Appointed Actuary under *Prudential Standard GPS 520 Fit and Proper*.

10 For example, the head office of a Category C insurer might cause a liability of another offshore branch to become a liability of the Category C insurer in Australia. If this change is unfunded, there will effectively be a weakening of the net assets in Australia of the Category C insurer but not an actual direct repatriation of assets. APRA will view this as amounting to an indirect repatriation of assets from Australia.

11 As defined in GPS 114.

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

Adjustments and exclusions

49. APRA may, by notice in writing to a regulated institution, adjust or exclude a specific requirement in this Prudential Standard in relation to that regulated institution.

Transition

50. On application by a regulated institution, APRA may grant transitional relief from the obligation for the regulated institution to comply with any requirement in this Prudential Standard up until 31 December 2014.