Prudential Practice Guide

GPG 220 Credit Risk

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Australian Prudential Regulation Authority

About this guide

Prudential Standard GPS 220 Risk Management (GPS 220) sets out APRA's requirements of **insurers** in relation to risk management. This prudential practice guide aims to assist insurers in complying with those requirements in relation to credit risk and, more generally, to outline prudent practices in relation to credit risk management.

Unless otherwise defined in this prudential practice guide, expressions in bold are as defined in *Prudential Standard GPS 001 Definitions*.

Subject to the requirements of GPS 220, insurers have the flexibility to configure their credit risk management framework in the way most suited to achieving their business objectives.

Not all the practices outlined in this prudential practice guide will be relevant for every insurer and some aspects may vary depending upon the size, complexity and risk profile of the insurer.

Credit risk

1. Credit risk is the risk of default by borrowers and transactional counterparties as well as the loss of value of assets due to deterioration in credit quality. Exposure to credit risk results from financial transactions with securities issuers, debtors, borrowers, brokers, policyholders, reinsurers and guarantors.

Credit exposures

2. Credit exposures can increase the risk profile of an insurer and adversely affect financial viability. A credit exposure includes both on-balance sheet and off-balance sheet exposures (including guarantees, derivative financial instruments and performance-related obligations) to single counterparties and groups of related counterparties. APRA envisages that actual and potential credit exposures to reinsurers arising from current or possible future claims, and other exposures, would be managed as part of the process of credit risk management.

3. In relation to credit exposures, APRA envisages that the risk management framework would incorporate the following elements:

    (a) a mandate setting out the acceptable range, quality and diversification of credit exposures, including those to reinsurers (e.g. reinsurance recoveries), brokers and policyholders (e.g. premium receivables) and investments. This may be integrated with a more general investment mandate;

    (b) limits for credit exposures to:

        (i) single counterparties and groups of related counterparties;

        (ii) intra-group asset exposures (to subsidiaries and related entities);

        (iii) single industries; and

        (iv) single geographical locations

    (c) a process for approving changes in the credit mandate and changes in limit structures;

    (d) a process for approving requests for temporary increases in limits and a process to ensure excesses are brought within the pre-approved limits within a set timeframe;

    (e) a process for reviewing and, if necessary, reducing or cancelling exposures to a particular counterparty where it is known to be experiencing problems;

    (f) a process to monitor and control credit exposures against pre-approved limits;

    (g) a process to review credit exposures and consider risks of recoverability beyond the risk of default associated with **reinsurance recoverables** due from a **non-APRA-authorised reinsurer**, including the reinsurer's willingness to pay and legal ability to pay (at least annually, but more frequently in cases where there is evidence of deterioration in credit quality);

    (h) a process to review other credit exposures (at least annually, but more frequently in cases where there is evidence of a deterioration in credit quality);

    (i) a management information system that is capable of aggregating exposures to any one counterparty (or group of related counterparties), asset class, industry or region in a timely manner; and

    (j) a process of reporting to the board and senior management:

        (i) any breaches of limits; and

        (ii) large exposures[1] and other credit risk concentrations.

[1] For these purposes, an exposure to an asset or counterparty (including related entities) of greater than 10 per cent of the insurer's capital base would generally be regarded as a large exposure.

Credit exposures of Category E insurers from loans to related companies

4. Under *Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Factor,* APRA recognises that an insurer may make loans to its parent company or related companies, subject to the loans being made on commercial terms. In the case of a Category E insurer making loans to its parent company or related companies, APRA envisages that the insurer's exposure to a related counterparty or a group of related counterparties would not exceed 100 per cent of its capital base, unless the insurer experiences large claims and its claim experience exceeds normal expectations. If this exposure does exceed 100 per cent of the insurer's capital base, APRA may consider exercising its power to adjust the insurer's MCR under *Prudential Standard GPS 110 Capital Adequacy*.

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