



Prudential Standard GPS 114

Capital Adequacy: Asset Risk Charge

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 asset risks associated with their activities. 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 Asset Risk Charge is the minimum amount of capital required to be held against asset risks. The Asset Risk Charge relates to the risk of adverse movements in the value of a fund's on-balance sheet and off-balance sheet exposures. Asset risk can be derived from a number of sources, including market risk and credit risk.

This Prudential Standard sets out the method for calculating the Asset Risk Charge. This charge is one of the components of the Standard Method for calculating the Prudential Capital Requirement for general insurers and Level 2 insurance groups.

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 Definitions (GPS 001)*.

Where a requirement is made in respect of 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.

Asset Risk Charge

5. This Prudential Standard sets out the method for calculating the **Asset Risk Charge** for a regulated institution using the **Standard Method** to determine its **prescribed capital amount**.
6. The Asset Risk Charge relates to the risk of an adverse movement in a regulated institution's **capital base** due to credit or market risks. Both assets and liabilities may be affected. Off-balance sheet exposures may also be affected.

Level 2 insurance groups

7. Certain adjustments to the methodologies and calculations in this Prudential Standard apply to Level 2 insurance groups. These adjustments are set out in Attachment A.

Asset Risk Charge calculation

8. The Asset Risk Charge is calculated as:
 - (a) the **aggregated risk charge component** determined in accordance with paragraph 9; less
 - (b) any **tax benefits** determined in accordance with paragraphs 12 to 14.

Aggregated risk charge components

9. A regulated institution must calculate the **risk charge components**, as defined in paragraph 10, by considering the impact on the capital base of the regulated institution of a range of stresses. These risk charge components are then aggregated using the formula set out in paragraphs 71 to 73, which allows for the likelihood of the stress tests occurring simultaneously. The result of applying the formula is defined as the aggregated risk charge component..

Risk charge components

10. The risk charge components are calculated by determining the fall in the capital base of the regulated institution of seven stress tests:
 - (a) **real interest rates** determined in accordance with paragraphs 25 to 30;
 - (b) **expected inflation** determined in accordance with paragraphs 31 to 34;
 - (c) **currency** determined in accordance with paragraphs 35 to 37;
 - (d) **equity** determined in accordance with paragraphs 38 to 41;
 - (e) **property** determined in accordance with paragraphs 42 to 46;
 - (f) **credit spreads** determined in accordance with paragraphs 47 to 58; and
 - (g) **default** determined in accordance with paragraphs 59 to 70.

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

11. For the purposes of paragraph 10, no risk charge component can be negative. Therefore, if there is no fall in the capital base of the regulated institution due to the application of the stresses, the risk charge component is assumed to be zero.

Tax benefits

12. The risk charge component for each stress test must be calculated so that no value is attributed to any tax benefits that may result from the stress test. However, tax benefits may be deducted from the aggregated risk charge components.

13. The tax benefits deducted from the aggregated risk charge component are the tax benefits resulting from the stress tests, reduced to allow for the reduction in Asset Risk Charge due to the aggregation formula. The tax benefits are therefore calculated as:

$$\text{tax benefits from stress tests} \times \frac{\text{aggregated risk charge component}}{\text{sum of risk charge components}}$$

14. The tax benefits from paragraph 13 must be recognised as a deduction from the asset risk charge only if tax legislation allows them to be absorbed by the existing deferred tax liabilities. For this purpose, the deferred tax liabilities are those liabilities (if any) that remain after netting off the deferred tax assets and liabilities in the calculation of the deductions from Tier 1 capital in *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (GPS 112)*.

Assets and liabilities to be stressed

15. In determining each risk charge component, a regulated institution must include the effective exposure of the regulated institution's assets and liabilities to each of the risks if the exposure is impacted by the stress test. Some assets and liabilities may have effective exposures to multiple risks.
16. The following assets and liabilities must not be stressed:
- (a) assets whose value must be deducted from the capital base (e.g. goodwill in subsidiaries) in GPS 112; and
 - (b) any part of assets in excess of the asset concentration limits specified in *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge*.
17. In addition to paragraph 16, a regulated institution that is an employer sponsor of a defined benefit superannuation fund does not need to reassess any deficit in the fund as a result of the seven stress tests, unless the regulated institution has provided a guarantee in relation to the benefits.
18. The stress tests must be applied to the fair value of each of the regulated institution's assets. The risk charge component for each asset is the value reported in the regulated institution's **statutory accounts** less the stressed value of the asset.

Off-balance sheet exposures

19. A regulated institution can be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet. A regulated institution must use effective exposure for any off-balance sheet exposures of the regulated institution. Detailed information on the treatment of off-balance sheet exposures is set out in Attachment B.

Collateral and guarantees

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

Treatment of specific asset classes

21. Hybrid assets such as convertible notes must be split into their interest-bearing and equity/option exposures. A regulated institution must consider the changes in value of the two exposures separately for each of the asset risk stresses.
22. A security which is the subject of a repurchase or securities lending agreement must be treated as if it were still owned by the lender of the security. Any counterparty risk that arises from the transaction must be recognised in the default stress.
23. Term deposits issued by an **ADI** must be treated in the same way as a corporate bond issued by the ADI. If the ADI guarantees a minimum amount on early redemption, this minimum amount can be recognised as a floor to the stressed value of the asset in each of the real interest rates and expected inflation stresses. In the credit spreads stress, the minimum amount can be recognised as a floor to the stressed value, but it must be reduced by multiplying it by (1 – default factor).

Extended Licence Entity

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

Real interest rates stress

25. This stress measures the impact on the capital base of a regulated institution from changes in real interest rates.
26. Real interest rates are the portion of the nominal risk-free interest rates that remain after deducting expected CPI inflation.
27. All assets and liabilities whose values are dependent on real or nominal interest rates must be revalued using the stressed real or nominal rates.
28. The stress adjustments to real interest rates are determined by multiplying the nominal risk-free interest rates by 0.25 (upward stress) or by -0.20 (downward stress). The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to real yields if these are used explicitly in the valuation of assets or liabilities (e.g. inflation indexed bonds).
29. The maximum stress adjustment is 200 basis points in either direction.

30. The regulated institution must calculate the impact on the capital base of an upwards movement and a downwards movement in real interest rates. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 71.

Expected inflation stress

31. This stress measures the impact on the capital base of changes to expected Consumer Price Index (CPI) inflation rates. The expected inflation stress also affects nominal interest rates.
32. In each scenario, assets and liabilities whose values are dependent on expected inflation or nominal interest rates must be revalued using the stressed expected inflation or nominal interest rates.
33. The stress adjustments to expected inflation rates are an increase of 125 basis points and a decrease of 100 basis points. The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to any explicit expected inflation rates used in the valuation of assets or liabilities.
34. The regulated institution must calculate the impact on the capital base of an upward movement and downward movement in expected inflation or nominal interest rates. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 71.

Currency stress

35. This stress measures the impact on the capital base of changes in foreign currency exchange rates.
36. The regulated institution must calculate the impact on the capital base of both an increase and a decrease of 25 per cent in the value of the Australian dollar against all foreign currencies. In each of these scenarios, the Australian dollar must be assumed to move in the same direction against all foreign currencies. The impact of each calculation cannot be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 71.
37. An increase in the capital base arising from a movement of the Australian dollar against one foreign currency cannot be used as an offset to reductions in the capital base arising from the movement of the Australian dollar against other foreign currencies.

Equity stress

38. This stress measures the impact on the capital base of a fall in equity and other asset values. This stress applies to both listed and unlisted equity assets and to any other assets that are not considered in any of the other asset risk stresses. This stress also includes an increase to equity volatility. The volatility stress

will affect assets whose value is affected by movements in equity volatility (e.g. equity derivatives).

39. For listed equities, the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by 2.5 per cent. The same proportionate fall in value must be applied to both Australian and overseas listed equities.
40. For unlisted equities and other assets, the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by three per cent. The same proportionate fall in value must be applied to all unlisted equities and other assets.
41. For assets whose value is affected by movements in equity volatility, an addition of 15 per cent must be made to the forward-looking equity volatility parameter for all durations.

Property stress

42. This stress measures the impact on the capital base of changes in property and infrastructure asset values.
43. The fall in value of the assets must be determined by increasing the rental yield for property assets or earnings yield for infrastructure assets by 2.75 per cent.
44. For property assets, the rental yields are to be based on the most recent leases in force and are determined net of expenses.
45. For infrastructure assets, the yields to be used are the earnings yields before tax.
46. The rental yields and fall in value can be determined separately for each asset, or on a portfolio basis.

Credit spreads stress

47. This stress measures the impact on the capital base of an increase in credit spreads and the risk of default.
48. This stress applies to interest bearing assets, including cash deposits and floating rate assets. Credit derivatives and zero-coupon instruments such as bank bills must also be included.
49. The stressed value of an asset must be determined by adding the spread specified in the table below to the current yield on the asset and then multiplying the reduced value of the asset by $(1 - \text{default factor})$. The credit spreads and default factors depend on the **counterparty grade** and the nature of the asset:

Counterparty grade	Default (%)	Bonds¹ spread (%)	Structured/ securitised spread (%)	Re-securitised spread (%)
1 (government)	0.0	0.0	0.0	0.0
1 (other)	0.2	0.6	1.0	1.8
2	0.6	0.8	1.4	2.4
3	1.2	1.2	2.0	3.2
4	3.0	1.6	2.5	4.0
5	6.0	2.0	3.0	5.0
6	10.0	2.5	3.5	6.0
7	16.0	3.0	4.5	7.5

50. A securitised/structured asset is an asset that provides an exposure to a pool or portfolio of assets or risks. This is typically in the form of a tranching exposure and includes credit related securitisation exposures and insurance linked securities. Examples of these assets include Residential Mortgage Backed Securities (RMBS), Asset-backed Securities (ABS) and Catastrophe Bonds.
51. Exposures to untranching pools of multiple reference entities, assets or risks must be treated on a 'look through' basis. A regulated institution may apply to APRA to treat these exposures as a securitised asset using the external rating of the untranching pool or the weighted average rating of the constituents.
52. Credit wrapped bonds must be treated as a securitised asset if the external rating of the bond makes some allowance for the structural protection offered by the credit wrap. Otherwise the bond must be treated as a bond with no credit wrap.
53. A re-securitisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranching and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more re-securitisation exposures is a re-securitisation exposure.
54. For floating rate assets, the increase in yield must be assumed to apply for the period until a regulated institution has the contractual right to redeem the asset at face value. For at-call floating rate assets, only the default factor must be applied. For floating rate assets that are not immediately redeemable, both the credit spread and default factors must be applied.

¹ and other non-securitised assets.

55. For fixed rate assets where the regulated institution has a contractual right to early redemption of the asset, the stressed value of the asset is subject to a minimum of the guaranteed redemption value multiplied by (1 – default factor).
56. Unsecured loans that have a 100 per cent charge applied in the default stress in accordance with paragraph 65 must be assumed to be unaffected by the credit spreads stress.
57. The ‘government’ category applies to assets guaranteed by the Commonwealth Government and assets guaranteed by foreign governments that have a counterparty grade of 1 and are denominated in the official or national currency of the guarantor.
58. Assets guaranteed by an Australian state or territory government may be rated up one grade. Assets with counterparty grade 1 can be treated as grade 1 (government) and assets with counterparty grade 2 can be treated as grade 1 (other).

Default stress

59. This stress applies to reinsurance assets, over the counter derivatives, unpaid premiums, and all other credit or counterparty exposures that have not been affected by the credit spreads stress.
60. This stress includes the risk of counterparty default. A regulated institution must determine risk charges for the default stress for the risk of counterparty default on exposures that include (but are not limited to) reinsurance assets, unpaid premiums, futures and options, swaps, hedges, warrants, forward rate and repurchase agreements.
61. The default factors are specified in the following table. These factors apply to all assets affected by this stress, with the exception of certain types of assets specified in later paragraphs in this section.

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

62. For the purpose of the default stress, reinsurance assets are to be the central estimate of reinsurance assets as measured in accordance with *Prudential Standard GPS 320 Actuarial and Related Matters (GPS 320)*. For other assets,

the default factor must be applied to the amount of loss that would be incurred if the counterparty defaulted and no recovery was made.

63. For unpaid premiums the factors are 4 per cent for premiums due less than 6 months previously and 8 per cent for other premiums due.
64. For unclosed business a 4 per cent factor applies. Unclosed business is business that has been accepted by the regulated institution but for which there is insufficient information available to report an exact amount of premium.
65. The following types of unsecured loans have a 100 per cent default factor applied:
 - Loans to directors of the regulated institution, or their spouses;
 - Loans to directors of related bodies corporate, or their spouses;
 - Loans to a parent or related company that are not on commercial terms; and
 - Loans to employees exceeding \$1,000.
66. Assets guaranteed by an Australian state or territory government may be rated up one grade. Assets with counterparty grade 1 can be treated as grade 1 (government) and assets with counterparty grade 2 can be treated as grade 1 (other).

Reinsurance recoverables due from non-APRA-authorised reinsurers

67. Reinsurance recoverables from non-APRA-authorised reinsurers are subject to the default stress such that the factors in paragraph 61 are stepped down a grade (e.g. for a grade 4 non-APRA-authorised reinsurer the factor used would be that applying for a grade 5 APRA-authorised reinsurer).
68. The default factors for reinsurance recoverables from non-APRA-authorised reinsurers arising under reinsurance contracts incepting on or after 31 December 2008 specified below apply (in replacement of those specified in paragraph 61) to each reinsurance recoverable on and from the second annual balance date after the event giving rise to the reinsurance recoverable occurred.² This treatment applies only to the extent that the reinsurance recoverables are not supported by collateral, a guarantee or a letter of credit as specified in Attachment C of this Prudential Standard.³

² For a claims made policy, the reference to “event” is to the date a claim notification was made.

³ For the avoidance of doubt, the default factors specified in paragraph 68 apply to the amount of relevant reinsurance recoverables that exceeds the amount of available collateral, guarantee or letter of credit.

Counterparty grade	Default factor (%)
1	20
2	40
3	60
4	100
5	100
6	100
7	100

69. A default factor of 100 per cent applies to a reinsurance recoverable due from a non-APRA-authorized reinsurer if:
- the recoverable has become a receivable (i.e. it is due and payable); and
 - the receivable is overdue for more than six months since a request for payment has been made to the reinsurer; and
 - there is no formal dispute between the insurer and reinsurer in relation to that receivable.⁴
70. For the purposes of determining the amount of a reinsurance recoverable, if there is an offsetting arrangement between the regulated institution and the reinsurer that results in premium being withheld by the insurer in lieu of claim payments, the withholding of that premium is taken to be payment to the extent any claims payments are overdue. However, if there is a requirement for offsets to be approved by the reinsurer the date of the offset request is taken to be the date that approval is given.

Aggregation formula

71. The aggregated risk charge component is calculated as:

$$A_{default} + \sqrt{\sum_{x,y} \text{Max}(0, \text{Corr}_{x,y} \cdot A_x \cdot A_y \cdot \text{sign}(x) \cdot \text{sign}(y))}$$

where

- A_x is the risk charge component for asset risk stress x ;
- A_y is the risk charge component for asset risk stress y ;

⁴ Any dispute between the insurer and reinsurer in relation to a receivable arising from a reinsurance recoverable would have been taken into account in the valuation processes provided for under GPS 320.

- (c) $\sum_{x,y}$ is the sum over all combinations of asset risk stresses, excluding the default stress;
- (d) $Corr_{x,y}$ is the correlation between asset risk stresses x and y;
- (e) $sign(x)$ is 1 for the equity, property and credit spreads stresses. For the real interest rates and expected inflation stresses, $sign(x)$ is 1 if the stress is a decrease in rates, otherwise it is -1. For the currency stress, $sign(x)$ is 1 if the stress is a depreciation of the Australian dollar against foreign currencies, otherwise it is -1; and
- (f) $sign(y)$ is defined in the same way as $sign(x)$.

72. The correlation matrix is:

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

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

Adjustments and exclusions

74. 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

75. 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.

Attachment A

Level 2 insurance groups

1. The following adjustments to the methodologies and calculations in the main body of this Prudential Standard must be applied by the Level 2 insurance group:

Tax benefit

- (a) Unlike insurers, Level 2 insurance groups can rely on tax benefits of other entities within the Level 2 insurance group. However, a Level 2 insurance group cannot recognise tax benefits whose value is contingent on the tax benefits being used by entities outside the Level 2 insurance group;

Currency stress

- (b) Level 2 insurance groups must make all consolidation adjustments for intra-group arrangements before applying the currency stress outlined in the main body of the Prudential Standard;

Default stress

- (c) Level 2 insurance groups must make all consolidation adjustments for intra-group arrangements before applying the stress outlined in the main body of the Prudential Standard;
 - (d) The modification to the default stress relating to reinsurance recoverables from non-APRA-authorized reinsurers, as set out in paragraph 67 of the main body of the Prudential Standard, does not apply to the reinsurance recoverables of the **international business** of the Level 2 insurance group⁵; and
 - (e) The modification to the default stress relating to reinsurance recoverables from non-APRA-authorized reinsurers, as set out in paragraph 68 of the main body of the Prudential Standard, does not apply to the reinsurance recoverables of the international business of the Level 2 insurance group⁶.
2. A Level 2 insurance group must consult with APRA prior to entering into a material securitisation transaction in order to reduce the Asset Risk Charge.
 3. A Level 2 insurance group may use a best endeavours basis to determine the identification of asset or counterparty exposures for international business. The best endeavours basis must use information held by entities within the Level 2

⁵ For clarity, this means that the reinsurance recoverables from non-APRA-authorized reinsurers of entities within the Level 2 insurance group that are not insurers are not stepped down a grade for the default stress test.

⁶ For clarity, this means that the reinsurance recoverables from non-APRA-authorized reinsurers of entities within the Level 2 insurance group that are not insurers are not stepped down a grade for the default stress test.

insurance group, or otherwise publicly available information, in a manner consistent with the group's documented credit risk management policies.

Attachment B**Off-balance sheet exposures**

1. A regulated institution can be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet.
2. The principle of considering the effective exposure of the regulated institution to asset risks must be applied to any off-balance sheet exposures of the regulated institution. Changes to the capital base arising from off-balance sheet exposures must be recognised in each of the asset risk stresses.
3. As a general rule, a regulated institution must not be exposed to a counterparty for an unlimited amount and any exposure must be for a finite period. An exception to this rule is where a potential credit exposure results from reinsurance of an insurance contract that is required by law to be unlimited. Before a regulated institution does enter into an arrangement with a counterparty that does not have appropriate limits, it must:
 - (a) notify APRA;
 - (b) explain how this arrangement complies with its Risk Management Strategy; and
 - (c) explain how it will be valued for the purposes of capital adequacy calculations.

Such an exposure may cause APRA to review the regulated institution's prescribed capital amount and adjust this in accordance with paragraph 31 of *Prudential Standard GPS 110 Capital Adequacy (GPS 110)*.

Direct credit substitutes

4. To the extent that a regulated institution has issued instruments of the following kind:
 - (a) guarantees (including written put options serving as guarantees);
 - (b) letters of credit; or
 - (c) any other credit substitute (other than insurance) in favour of another party,

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

Derivatives

5. Derivatives include forwards, futures, swaps, options and other similar contracts. Derivatives expose a regulated institution to the full range of investment risks, even though in many cases there may be no, or only a very small, initial outlay.
6. Changes to the capital base that would arise from changes in the value of derivatives (and other hedging instruments) must be included in the risk charges arising from each of the asset risk stresses.
7. A risk charge must be applied to the fair value of over the counter derivatives in the default stress to allow for the risk of counterparty default. This is in addition to any charges that would arise from other asset risk stresses.
8. A regulated institution must consult with APRA prior to entering into derivative contracts other than those over:
 - (a) equities;
 - (b) interest rates; and
 - (c) foreign exchange.

Such an exposure may cause APRA to review the regulated institution's prescribed capital amount and adjust this in accordance with paragraph 31 of GPS 110.

Surety bonds

9. A different approach to that set out in paragraph 4 of this Attachment is available for surety bonds issued by the regulated institution. The regulated institution has the choice of either:
 - (a) treating any surety bonds the insurer has issued as a type of direct credit substitute. In this case, 25 per cent of the value of the asset over which the surety has been written must be included in the assets at risk for the asset risk charge. The type of underlying asset will determine which asset risk stresses are to be applied; or
 - (b) seeking written approval from APRA to treat any surety bonds the insurer has issued as if they were an insurance risk (for the purposes of meeting the requirements of the prudential standards only). This would require the insurer to include surety bond exposures within the insurer's assessment of insurance liabilities, as determined under GPS 320, and to apply the relevant capital factors specified in *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge*. For the purpose of calculating net outstanding claims liabilities and net premiums liabilities (as determined under GPS 320) the regulated institution may treat any risk mitigation arrangement as if it were reinsurance. A regulated institution seeking APRA's approval for this approach would need to include with its

application a written confirmation from the regulated institution's Appointed Actuary that that person is able to appropriately measure the risk of the surety bond business within the regulated institution's insurance liabilities.

The regulated institution must use the same approach for all surety bonds issued by it, and apply that approach consistently over time.

10. For the purposes of paragraph 9 of this Attachment, a surety bond means an undertaking given by an regulated institution at the request of a person (Customer) pursuant to an agreement (Surety Agreement) between the regulated institution and the Customer made in the following circumstances:
 - (a) the Customer enters into the Surety Agreement in order to enable the Customer to meet a requirement of another agreement (Principal Agreement) between the Customer, or a person associated with the Customer, and a person other than the regulated institution (Principal);
 - (b) under the surety bond, the regulated institution undertakes to make a payment to, or perform an obligation for the benefit of, the Principal or another person nominated by the Principal (Beneficiary) in the circumstances specified in the surety bond;
 - (c) the surety bond is issued to the Principal or the Beneficiary in relation to or in connection with an obligation owed by the Customer, or a person associated with the Customer, to the Principal under the Principal Agreement being an obligation which:
 - (i) is a performance obligation or contains an element of performance on the part of the Customer, or a person associated with the Customer; and
 - (ii) does not relate solely to an obligation on the part of the Customer, or a person associated with the Customer, to pay a stipulated amount to the Principal in the event that a specified event occurs; and
 - (d) under the Surety Agreement, the Customer is liable to the regulated institution if the regulated institution makes a payment or incurs a liability to the Principal or the Beneficiary under the surety bond.

Attachment C

Treatment of collateral and guarantees as risk mitigants

1. The impact of applying the asset risk stress tests may be reduced where the regulated institution holds certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk.
2. For a regulated institution where the assets in question are reinsurance recoverables due from non-APRA-authorized reinsurers, different rules regarding treatment of collateral and guarantees apply (refer to paragraphs 6 to 10 of this Attachment).

Collateral

3. Collateral held against an asset may be considered in place of the asset if this would reduce the asset risk charge. Where the fair value of the collateral does not cover the full value of the asset, the collateral can only replace that part of the asset that is covered by the collateral.
4. Collateral can be recognised in place of an asset only to the extent that it takes the form of a registered charge, registered mortgage or other legally enforceable security interest in, or over, an **eligible collateral item**. The eligible collateral item must also be held for a period not less than that for which the asset is held.

Guarantees

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

Collateral, guarantees and letters of credit in respect of reinsurance recoverables due from non-APRA-authorized reinsurers

6. Where a regulated institution possesses recognised collateral in Australia against reinsurance recoverables due from a non-APRA-authorized reinsurer, it may, in the default stress, apply the default factor relevant to the collateral to the value of the reinsurance recoverables (instead of applying the default factor that would otherwise apply to the reinsurance recoverables). For the purposes of this paragraph, collateral is recognised only:
 - (a) to the extent that it takes the form of:
 - (i) assets held in Australia which form part of a trust fund maintained by a trustee resident in Australia for the benefit of the insurer;

- (ii) deposits held by the insurer in Australia, which are controlled by the insurer in Australia, made by the non-APRA-authorized reinsurer;
 - (iii) a combination of the two forms of collateral specified in paragraphs (i) and (ii); or
 - (iv) any other form of collateral as may be approved by APRA in writing in a particular case; and
- (b) if it provides effective security against liabilities arising under the reinsurance contract; and
- (c) if it is not available for distribution to creditors of the reinsurer other than the insurer in the event of the insolvency of the reinsurer.
7. Where the fair value of the collateral does not cover the full value of the reinsurance recoverables, only that part of the value of the reinsurance recoverables that is covered by collateral may be assigned the default factor applicable to the collateral.
8. Where a regulated institution possesses a guarantee or letter of credit in respect of the reinsurance recoverables due from a non-APRA-authorized reinsurer, the default factor to be used is that applicable to the guarantor or the issuer of the letter of credit, as the case may be. This paragraph applies only if each of the following conditions is satisfied:
- (a) the guarantor or issuer of the letter of credit is an ADI or, in the case of a **Category E** insurer, its parent entity or other related entity provided the entity has a counterparty grade of 1, 2 or 3;
 - (b) the guarantee or letter of credit is explicit, unconditional and irrevocable;
 - (c) the guarantor or issuer of the letter of credit is obliged to pay the insurer in Australia; and
 - (d) the obligation of the guarantor or issuer of the letter of credit to pay the insurer is specifically linked to performance of the reinsurance contract or contracts under which the reinsurance recoverables arise.
9. Except in the case of a Category E insurer, a guarantee or letter of credit provided to an insurer by its parent entity or other related entity is not eligible for the treatment provided for in this paragraph.
10. The collateral, guarantee or letter of credit referred to in paragraphs 6 to 8 of this Attachment must be effective for the expected period for payment of claims under the reinsurance contract under which the reinsurance recoverables arise. If this is impractical, the collateral, guarantee or letter of credit must be effective for a period of at least 24 months and must include a termination provision requiring the issuer to give the insurer 12 months written notice of the issuer's intention to terminate the collateral, guarantee or letter of credit.

Attachment D**Extended Licensed Entity (ELE)**

1. In certain circumstances, a regulated institution may choose to hold assets in a SPV or other related entity, rather than on its own balance sheet. Where a regulated institution receives approval under paragraph 2 of this Attachment, the regulated institution will be able to determine its Asset Risk Charge based on the individual assets and liabilities of the related entity, rather than simply on the regulated institution's direct exposure to that entity. This treats the activities of the regulated entity and the related entity as comprising an Extended Licensed Entity (ELE).
2. The extent to which the risk of a regulated institution's exposure to a related entity is commensurate with the underlying holdings of that entity, depends on the extent to which the regulated institution has control over, or is integrated with the entity, as well as on the existence of material third party liabilities of the entity. The regulated institution must consider any potential complications under a scenario where underlying asset holdings must be liquidated during financial stress.
3. Subject to the specific requirements set out in paragraph 4 of this Attachment, a regulated institution may apply to APRA to have one or more related entities approved as part of its ELE. Once approved, APRA will allow the regulated institution to 'look through' the legal structures involved, and to 'consolidate' the balance sheet of the related entity with its own, for the purposes of determining the Asset Risk Charge. In effect, this allows the regulated institution to treat its own balance sheet and that of the approved related entity as a single entity for the purpose of calculating that charge.
4. In deciding whether to approve an entity as part of a regulated institution's ELE, APRA will have regard to the following criteria in respect of the relationship between the regulated institution and the related entity:
 - (a) the related entity must be wholly owned and controlled by the regulated institution, with a Board of directors/trustees that is comprised entirely of members of the regulated institution's Board or senior management;
 - (b) the regulated institution must demonstrate to APRA that there are no legal or regulatory barriers (e.g. restrictions imposed by law or a regulator in a foreign jurisdiction) to the transfer of the assets back to the regulated institution;
 - (c) the regulated institution's risk management systems and controls must apply fully to the operations of the related entity. The senior management of the regulated institution must be in a position to monitor the operations of the related entity to the same extent as the operations of the regulated institution itself. Systems for monitoring and maintaining control over the related entity must be included within the internal and external audit programs of the regulated institution;

- (d) the regulated institution must be able to furnish stand-alone accounting records for the related entity, and provide APRA with full and unfettered access to this information at any time (including during on-site visits);
- (e) where the related entity holds or invests in assets on behalf of the regulated institution, the related entity must have no material third party liabilities, other than exempt tax liabilities and employee entitlements;
- (f) where the related entity borrows on behalf of the regulated institution, all funds must be on-lent directly to the regulated institution; and
- (g) the related entity must not conduct any business that the regulated institution would otherwise be prevented from conducting under the Act.