



Prudential Standard GPS 117

Capital Adequacy: Asset Concentration Risk Charge

Objectives 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 asset concentration in 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 Concentration Risk Charge is the minimum amount of capital required to be held against asset concentration risks. The Asset Concentration Risk Charge relates to the risk of a general insurer and a Level 2 insurance group's concentration in particular assets resulting in adverse movements in the general insurer and Level 2 insurance group's capital base.

This Prudential Standard sets out the method for calculating the Asset Concentration Risk Charge. This charge is one of the components of the Standard Method for calculating the Prudential Capital Requirement for 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.
5. For the purposes of this Prudential Standard:
 - (a) **eligible collateral item** means cash, government securities or debt obligations where the obligor has a counterparty rating of Grade 1, 2 or 3 as defined in Attachment C of GPS 001.
 - (b) **non-reinsurance exposures** are the on- and off- balance sheet exposures of an insurer or Level 2 insurance group other than exposures to a reinsurer;
 - (c) **reinsurance exposures** are the on- and off- balance sheet exposures of an insurer or Level 2 insurance group to **reinsurance assets**; and
 - (d) **residual maturity** is the remaining time until the expiration or the repayment of a financial instrument;

Asset Concentration Risk Charge principles

6. This Prudential Standard sets out the method for calculating the **Asset Concentration Risk Charge** for a regulated institution using the Standard Method to determine its **prescribed capital amount**.
7. The Asset Concentration Risk Charge relates to the risk of a regulated institution's concentrations in particular assets resulting in adverse movements in the regulated institution's capital base.

8. For the purposes of the Asset Concentration Risk Charge, exposures include all on- and off-balance sheet exposures of the regulated institution. On-balance sheet exposures of the regulated institution should be net of any deductions expressly related to the item that are required under *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital*.
9. All exposures should be converted to Australian dollars (AUD) as at the reporting date.
10. The amount of any exposure which is subject to the Asset Concentration Risk Charge must not be subject to the **Asset Risk Charge** as defined in *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge*. The portion of the exposure which is not subject to the Asset Concentration Risk Charge must be subject to the Asset Risk Charge.

Definitions

11. Two or more counterparties will form a **group of related counterparties** if they are linked by:
 - (a) cross guarantees;
 - (b) common ownership or management;
 - (c) the ability of a counterparty to exercise control (defined in accordance with the **Australian Accounting Standards**) over the other(s), whether direct or indirect;
 - (d) financial interdependency such that the financial soundness of any of them may affect the financial soundness of the other(s); or
 - (e) other connections or relationships exist between counterparties, which in the regulated institution's assessment, constitute exposure to the counterparties as a single risk.
12. In respect of any overseas entities within a Level 2 insurance group carrying on **international business**, identification of asset or counterparty exposures is to be carried out on a best endeavours basis using information held by entities within the Level 2 insurance group, or otherwise publicly available information, in a manner consistent with the group's documented credit risk management policies.
13. For the purposes of the limits in respect of non-reinsurance exposures in Attachment A, exposures are classified depending on whether or not the counterparty is part of an APRA-regulated group. A counterparty is part of an APRA-regulated group if the ultimate parent is:
 - (a) authorised by APRA under the Act as a general insurer or **authorised NOHC**; or
 - (b) authorised by APRA under the *Banking Act 1959* as an **authorised deposit-taking institution (ADI)** or authorised NOHC of an ADI; or

- (c) registered by APRA under the *Life Insurance Act 1995* as a life company.
14. For the purposes of the limits in Table 2 (c) of Attachment A, exposures are classified as either short-term or long-term. Short-term means a **residual maturity** of less than or equal to one year. Long-term means perpetual or a residual maturity of greater than one year.

Asset Concentration Risk Charge calculation

15. The Asset Concentration Risk Charge for each exposure of a regulated institution to a particular asset, counterparty or group of related counterparties is the amount by which this exposure exceeds the limits set out in Attachment A. Separate treatment applies for reinsurance exposures and non-reinsurance exposures. A differing treatment also applies for collateral, guarantees and reinsurance recoverables from **non-APRA-authorised reinsurers** as set out in paragraphs 19 to 32.
16. For exposures to unrelated parties that are part of an APRA-regulated group (Table 2 (c) of Attachment A), the Asset Concentration Risk Charge is calculated as the maximum amount after applying each of the sub-limits to the relevant exposures.
17. In the case of reinsurance exposures (both on-balance and off-balance sheet) to a group of related counterparties, exposures need to be compared and aggregated against each of the limits in Table 1 of Attachment A. This means that exposures within the group that have a counterparty grade of 5 or below are compared to the limit (Table 1 (c)) and an Asset Concentration Risk Charge is determined. The reinsurance exposures of grade 5 and below that are not part of the Asset Concentration Risk Charge are then added with those with a counterparty grade of 4 and compared to the limit (Table 1(b)), and a further Asset Concentration Risk Charge is determined. The reinsurance exposures of grade 4 and below that are not part of the Asset Concentration Risk Charge are then added to those with a counterparty grade above 4 and compared to the limit (Table 1(a)). The total Asset Concentration Risk Charge for the reinsurance exposure is the sum of the above three risk charges.
18. The total Asset Concentration Risk Charge is the sum of each resulting risk charge for each exposure of the regulated institution.

Treatment of collateral and guarantees as risk mitigants

19. A regulated institution that holds certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk may apply a different approach to determining the Asset Concentration Risk Charge for that asset. Where the assets in question are **reinsurance recoverables** due from non-APRA-authorised reinsurers, different rules regarding treatment of collateral and guarantees apply (refer to paragraphs 25 to 32).

Collateral

20. Subject to paragraph 22, where a regulated institution possesses eligible collateral against an asset (other than reinsurance recoverables due from non-APRA-authorised reinsurers), it may treat the underlying asset as an exposure to the eligible collateral item. This means that the asset is included in the limits in Attachment A with respect to the collateral, rather than the underlying counterparty.
21. For the purposes of paragraph 20, collateral is recognised only to the extent that it takes the form of a charge, mortgage or other security interest in, or over, an eligible collateral item. The eligible collateral item must be held for the period for which the asset is held.
22. Where the fair value of the collateral does not cover the full value of the asset, the collateral counterparty rating can only replace that part of the asset that is covered by the collateral. The remaining portion of the asset must be treated as an exposure to the underlying counterparty.

Guarantees

23. Subject to paragraph 24, where a regulated institution possesses an asset (other than reinsurance recoverables due from non-APRA-authorised reinsurers) that has been explicitly, unconditionally and irrevocably guaranteed for its remaining term to maturity by a guarantor with a counterparty rating (or for governments, the long-term foreign currency credit rating) of grade 1, 2 or 3, it may treat the underlying asset as an exposure to the counterparty providing the guarantee. This means that the asset is included in the limits in Attachment A with respect to the guarantee, rather than the underlying counterparty.
24. Guarantees provided to a regulated institution by its own parent or a related entity are not eligible for the treatment provided for in paragraph 23.

Reinsurance recoverables due from non-APRA-authorised reinsurers

Collateral

25. Subject to paragraphs 26, 27 and 30, where a regulated institution possesses eligible collateral in Australia against reinsurance recoverables due from a non-APRA-authorised reinsurer, it may elect to treat the reinsurance recoverable as an exposure to the eligible collateral. This means that the asset is included in the limits in Attachment A with respect to the collateral, rather than the underlying reinsurer.
26. For the purposes of paragraph 25, eligible 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;

- (ii) deposits held by the regulated institution in Australia made by the non-APRA-authorized reinsurer;
 - (iii) a combination of the two forms of collateral specified in subparagraphs (i) and (ii); or
 - (iv) any other form of collateral as may be approved by APRA in writing in a particular case;
- (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 regulated institution in the event of insolvency of the reinsurer.
27. Where the fair value of the collateral does not cover the full value of the reinsurance recoverables, only the part of the value of the reinsurance recoverables that is covered by collateral may be assigned the counterparty grade of the collateral. The remaining portion of the reinsurance recoverable must be treated as an exposure to the underlying reinsurer.

Guarantees

28. Subject to paragraph 30, where a regulated institution possesses a guarantee or letter of credit in respect of the reinsurance recoverables due from a non-APRA-authorized reinsurer, it may elect to treat the reinsurance recoverables as an exposure to the guarantor or the issuer of the letter of credit (as applicable). This means that the asset is included in the limits in Attachment A with respect to the guarantor or issuer of the letter of credit, rather than the underlying reinsurer. This paragraph applies only if:
- (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 rating of grade 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 regulated institution in Australia; and
 - (d) the obligation of the guarantor or issuer of the letter of credit to pay the regulated institution is specifically linked to performance of the reinsurance contract or contracts under which the reinsurance recoverables arise.
29. Except in the case of a Category E insurer, a guarantee or letter of credit provided to a regulated institution by its parent entity or other related entity is not eligible for the treatment provided for in paragraph 28.
30. The collateral, guarantee or letter of credit referred to in paragraphs 28 and 29 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 at least 2 years but be renegotiable each year to allow at least a year to identify alternative arrangements if the collateral, guarantee or letter of credit cannot be renegotiated.

31. Subject to paragraph 32, a regulated institution may elect to not apply the treatment for reinsurance recoverables from non-APRA-authorized reinsurers in paragraphs 25 and 28 and instead apply the counterparty grade of the non-APRA-authorized reinsurer in order to determine the Asset Concentration Risk Charge.
32. APRA may determine that a regulated institution must apply a specified treatment for:
 - (a) a particular reinsurance recoverable;
 - (b) a class of reinsurance recoverables;
 - (c) reinsurance recoverables from a particular non-APRA-authorized reinsurer;
 - (d) reinsurance recoverables from a class of non-APRA-authorized reinsurers;
 - (e) a particular collateral item, guarantee or letter of credit;
 - (f) a class of collateral items, guarantees or letters of credit; or
 - (g) a combination of sub-paragraphs (a), (b), (c), (d), (e) and (f).

In making this determination, APRA will have regard to the previous use by the regulated institution of paragraphs 25, 28 and 31, the level of reinsurance recoverables from non-APRA-authorized reinsurers, the resulting change in the Asset Concentration Risk Charge and any other relevant matters.

Adjustments and exclusions

33. If a large claim or aggregation of claims arising from a catastrophic event causes the outstanding reinsurance assets of a regulated institution to temporarily exceed the limits in Attachment A, the regulated institution may apply to APRA to vary the application of the limits for a specified period of time. APRA may grant written approval for such variation subject to conditions and may specify any period of time for such variation.
34. A regulated institution may apply to APRA to vary the application of the limits in Attachment A for a specified period of time for a specified asset or an asset of a specified class. In deciding whether to grant the application, APRA will have regard to the type of exposure, the term of the exposure, the ability for the regulated institution to mitigate the Asset Concentration Risk Charge by other means and any other matters which APRA considers relevant. APRA may grant written approval for such variation subject to conditions and may specify any period of time for such variation.

35. A regulated institution may apply to APRA to vary the application of all limits in Attachment A. In deciding whether to grant the application, APRA will have regard to:
- (a) the ultimate parent or any intermediate parent of the regulated institution and whether it is APRA-regulated;
 - (b) the risks insured by the regulated institution and whether third parties are involved in the insurance provided by the regulated institution; and
 - (c) whether the regulated institution is writing compulsory insurances, such as workers' compensation insurance, public liability insurance or professional indemnity insurance, to a group of practitioners that require such cover in order to practise.

Regulated institutions which meet any of the criteria above (i.e. APRA-regulated parent, third parties involved and/or compulsory insurances) are unlikely to be granted approval. APRA may grant written approval subject to conditions and may specify any period of time for such variation.

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

Transition

37. 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

1. This attachment sets out the Asset Concentration Risk Charge limits for exposures to single assets, counterparties and groups of related counterparties.

Table 1: Reinsurance exposures

	Exposure – reinsurance counterparty or group of counterparties	AUD limit
(a)	Exposures to reinsurers with a counterparty grade of 1, 2 or 3	No limit
(b)	Exposures to reinsurers with a counterparty grade of 4	50% of capital base
(c)	Exposures to reinsurers with a counterparty grade of 5, 6 or 7	25% of capital base

Table 2: Non-reinsurance exposures

	Exposure – asset, counterparty or group of counterparties	AUD limit
(a)	Governments with a counterparty grade 1 or 2	No limit
(b)	Related parties that are part of an APRA-regulated group	Greater of \$20 million and 100% of capital base
(c)	Unrelated parties that are part of an APRA-regulated group: <ul style="list-style-type: none"> (i) Short term exposures (ii) Long term exposures (iii) Total exposure 	<ul style="list-style-type: none"> Greater of \$20 million and 100% of capital base Greater of \$10 million and 50% of capital base Greater of \$20 million and 100% of capital base
(d)	All other exposures	25% of capital base