Prudential Standard LPS 118

Capital Adequacy: Operational Risk Charge

Objectives and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that life companies maintain adequate capital against the operational 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 life company.

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

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

Authority

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

Application

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

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

   (a) for a life company other than a friendly society, each statutory fund; and

   (b) for a friendly society, its management fund.

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

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

Interpretation

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

Operational Risk Charge

7. The **Operational Risk Charge:**

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

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

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

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

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

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

[2] Refer to section 16ZD of the Act.

Calculation of the Operational Risk Charge

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

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

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

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

10. For the purposes of paragraphs 11 to 14:

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

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

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

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

    where:

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

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

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

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

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

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

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

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

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

where:

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

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

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

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

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

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

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

Adjustments and exclusions

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

Transition

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