Response to Submissions

Review of capital standards for general insurers and life insurers

31 May 2012

Preamble

APRA is reviewing its capital standards for general insurers and life insurers.

Consultation on the capital framework commenced in May 2010 with the release of a discussion paper. APRA also released three technical papers in the third quarter of 2010. There have been two subsequent rounds of consultation and two quantitative impact studies. Draft capital prudential standards were released as part of the third round of consultation in December 2011.

This response paper outlines a number of final clarifications or refinements to the calculation of the capital requirements for general insurers and life insurers. This paper also sets out APRA's response to submissions in relation to the composition of the capital base, on which APRA consulted in detail for the first time in December 2011. Draft standards on this topic are now being released for consultation. Following the previous consultation rounds, APRA has now finalised the remaining capital standards that were released in December 2011.

Finally, this paper sets out the proposed amendments to the other relevant prudential standards for general insurers and life insurers. These amendments are consequential to the revised capital framework for insurers. In updating these standards, APRA has also proposed a small number of other amendments to enhance readability and address minor prudential matters.

APRA will consult in June 2012 on the revised reporting standards for general insurers and life insurers to reflect the revised capital framework. Final prudential standards and reporting standards will come into effect on 1 January 2013.

This response paper and the suite of draft and final prudential standards are available on APRA's website at www.apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-Consultation-May-2012.aspx . Written submissions should be sent to InsuranceCapital@apra.gov.au by 27 July 2012 and addressed to:

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Important disclosure notice – publication of submissions

All information in submissions will be made available to the public on the APRA website unless a respondent expressly requests that all or part of the submission is to remain in confidence. Automatically generated confidentiality statements in emails do not suffice for this purpose. Respondents who would like part of their submission to remain in confidence should provide this information marked as confidential in a separate attachment.

Submissions may be the subject of a request for access made under the *Freedom of Information Act 1982* (FOIA). APRA will determine such requests, if any, in accordance with the provisions of the FOIA. Information in the submission about any APRA regulated entity which is not in the public domain and which is identified as confidential will be protected by section 56 of the *Australian Prudential Regulation Authority Act 1998* and therefore will ordinarily be exempt from production under the FOIA.

Contents

Glossary

ADI	An authorised deposit-taking institution under the *Banking Act 1959.*
APRA	Australian Prudential Regulation Authority
Additional Tier 1 Capital	Capital instruments that provide loss-absorption, but that do not satisfy all of the criteria for inclusion in Common Equity Tier 1 Capital.
Appointed Actuary	The actuary appointed under the *Life Insurance Act 1995* or the *Insurance Act 1973.*
Capital base	The capital that is eligible under the relevant prudential standards for meeting the Prudential Capital Requirement.
Common Equity Tier 1 Capital (CET1)	The highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date.
Friendly society	A friendly society as defined in the *Life Insurance Act 1995**
General insurer	A general insurer authorised under the *Insurance Act 1973.*
ICAAP	Internal Capital Adequacy Assessment Process
Insurance Act	*Insurance Act 1973*
Insurer	A general insurer or a life insurer.
Level 2 insurance group	A consolidated general insurance group headed by either an APRA-authorised Level 1 insurer or an APRA-authorised NOHC and including all general insurance controlled entities.
Life insurer	A life company, including friendly societies, registered under the *Life Insurance Act 1995.*
Life Act	*Life Insurance Act 1995*
Non-capital prudential standards	The relevant prudential standards with amendments that are consequential to the revised capital framework and that are being released in draft form with this paper.
Prudential Capital Requirement (PCR)	The required level of capital for regulatory purposes. It is determined as the prescribed capital amount plus any Pillar 2 supervisory adjustment.
Prescribed capital amount	Prescribed capital amount determined in accordance with the quantitative rules as set out in the prudential standards, including any Pillar 1 supervisory adjustment, but before any Pillar 2 supervisory adjustment is applied.

* In this paper the terminology relating to friendly societies follows, in general, the conventions of the *Life Insurance Act 1995* and APRA's existing standards. For example, references to statutory funds should be read as references to benefit funds, unless otherwise stated.

Supervisory adjustment	An adjustment that APRA may require to the Prudential Capital Requirement of a life insurance fund, life insurer or general insurer. A Pillar 1 supervisory adjustment forms part of the prescribed capital amount. A Pillar 2 supervisory adjustment is separate from the prescribed capital amount.
Target capital	The targeted amount of capital as determined by the Board of the insurer or group.
Tier 1 Capital	Capital that provides loss-absorption, comprised of Common Equity Tier 1 Capital and Additional Tier 1 Capital.
Tier 2 Capital	Capital instruments that provide loss-absorption, but that do not satisfy the criteria for Common Equity Tier 1 Capital or Additional Tier 1 Capital.

Executive summary

APRA is reviewing its capital standards for general insurers and life insurers. The aims of the review are to:

- improve the risk sensitivity and appropriateness of the capital standards in general and life insurance; and
- where appropriate, improve the alignment of the capital standards across industries.

Consultation with industry

Consultation on the capital framework commenced in May 2010 with the release of a discussion paper. APRA also released three technical papers in the third quarter of 2010. There have been two subsequent rounds of consultation and two quantitative impact studies. Draft capital prudential standards were released as part of the third round of consultation in December 2011.

Over the two years of consultation, APRA has received more than 120 written submissions and more than 100 insurers participated in both quantitative impact studies. Submissions have consistently indicated a broad level of support for APRA's aims in undertaking the review and APRA has refined its proposals in a number of areas.

Recent communication with industry

On 14 March 2012, APRA released a letter[1] to general insurers advising that formal implementation of one aspect of the insurance concentration risk charge (the horizontal requirement) would be deferred until 1 January 2014. This followed submissions from industry that additional time was necessary for general insurers to determine and implement a suitable strategy for meeting the horizontal requirement and to obtain appropriate reinsurance cover or raise additional capital. General insurers are expected to determine the horizontal requirement that would have applied at 1 January 2013, and to address in their Internal Capital Adequacy Assessment Process (ICAAP) how they will meet the horizontal requirement by 1 January 2014.

On 30 March 2012, APRA released a letter[2] to the life insurance industry setting out APRA's proposals for the measurement of the illiquidity premium to be added to the risk-free interest rate for discounting certain liabilities. Submissions on this proposal close on 1 June 2012.

Prescribed capital amount proposals

The submissions received in the latest round of consultation focused on a small number of proposals and sought clarification on various aspects of the implementation of the revised capital framework. This paper provides APRA's response to the main issues raised in relation to the December 2011 package and sets out the final clarifications or refinements to the calculation of the capital requirements for general insurers and life insurers. APRA has released with this paper the final prudential standards relating to the calculation of the prescribed capital amount for both general and life insurers.

Composition of capital base proposals

The December 2011 response paper included APRA's proposals regarding the composition of the capital base for insurers, including definitions of the components of the capital base, regulatory adjustments and quality of capital limits. This paper includes APRA's response to submissions in relation to the composition of the capital base (including quality of capital limits for insurers and treatment of investments in subsidiaries, joint ventures or associates). The paper also sets out a small number of other matters relating to the composition of the capital base. APRA has released with this paper the drafts of the prudential standards on the composition of the capital base.

1 Refer to www.apra.gov.au/GI/PrudentialFramework/Documents/120314_LTI_LAGIC_GI_implementation_date_of_the_horizontal_requirement_of_the_ICRC.pdf

2 Refer to www.apra.gov.au/lifs/PrudentialFramework/Documents/120330_LTI_LAGIC_LI_illiquidity_premium_consultation.pdf

Consequential amendments to other prudential standards

This paper sets out proposed amendments to the other relevant (non-capital) prudential standards for general insurers and life insurers. These draft prudential standards accompany this paper and contain amendments that are in the main consequential to the revised capital framework for both general insurers and life insurers. In updating these non-capital prudential standards, APRA has also proposed a small number of other amendments to enhance readability and address minor prudential matters.

Transition and disclosure

APRA notes that a number of insurers are likely to seek transition arrangements. This may be to provide insurers time to address a material increase in their minimum capital requirements, or to address the changed requirements for quality of capital. If an insurer is unable to implement changes to its current operations or arrangements to mitigate these impacts before 1 January 2013, APRA will consider allowing transition arrangements. These requests will be determined on a case-by-case basis and must be supported by compelling arguments and capital projections. Insurers should contact their APRA supervisor at their earliest convenience to discuss any application for transition arrangements. Applications must be received by APRA by 30 September 2012.

APRA's supervisory approach recognises the importance of adequate market disclosure by insurers to assist market observers to assess capital adequacy. APRA consulted in 2011 on the proposed disclosure requirements and these are set out in the final capital standards. APRA reminds insurers that the components of the prescribed capital amount, including any agreed transition amount, will need to be individually disclosed on an annual basis. Disclosure by the insurer of a Pillar 2 supervisory adjustment will not be permitted.

Next steps

Submissions on the proposals in Chapters 3 to 6 and the draft standards are due by 27 July 2012.

APRA will continue consultation with industry on the draft prudential standards released with this paper and the draft reporting forms and instructions to be released in June 2012. The remaining final prudential standards and draft prudential practice guides are expected to be released by October 2012. The final reporting forms and instructions are expected to be released in October 2012.

The new capital framework will be effective from 1 January 2013, with the first reporting under the revised framework commencing from the first quarter in 2013.[3]

3 For Level 2 general insurance groups, this will be the first half-year of 2013.

Chapter 1 – Introduction

1.1 Background

APRA commenced its review of capital standards with the release of a discussion paper in May 2010. This paper indicated that the main objectives of the review are to:

- improve the risk sensitivity and appropriateness of the capital standards in general and life insurance; and
- where appropriate, improve the alignment of the capital standards across industries.

The first round of consultation that commenced in May 2010 with the release of the discussion paper was followed by the release of three technical papers in the third quarter of 2010. APRA also invited insurers to participate in a quantitative impact study (QIS1) in late 2010.

The second round of consultation commenced with the release of a response paper in March 2011. This response paper included refinements and clarifications to a number of the original proposals to address the issues raised in submissions. Clarifications were provided on other aspects of the original proposals. The March 2011 response paper was followed by the second quantitative impact study (QIS2), which was released in April 2011.

The third round of consultation commenced in December 2011, with the release of a second response paper and 14 draft prudential standards. The package provided a number of further refinements and clarity on certain aspects of the proposals. The prudential standards set out the implementation of the capital proposals.

On 30 March 2012, APRA released a letter to the life insurance industry setting out APRA's proposals for the measurement of the illiquidity premium to be added to the risk-free interest rate for discounting certain liabilities. Submissions on this proposal close on 1 June 2012.

Over the two years of consultation, APRA has received over 120 written submissions and over 100 insurers participated in QIS1 and QIS2. Over this time period, APRA has met with a number of insurers and other stakeholders to discuss its proposals and the feedback provided in submissions. APRA has also held workshops to discuss implementation issues.

Submissions have consistently indicated a broad level of support for APRA's aims in undertaking the review and APRA has refined its proposals in a number of areas. The submissions received in the latest round of consultation focused on a small number of proposals and sought clarification on various aspects of the implementation of the revised capital framework.

1.2 Capital standards for insurers

This paper provides APRA's response to the main issues raised in relation to the December 2011 package and sets out the final clarifications or refinements to the calculation of the capital requirements for general insurers and life insurers.

APRA is releasing 11 final prudential standards relating to the calculation of the prescribed capital amount for both general and life insurers.[4]

Final general insurance prudential standards

- *Prudential Standard GPS 110 Capital Adequacy* (GPS 110)
- *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* (GPS 114)
- *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge* (GPS 115)
- *Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* (GPS 116)
- *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge* (GPS 117)
- *Prudential Standard GPS 118 Capital Adequacy: Operational Risk Charge* (GPS 118)

4 APRA has invited comments from industry as to whether the final wording on ICAAP in GPS/LPS 110 and the insurance concentration risk charge for general insurers in GPS 116 implement APRA's policy intent. Further details are set out in Chapter 2.

Final life insurance prudential standards

- *Prudential Standard LPS 110 Capital Adequacy* (LPS 110)
- *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge* (LPS 114)[5]
- *Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge* (LPS 115)
- *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117)
- *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge* (LPS 118)

The final capital standards incorporate the amendments to the capital framework and minor refinements to wording to increase clarity on the implementation of the calculations. These amendments and refinements are set out in Chapter 2.

In addition, APRA is releasing two updated drafts of capital prudential standards:

- *Prudential Standard GPS 001 Definitions* (GPS 001)
- *Prudential Standard LPS 001 Definitions* (LPS 001)

GPS 001 and LPS 001 are released as updated drafts and reflect changes due to the amendments to the capital standards as well as proposed changes as a result of the consequential amendments to the non-capital prudential standards. These two standards may need further minor amendments in response to feedback on the non-capital prudential standards. Final versions of these standards will be released by October 2012.

To assist industry in reviewing the capital standards, APRA has released a copy of all of these standards with the changes shown in mark-up.

1.3 Composition of the capital base for insurers

The December 2011 response paper included proposals regarding the composition of the capital base for insurers, including definitions of the components of the capital base, regulatory adjustments to the capital base, quality of capital limits and transition arrangements for existing capital instruments. APRA also released a draft of *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112). In December 2011, APRA indicated that it would release in March 2012 an updated draft of LPS 112 and a first draft of *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112). APRA had intended that these draft standards would simply formalise the December 2011 proposals. APRA received a number of submissions on these proposals and considered it more appropriate to incorporate APRA's response to these issues in the draft standards. Accordingly, this paper includes APRA's response to submissions in relation to the composition of the capital base. It also sets out a small number of other matters relating to the composition of the capital base. APRA has released with this paper a draft of GPS 112 and a revised draft of LPS 112. Further detail on the composition of the capital base is set out in Chapter 3.

1.4 Consequential amendments to other prudential standards

A number of other prudential standards need to be amended to reflect the revised capital framework. APRA is therefore releasing for consultation draft prudential standards that contain amendments that are in the main consequential to the revised capital framework for general insurers and life insurers. In updating these standards (collectively referred to as non-capital prudential standards), APRA has also proposed a small number of other amendments to enhance readability and address minor prudential matters. Further details on these draft non-capital prudential standards are set out in Chapter 4 for general insurers and Chapters 5 and 6 for life insurers.

5 Note that APRA is currently consulting on two paragraphs within LPS 114 as part of APRA's proposals relating to the illiquidity premium for life insurers. Those two paragraphs may alter as a result of the consultation. The remaining paragraphs within LPS 114 should be considered as final.

To assist industry in reviewing the draft prudential standards, APRA has released the majority of these standards with the most significant changes shown in mark-up.

1.5 Timetable

The key milestones in the timetable for completion of the review of the capital framework for insurers are set out in Table 1 below.

1.6 Transition arrangements

APRA recognised in its May 2010 discussion paper and March 2011 response paper that the implementation of the new capital framework would lead to most insurers having different capital requirements and hence that some insurers may need transition arrangements. This may be to provide insurers time to address a material increase in their minimum capital requirements, or to address the changed requirements for quality of capital.

All transition requests will be determined on a case-by-case basis. Requests for transition arrangements should be submitted to APRA by no later than 30 September 2012. Insurers are strongly encouraged to discuss any requests for transition arrangements with APRA well ahead of this deadline. Insurers will need to provide details of the transition arrangements sought, including the requested transition period and the rationale for the requested transition arrangements.

Requests for transition arrangements should be accompanied by details of the insurer's projected capital position as at 1 January 2013 and for a further period of at least three years beyond that date.

APRA will assess the information submitted by insurers once the requisite information is received and will advise insurers of its decisions on requests for transition arrangements as soon as practicable.

1.7 Structure of this paper

Chapter 2 sets out APRA's response to the main issues raised in submissions on the December 2011 package and outlines the final refinements to the determination of the prescribed capital amount. Chapter 3 focuses on APRA's proposals regarding the composition of the capital base, including responding to issues raised in submissions on the December 2011 response paper. Chapter 4 outlines APRA's proposals relating to the non-capital prudential standards for general insurers. Chapter 5 outlines APRA's proposals relating to the non-capital prudential standards for life insurers and Chapter 6 proposes other refinements to the life insurance prudential standards. Chapter 7 requests insurers to provide cost-benefit information. Appendices 1 and 2 list the full suite of prudential standards that will be effective from 1 January 2013 for general insurers and life insurers, respectively.

Table 1 – Timetable for completion of the review of the capital framework

June 2012	Release of draft reporting forms and instructions.
27 July 2012	Submissions due on draft prudential standards released for consultation in May 2012.
August 2012	Submissions due on draft reporting standards released in June 2012.
September 2012 to October 2012	Release of remaining final prudential standards. Release of draft prudential practice guides.
October 2012	Release of final reporting standards.
1 January 2013	New standards effective.
First quarter 2013	Release of final prudential practice guides.
1 January 2013 to 31 March 2013	First reporting period under new standards for life insurers and general insurers.
1 January 2013 to 30 June 2013	First reporting period under new standards for Level 2 insurance groups.

Chapter 2 – Prudential capital amount and supervisory review process

This chapter addresses submissions on APRA's proposals for the calculation of the prescribed capital amount and the supervisory review process. The chapter also addresses submissions on the draft prudential standards that were released in December 2011. APRA's response to submissions on the proposals in relation to the composition of the capital base are contained in Chapter 3.

APRA's response is set out in three sections: responses that relate to both general insurers and life insurers; responses that relate only to general insurers; and responses that relate only to life insurers.

This chapter does not necessarily consider items that were raised by submissions if these items were considered and addressed in previous response papers. When reviewing submissions, APRA has considered whether these submissions have provided new information that may not have been fully addressed in the previous response on those topics. In a number of cases, the submissions have not raised any new information or perspective and APRA refers industry to the previous response papers that outline APRA's prudential approach to those topics.

2.1 Response to APRA's proposals: general insurers and life insurers

2.1.1 Internal Capital Adequacy Assessment Process

APRA proposed that insurers be required to have an ICAAP appropriate for the size and complexity of the insurer. APRA also proposed to require certain documentation to be provided to it. An insurer's ICAAP will address all aspects of the insurer's capital adequacy framework and must be overseen by the Board. APRA indicated its intention to release a Prudential Practice Guide (PPG) in September 2012 containing additional guidance on the supervisory review process and APRA's expectations of ICAAPs.

Comments received

Many submissions commented on aspects of the ICAAP proposals. This included requests for further clarification of the ICAAP requirements, in particular how they will apply to smaller insurers and branch insurers, use of group policies and the sign-off requirements for the ICAAP report.

Some submissions also expressed concern regarding the timing of submission of the ICAAP report. This included requests that the preparation of the report be de-coupled from the financial year-end process. This would provide flexibility for insurers to prepare the report as part of their business and/or capital planning processes.

Submissions also indicated that more guidance is needed on APRA's expectation for ICAAPs and that the PPG should be released sooner than proposed to allow insurers to take the information in the PPG into account when preparing their ICAAP.

APRA's response

The ICAAP is fundamentally an internal process that must be overseen by the insurer's Board and adapted to the specific nature of that insurer's business and structure. APRA guidance can assist insurers in that process, but will not replace the need for management and Boards to give serious consideration to how best to develop and implement the ICAAP requirements for their institution. Insurers should not await the release of APRA's PPG on supervisory review and ICAAPs before starting development of their ICAAP. Insurers should already be developing their ICAAP and engaging with their Board and with APRA.

To assist insurers in the development of their ICAAP, APRA has expanded the section on ICAAP in the final versions of GPS 110 and LPS 110. This expanded wording includes clarification that:

- the ICAAP needs to be appropriate to the size, risk and complexity of the individual insurer;

- the 'Board' for a branch insurer is the Compliance Committee for an Eligible Foreign Life Company and the senior officer outside Australia for Category C general insurers – APRA has implemented this by amending the definition of 'Board' in LPS 001 and GPS 001, respectively;
- use of a group ICAAP is acceptable provided the Board of the individual insurer is satisfied the group ICAAP meets the requirements for the individual insurer; and
- the ICAAP report must be signed by the Chief Executive Officer after it has been endorsed by the Board.

APRA welcomes comments from industry on whether further refinements are needed in the wording of the ICAAP requirements to reflect the above points.

APRA accepts that some insurers may wish to complete their annual ICAAP report at a date other than their financial year-end. Therefore, the prudential standard has been amended to give insurers the flexibility to complete their ICAAP report at a time other than year-end, for example, as part of the annual business planning cycle.[6]

2.1.2 Supervisory review process and supervisory adjustments to capital

APRA proposed that the prudential standards would allow it to set a supervisory adjustment to the capital requirements for an insurer where there are prudential reasons for that adjustment. The adjustment could be an adjustment to an aspect of the prescribed capital amount calculation where the method in the prudential standard does not produce an appropriate outcome (known as a 'Pillar 1 supervisory adjustment') or an addition to the prescribed capital amount or increase in the composition of the capital base limits (known as a 'Pillar 2 supervisory adjustment').

Comments received

Submissions raised some concerns in relation to the proposed supervisory adjustment powers available to APRA. These concerns mainly related to how the powers will be used in practice, including frequency of use and the notice period that an insurer will receive.

APRA's response

APRA provided substantial guidance on the supervisory review process in the December 2011 response paper. APRA's proposed PPG on supervisory review and ICAAPs will provide additional guidance on how APRA expects this process to operate in practice. It is not possible, however, to foresee and describe every possible circumstance in which a supervisory adjustment may apply. The risk-sensitive nature of the revised capital framework and its comprehensive coverage of different types of risks are expected to reduce the need for APRA to apply a Pillar 2 adjustment to capital to reflect the peculiar nature of the risks to which an insurer may be exposed. As explained in the December 2011 response paper, however, there may be other reasons for such an adjustment. All supervisory adjustments will be made in the context of the supervision and decision-making process with which insurers are already familiar. The power to require a supervisory adjustment to capital is only one tool in a broader supervisory toolkit for addressing prudential concerns.

If an insurer currently has an increased capital requirement imposed, APRA will decide, as part of its consideration of transition arrangements, whether there is an ongoing need for that adjustment when the new capital framework comes into effect. Some current adjustments may have been put in place to address risks that will now be adequately captured under the standard method for calculating the prescribed capital amount. In such cases, there may be no ongoing need for the adjustment. APRA is unlikely to apply a supervisory adjustment to capital just because the ICAAP and its documentation are being refined over the next 12-24 months, so long as a well-considered and developed ICAAP is in place from 1 January 2013.

6 Note that an insurer that wants to combine the ICAAP report with the Financial Condition Report (FCR) would still need to prepare its ICAAP report at year-end, to align with the timing of the FCR.

2.1.3 Asset risk charge calculations

Look-through approach

APRA proposed in the July 2010 technical paper on the asset risk charge that insurers could use a 'look-through' approach in respect of each unlisted or controlled investment entity to determine the underlying exposure of the insurer to assets. Assets where look-through was not applied would be treated as listed or unlisted equity, as appropriate.

Comments received

Submissions noted that there was no allowance for the use of the look-through approach for certain investments in the drafts of GPS 114 and LPS 114. Submissions also queried the implementation of the look-through approach, including:

- whether it is optional or mandatory;
- whether a materiality threshold applies; and
- how look-through applies for structured assets.

APRA's response

APRA's intention is that insurers would be able to use a look-through approach for investments and calculate the capital requirements based on the underlying assets and liabilities. Wording to that effect was omitted from draft GPS 114 and LPS 114. This has been updated in the final versions of these prudential standards.

The use of the look-through approach will be optional for all investments except for unlisted, geared trusts. APRA will require insurers to look-through these types of trusts as this approach will provide a more appropriate risk charge than treatment of these trusts as an equity investment. APRA has clarified in the final GPS 114 and LPS 114 that the look-through requirements for structured assets with exposure to untranched pools of reference entities, assets or risks will be the same as for other investments.

Use of derivatives

In the draft prudential standards, APRA proposed that insurers would need to consult with APRA before investing in derivative contracts other than those over equities, interest rates and foreign exchange. This was a continuation of the position in general insurance that consultation was required prior to entering into complex derivatives.

Comments received

Submissions argued that insurers should not need to consult with APRA before investing in these types of derivatives.

APRA's response

Given there is an appropriate risk charge for use of derivatives within the asset risk charge, there is less need for prior consultation with APRA for use of most derivatives. APRA has therefore amended the prudential standards so that consultation with APRA is not required prior to entering into derivatives contracts. The proposed reporting requirements to be released in June 2012 will set out requirements for reporting on the use of derivatives so that APRA can monitor their use.

Valuation of residential property used as collateral for mortgages

APRA proposed that insurers could determine the counterparty grade for non-publicly rated secured or mortgaged assets by reference to the loan-to-valuation ratio (LVR) of the asset.[7] In order to use this treatment, a valuation of the collateral by a qualified valuer would need to be obtained every three years. In addition, for standard residential mortgages the collateral properties would need to be revalued when the insurer becomes aware of a material change in the market value of property in an area or region.

7 APRA defined in the draft prudential standards that a secured or mortgaged asset comprises an investment held by way of a registered lien, charge or mortgage over residential property or an asset of a like kind.

Comments received

Submissions argued that it may be burdensome to require a revaluation of property every three years as well as when an insurer becomes aware of a material change in values in an area or region. The submissions noted that the proposed approach for assets supported by residential mortgages was not aligned with that applicable for authorised deposit-taking institutions (ADIs).

APRA's response

APRA has reviewed the requirements relating to treatment of secured assets and has decided to align them to the equivalent ADI requirements. As a result:

- the requirement to revalue property after an insurer becomes aware of a material change in values in an area or region will continue as this is consistent with the ADI approach;
- the requirement to revalue on a triennial basis does not apply for ADIs and therefore this will not be required for insurers. APRA notes that where investments in residential mortgages are a significant risk for a particular insurer, robust controls would be expected as part of the insurer's risk management framework; and
- the insurance proposals have been amended such that only mortgages over residential property are eligible to be rated on an LVR basis as this is consistent with the ADI approach. Mortgages over commercial property, speculative construction and property developments cannot apply the LVR basis and instead, unless APRA approval is granted, are treated as 'Grade 6' counterparty exposures.

These amendments are included in draft GPS 001 and draft LPS 001.

Treatment of semi-government bonds

APRA proposed in the December 2011 response paper that semi-government securities would be rated up one counterparty grade for the purposes of the credit spreads stress. This means that AAA-rated semi-government securities are classified by APRA as 'Grade 1 (government)' and have 0 per cent default and spread factors and AA-rated semi-government securities are classified by APRA as 'Grade 1 (other)' and have 0.2 per cent and 0.6 per cent default and spread factors, respectively.

Comments received

Submissions argued that AA-rated semi-government securities should be rated up two counterparty grades instead of one for the purposes of the credit stresses module. This would effectively place them in the 'Grade 1 (government)' category and they would have a zero credit spreads stress. Submissions noted that the ADI capital standards apply the same capital charge for AAA-rated and AA-rated semi-government securities.

APRA's response

APRA proposed to separate the AAA-rated and AA-rated semi-government securities as the market (through credit spreads) and the rating agencies assess such AA securities as having a higher credit risk than the AAA securities. It is therefore appropriate for a higher capital requirement to apply. APRA notes that under the capital framework for ADIs, AAA-rated and AA-rated securities are assigned the same APRA counterparty grade and, as a result, are assigned the same capital charge, irrespective of whether these are government, semi-government or corporate exposures. The revised insurance capital framework, however, adopts additional granularity in counterparty grades and uses stresses that are duration sensitive. APRA therefore proposes to retain the approach used in the December 2011 response paper for semi-government securities.

2.1.4 Clarifications and minor amendments

In addition to the above items, APRA has made a small number of clarifications or minor amendments to the capital prudential standards to address questions raised in submissions on the application or calculation of the prescribed capital amount.

PS 110 – Capital Adequacy

- APRA has added a footnote in the disclosure section of GPS 110 and LPS 110 to indicate that any agreed transition arrangements are disclosable as a component of the prescribed capital amount.
- For general insurers, the definition of financial year for the purposes of capital reductions has been incorporated into GPS 110. This information was previously contained in GPS 112.
- For life insurers, APRA has renamed the adjustment for tax and management actions as the 'combined stress scenario adjustment' to recognise that this adjustment also allows for second order interactions between the insurance and asset risk stresses (e.g. it uses a stressed discount rate to value the stressed policy liabilities).

PS 114 – Asset Risk Charge

- In GPS 114 and LPS 114, APRA has clarified the treatment of investment income receivable, requiring it to be included with the asset that generated the income and then subjected to the appropriate stress tests.
- APRA has clarified the dividend yield to be used for unlisted equities and other assets.
- APRA has made a number of other minor clarifications to assist insurers in the application of the asset risk charge and these amendments are shown in mark-up in the capital standards released with this paper.

PS 115 – Insurance Risk Charge

- For general insurers, APRA has moved the definition and capital treatment of 'material net written premiums' to GPS 115. This information was contained in GPS 320; however, it is more appropriate for it to be contained in the prudential standard that determines the insurance risk charge.

PS 117 – Asset Concentration Risk Charge

- For general insurers, the draft of GPS 117 included a number of adjustments and exclusions paragraphs. To simplify the application process, APRA has included in the final version of GPS 117 one general application paragraph for insurers to apply to APRA for temporary or permanent adjustment to the asset concentration limits. The standard also contains a provision for APRA to adjust or exclude specific requirements.
- For life insurers, APRA has clarified that, for the purposes of the limits for reinsurance assets, the value of these assets should be the same as the stressed value for the insurance risk charge, rather than the value from the statutory accounts.

PS 118 – Operational Risk Charge

- For general insurers, APRA has also clarified that the recognition of premium and insurance liabilities for acquisitions or disposals should be consistent with the requirements under Australian Accounting Standards, whereby the amounts are recognised at the point at which significant insurance risk is assumed or transferred.

2.2 Response to APRA's proposals: general insurers only

2.2.1 Timing of submission of actuarial reports

Under the current prudential standards, a general insurer must submit its FCR and Insurance Liability Valuation Report (ILVR) to APRA within four months of its financial year-end. A life insurer must currently submit its FCR within three months of its financial year-end. APRA proposed in the December 2011 response paper to require a general insurer to submit both the FCR and ILVR within three months of its financial year-end. This would harmonise the requirements for the two industries and also enable insurers to use the outcomes of the FCR and ILVR as input to the ICAAP report.

Comments received

Submissions were opposed to APRA's proposal to bring forward the due date of the FCR and ILVR. Submissions argued that this may place a strain on key actuarial resources and could reduce the quality and usefulness of the documents. Submissions noted the timeline would make the time for peer review shorter and would make it difficult to present the results to the Board prior to the three-month deadline.

APRA's response

APRA has considered the submissions by industry and held discussions with other stakeholders to ascertain the extent to which the three-month deadline is not feasible due to actuarial and Board availability. APRA is of the view that insurers will be able to adjust their processes to be able to meet the three-month timeframe, such as completion of some of the components of the FCR before the end of the financial year. In addition, APRA understands that many Boards consider preliminary insurance liability results much earlier than three months after the financial year-end to assist with statutory reporting requirements. Providing the ILVR and FCR to the Board and to APRA within a three-month deadline will increase their usefulness because they will be considered closer to the financial year-end.

APRA has therefore decided to implement the three-month deadline for the FCR and ILVR. In order to give insurers time to adapt their processes where necessary, APRA will phase-in the requirement to submit the reports. ILVR and FCRs for financial years ending up until 31 March 2014 can still be submitted within four months of the financial year-end. The three-month deadline will come into effect for the first ILVR and FCR for balance dates from 30 June 2014 onwards. This provides all insurers two balance dates from release of this paper to work towards meeting the three-month timeframe.

2.2.2 Insurance concentration risk charge calculation

APRA proposed a number of amendments to the calculation of the insurance concentration risk charge (ICRC) in the December 2011 response paper. Written submissions and other feedback from industry raised a number of areas where amendments to the implementation of the ICRC were required.

On 14 March 2012, APRA released a letter to general insurers advising that formal implementation of one aspect of the ICRC (the horizontal requirement) would be deferred until 1 January 2014. This followed submissions from industry that additional time was necessary for general insurers to determine and implement a suitable strategy for meeting the horizontal requirement, and to obtain appropriate reinsurance cover or raise additional capital. General insurers are expected to determine the horizontal requirement that would have applied at 1 January 2013, and to address in their ICAAP how they will meet the horizontal requirement by 1 January 2014.

APRA has issued a final version of GPS 116 with this paper. APRA nevertheless welcomes feedback from industry as to whether further refinements are needed to the wording of the prudential standard to reflect the policy position outlined in this paper.

Calculation of the vertical and horizontal requirements a gross and net basis

Comments received

Submissions noted that the wording in draft GPS 116 relating to the Natural Perils Vertical Requirement (NP VR) implied that the insurer did not need to consider the whole-of-portfolio net loss to the insurer at the 0.5 per cent probability of occurrence. This is inconsistent with the current approach to the determination of the Maximum Event Retention.

APRA's response

Draft GPS 116 is prescriptive, setting out the steps the insurer must undertake to arrive at the NP VR on a whole-of-portfolio basis. As a result, the calculation considers the largest gross loss from a single event and then determines the level of potential reinsurance recoverables in relation to that single event. If only this requirement is in place, it may create an incentive to purchase layers of catastrophe reinsurance that do not protect the entire portfolio.

It is important for an insurer to also consider the calculation on a net basis (i.e. Probable Maximum Loss (PML) less reinsurance) at the 0.5 per cent level as this resulting figure represents the actual loss to which the insurer is exposed at the required return period. This calculation factors in the structure and coverage of the insurer's reinsurance program.

APRA has therefore amended the prudential standard to require the vertical requirement to be determined based on the worst loss at a 0.5 per cent probability of occurrence from both the gross PML single event and after netting off reinsurance recoverables. The highest outcome from consideration of the gross and net outcomes would then be adjusted for the other components of the vertical requirement (such as reinstatement premiums and costs) to determine the NP VR. APRA has also amended the calculation of the horizontal requirement to reflect the above principle.

Reinsurance reinstatements

Comments received

Submissions expressed concern regarding the requirement that an insurer have a contractually agreed reinstatement of its catastrophe reinsurance program in place at the start of the catastrophe reinsurance program. The submissions noted that the practical implementation of this proposal may have unintended consequences. Submissions also requested that APRA reconsider the minimum level of cost for reinstatements prescribed in the prudential standard for the horizontal requirement. Finally, submissions queried the wording of the requirement in relation to netting of reinstatement premiums in the calculation.

APRA's response

APRA remains of the view that it is prudent to require an insurer to have a contractually agreed reinstatement of its reinsurance program that reduces its vertical requirement at the start of the treaty year. This ensures that, after a catastrophic event, the insurer will have access to reinsurance protection at an agreed price. APRA accepts that, in some circumstances, contractually agreed reinstatements may not be practicable. As a result, APRA will require an insurer to meet the requirement as set out in the prudential standard unless it is able to demonstrate to APRA's satisfaction that it is not practical or appropriate given the nature of their reinsurance arrangements to place the full reinstatement. In either case, the insurer will be required to set aside the capital for the cost of the reinstatement. The insurer would need to set out its approach to the placement of the reinstatement in its Reinsurance Management Strategy (ReMS). The Board and senior management should also consider the implications of the reinstatement of the catastrophe program in its ICAAP. APRA may apply a supervisory adjustment if it is not satisfied with the insurer's approach to placing a reinstatement of its catastrophe program.

The cost of reinstatement after the occurrence of an event will depend on a number of factors, including the protection provided by the original cover, the timing and size of the event, reinsurance availability and the insurer's relationship with the reinsurer(s). This means that the cost could vary quite significantly and could be less than the original cover or quite a significant margin above the cost of the original cover. As a result, APRA considers that the original cost of the reinsurance cover is the most suitable measure of the minimum level of reinstatement cost to be applied in the horizontal requirement where an agreed rate for reinstatements is not in place. APRA has, however, amended the wording of the prudential standard such that the minimum cost is the original cost unless the insurer can demonstrate to APRA's satisfaction that this cost materially overstates the cost that would prevail in the market after the requisite number of events.

APRA has also aligned the terminology relating to the offset of reinstatement premiums due to reinsurers with market practice. The amended wording states that the offset is allowed where it is specifically stipulated in the reinsurance contract and occurs at the time of payment of the reinsurance claim.

Timing of ICRC calculation

Comments received

Some submissions sought clarification on APRA's intention regarding when components of the ICRC are to be calculated. Submissions queried:

- when the ICRC needs to be recalculated;
- what reinsurance program should be taken into account in between reporting dates; and
- whether there are unintended differences in the calculation of the ICRC due to the different reporting cycles for insurers and Level 2 insurance groups.

APRA's response

An insurer needs to be able to calculate its ICRC at all times and this calculation must only take into account the actual position of the insurer, including the contractually agreed reinsurance available at the time. As a result, APRA has continued the requirement to consider the impact on the vertical requirement after the occurrence of an event. This means that an insurer's NP VR may change during a reporting quarter as a result of an event.

Separate to the above consideration, an insurer must calculate and report to APRA its vertical requirement at the end of each quarter (or half year for a Level 2 insurance group). It is APRA's intention that the vertical requirement be forward-looking and consider changes in reinsurance arrangements that may take place in the next reporting period. This means that the calculation at each reporting date must consider the reinsurance program (if any) in place in the next reporting period. This calculation can only take account of reinsurance that was contractually agreed at the reporting date.

The horizontal requirement would need to be calculated at the reporting date on or prior to the date of change in the reinsurance program. As indicated in the December 2011 draft of GPS 116, an insurer should approach APRA in relation to the timing of the calculation of the horizontal requirement if it has multiple treaty dates.

APRA has also clarified in GPS 116 that the applicable components of the ICRC will need to be recalculated when there are material cancellations or additions of reinsurance layers to the catastrophe reinsurance program. If an insurer has made a significant purchase or sale of a portfolio of business, it will need to recalculate all components of the ICRC. An insurer will need to consult with APRA to determine the approach to recalculate the horizontal requirement. Further guidance on the timing of the calculation of the ICRC will be provided in the draft PPG to be released in September 2012.

APRA has also clarified in GPS 116 the approach to determine the horizontal requirement on 1 January 2013 if this is part-way through a treaty year.

Use of the 'whole-of-portfolio' approach for other accumulations exposures

Comments received

Submissions and industry feedback sought clarification on the implementation of whole-of-portfolio principles for other accumulations exposures and suggested that APRA consider the use of scenarios rather than the 'property approach' of combining outcomes from simulations of property events.

APRA's response

APRA is of the view that the principles of a whole-of-portfolio approach can be applied to exposures to other accumulations; however, the practical implementation will be different to that for exposures to natural perils. GPS 116 requires an insurer to determine the largest loss across all of its classes of business and business written in those portfolios. This approach is consistent with the principle of whole-of-portfolio. APRA will provide further guidance in the PPG in relation to the approach to other accumulations. APRA will not include specific scenarios to be used by insurers; insurers should be determining scenarios that are relevant to their particular portfolios.

Clarifications and minor amendments

APRA received requests from industry to clarify a number of other provisions in draft GPS 116. APRA has made a number of clarifications in GPS 116 and will also consider whether further detail should be included in the PPG. GPS 116 also clarifies a number of points, as outlined below.

Aggregate cover

- The aggregate offset within the horizontal requirement is applied within each of the H3 and H4 scenarios rather than later in the calculation, as there can be different aggregate offset outcomes for each scenario.
- The aggregate offset can take into account catastrophe events that contribute to the aggregate reinsurance cover on the condition that there is no double-counting within this offset and the Premiums Liability (PL) offset.
- The inclusion of reinstatements of aggregate cover will not be allowed unless there is a contractually agreed reinstatement.

PL offset

- The Appointed Actuary must provide the calculation of the PL offset to the insurer in time to complete its reporting requirements. APRA has also clarified wording in the paragraph such that the net central estimate plus risk margin and premiums liability risk charge are included in the offset.

Catastrophe models

- The wording of GPS 116 has been updated to be less prescriptive on the approach to the sound understanding of the catastrophe models that insurers use.

Non-traditional reinsurance

- Insurers must apply to APRA to include alternative capital and risk mitigants such as securitisation, reinsurance premium protections, capital market structures and catastrophe bonds in the determination of the ICRC.

Materiality

- A materiality clause has been added to the requirement to report changes in the ICRC to APRA that result from any changes in the insurer's ReMS, risk profile, classes of business underwritten or reinsurance program.

Level 2 insurance groups

- For consistency with the other prudential standards, APRA has moved all paragraphs relating to Level 2 insurance groups into an Attachment to GPS 116. APRA has also added the ability for a Level 2 insurance group to apply to APRA to undertake an alternative approach to the calculation of the ICRC on a whole-of-portfolio basis.

In addition, as outlined in the 14 March 2012 letter, the implementation of the horizontal requirement in the determination of the ICRC is deferred until 1 January 2014. This deferral has been added to GPS 116.

2.3 Response to APRA's proposals: life insurers only

2.3.1 Illiquid liabilities

APRA proposed that certain types of products would be considered illiquid and as such have an illiquidity premium added to the risk-free interest rate. The eligible products were restricted to annuities, fixed term/rate products and funeral bonds.

Comments received

Submissions argued that the current list of products considered to be illiquid should be amended and include products distinguished by a particular set of features or that have termination values at policy level or that are types of annuities that have no surrender value.

APRA's response

APRA is of the view that a product should not be considered illiquid simply because the adjusted policy liability has a termination value minimum applied at policy level. This ignores the uncertainty in the timing of claim payments and would result in too many life insurance liabilities being eligible to use the illiquidity premium.

APRA accepts, nonetheless, that there may be other types of illiquid annuities outside of those listed in the December 2011 draft of LPS 112. Therefore draft LPS 112 has been amended to recognise as illiquid other types of annuities where there are no insurance risks other than longevity and servicing expenses. This would allow life insurers to treat single premium deferred annuities as illiquid if they have no surrender value as such annuities would be expected to be at least as illiquid as immediate annuities.

On 30 March 2012, APRA released a letter to the life insurance industry setting out APRA's proposals for the measurement of the illiquidity premium to be added to the risk-free interest rate for discounting certain liabilities. APRA also released the draft prudential standard wording for LPS 112 and LPS 114. Submissions on this proposal close on 1 June 2012. Following review of submissions, APRA expects to release the final version of the two relevant paragraphs of LPS 114 in the second half of 2012.

2.3.2 Offsets between statutory funds

In the December 2011 response paper, APRA proposed to remove the allowance for offsets between statutory funds where the same stress would result in an increase in capital for one fund and a reduction in another. APRA noted that each statutory fund must be treated as a stand-alone entity and there is no guarantee that it will be possible to transfer capital between statutory funds in severely stressed circumstances.

Comments received

Submissions argued that APRA's proposal does not recognise that interest rate movements in opposite directions cannot occur simultaneously. On that basis, it was argued that allowance for offsetting stresses between statutory funds be restored.

APRA's response

The arguments made in submissions assume that a surplus arising within a statutory fund from a particular cause can always be transferred to another fund. This will not always be the case. For example, there is no guarantee that a statutory fund that benefits from an interest rate movement will be able to release capital to another fund that is adversely impacted by the same interest rate movement. APRA's key consideration is how the requirements would operate at a time of significant stress for the life insurer. It is not appropriate to recognise the possibility of such a capital transfer when setting minimum capital requirements. The possibility of transferring capital between statutory funds can, where appropriate, be recognised by life insurers in setting their target capital levels as part of their ICAAP.

2.3.3 Deferred acquisition costs

Comments received

Submissions again argued that deferred acquisition costs (DAC) and future profit margins have value to a life insurer, even in severely stressed circumstances, and hence should be given more value than intangible assets of a life insurer.

APRA's response

The DAC of a life insurer may have some value to a life insurer under certain severe stress situations such as if a stressed insurer is recapitalised or the policies are transferred to another insurer. As a result, APRA proposed in the December 2011 response paper to allow some of the value of the DAC to be included by allowing one year of DAC and profit margins to be explicitly allowed as an offset in the insurance risk charge, subject to the insurance risk charge not being negative.

In addition, the methodology under the revised capital framework allows for additional implicit value to be attributed to DAC and profit margins:

- in the calculation of the capital base, the termination value minimum is applied at statutory fund level (except for participating and other discretionary investment business). This allows DAC and profit margins for policies whose policy liability is less than the termination value to be offset against the liabilities for other policies;
- in the calculation of the insurance risk charge, the stressed termination value minimum is applied at statutory fund level. For example, group risk business may have losses expected for several years in the stressed scenario, but these losses can be offset against DAC and profit margins that are expected to be recovered from individual risk business; and
- there is no allowance for the capital requirements of future new business within the prescribed capital amount. The capital required for new business can be substantial if it has deferred acquisition costs. In the absence of significant surplus assets, the life insurer may be reliant on the recovery of existing DAC to fund the DAC in the new business. This reliance gives an implicit value to the existing DAC.

As a result, APRA does not consider it appropriate to make any additional changes to the treatment of DAC and future profit margins for a life insurer.

Chapter 3 – Composition of the capital base

The December 2011 response paper outlined APRA's proposed approach to the composition of the capital base for general insurers and life insurers. APRA proposed to:

- maintain consistent capital definitions for insurers and ADIs under the Basel Committee of Banking Supervision capital reforms (Basel III)[8];
- strengthen the quality of components of capital eligible for inclusion in the capital base; and
- increase the amount of the highest quality capital components that must meet the Prudential Capital Requirement (PCR).

Further detail on the proposals relating to the capital base of general insurers and life insurers is contained in Chapter 4 of the December 2011 response paper.

APRA has now released for consultation a draft *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* for ADIs, which sets out APRA's implementation of Basel III.[9] As a result, APRA is releasing an updated draft of LPS 112 and a draft of GPS 112 with this response paper. These drafts reflect APRA's proposals to align with Basel III whilst making certain industry-specific alterations to reflect the nature of insurance business, as outlined in the December 2011 response paper. These drafts also incorporate relevant aspects of APRA's response to submissions received from industry on the December 2011 response paper. These are discussed below. This chapter also sets out a small number of other matters relating to the composition of the capital base. APRA invites comments from industry on the drafts of LPS 112 and GPS 112 and the proposals in section 3.2.

3.1 Response to APRA's proposals

3.1.1 Base for composition of capital base limits

APRA proposed that GPS 112 and LPS 112 would set limits on the allowable composition of the capital base by reference to the PCR.

Comments received

Submissions noted that expressing the limits for Common Equity Tier 1 Capital (CET1) and Total Tier 1 Capital as a percentage of PCR may result in an effective disclosure of the insurer's Pillar 2 supervisory adjustment to capital.

APRA's response

If the quality of capital limits were based on the PCR as proposed, disclosure of any Pillar 2 adjustment could occur in some cases and this would be an undesirable outcome. To address this issue, APRA has amended the prudential standards to express the CET1 and Total Tier 1 limits as percentages of the prescribed capital amount instead of the PCR. The requirement for the entire capital base to cover the PCR is unchanged. As part of determining any Pillar 2 supervisory adjustment to capital, APRA will mandate the quality of capital required to meet the Pillar 2 supervisory adjustment.

3.1.2 Quality of capital limits

APRA proposed that, for life insurers at company level and for general insurers, at least 70 per cent of the PCR would need to be met by CET1 and at least 80 per cent by Tier 1 Capital.

For life insurance statutory funds, it was proposed that at least 80 per cent of the PCR would need to be met by the capital base net of Tier 2 Capital, and 100 per cent met by the capital base. The capital base for the general fund would need to exceed the fund's PCR.

Comments received

Submissions argued that the limits on composition of the capital base should be reduced, allowing increased reliance on Additional Tier 1 Capital and Tier 2 Capital. Several arguments were put forward in support of these submissions including that the comparison to the Basel III limits should not include the Basel III capital conservation buffer, the existence and operation of non-viability provisions will be different in insurance and banking and that banks and insurers have different risk profiles.

8 Refer to *Basel III: A global regulatory framework for more resilient banks and banking systems,* Basel Committee, December 2010 (revised June 2011), available at www.bis.org/publ/bcbs189.pdf

9 Refer to www.apra.gov.au/adi/PrudentialFramework/Pages/Basel-III-Capital-Reforms-March-2012.aspx

APRA's response

In the December 2011 response paper, APRA proposed composition of capital limits for insurers that were broadly aligned with the Basel III limits for ADIs, including the capital conservation buffer. If an ADI's capital falls within the capital conservation buffer there is no breach of minimum capital requirements. Rather, in such circumstances, there are prescribed restrictions on earnings distributions by the ADI. ADI capital, including this buffer, is in some ways comparable to the target capital of an insurer under the revised capital framework. As a result, there is an argument that, in setting the minimum percentages, the comparison between ADI limits and insurance should consider the quality and level of target capital of insurers. APRA expects that a high proportion of capital above the minimum requirements will be held in CET1 to ensure that the minimum CET1 limits are not breached, and this will impact on the overall proportion of CET1 in target capital. As a result, APRA accepts that a lower minimum percentage of CET1 is appropriate. APRA therefore proposes to amend the minimum CET1 limit to 60 per cent of the prescribed capital amount. APRA will maintain a power in GPS 112 and LPS 112 to increase this limit if it has prudential concerns with the quality of the insurer's capital base.

Thus, the quality of capital limits are proposed to be:

For general insurers and a life insurer as a whole:

- CET1 must exceed 60 per cent of the prescribed capital amount (**previously 70 per cent of PCR**);
- Tier 1 Capital must exceed 80 per cent of the prescribed capital amount (**previously expressed as percentage of PCR**); and
- the capital base must exceed the PCR (**unchanged**).

For life insurance statutory funds:

- the capital base of each statutory fund, excluding Tier 2 Capital, must exceed 80 per cent of the prescribed capital amount of the fund (**previously expressed as a percentage of PCR**);
- the capital base of each statutory fund, including Tier 2 Capital, must exceed the PCR of the fund (**unchanged**); and
- the capital base of the general fund must exceed the PCR of the fund (**unchanged**).

3.1.3 Regulatory adjustment for investments in subsidiaries, joint ventures and associates

APRA proposed that any intangible assets and regulatory capital requirements of a subsidiary, joint venture or associate of an insurer would be deducted from CET1.

Comments received

One submission raised a technical question on whether the deduction for regulatory capital requirements of subsidiaries, joint ventures and associates should be limited to the value of the investment recorded on the balance sheet. This is because, under *Accounting Standard AASB 127 Separate Financial Statements*, an insurer can either account for an investment in a subsidiary, joint venture or associate at cost, or in line with *Accounting Standard AASB 9 Financial Instruments* (and *Accounting Standard AASB 139 Financial Instruments: Recognition and Measurement*), which allows for the investment to be measured at fair value.[10]

APRA's response

The objective of APRA's proposal is to ensure that there is no double-counting of capital. If the value of the investment on the parent insurer's balance sheet is lower than the capital requirement of the investment, there is no double-counting of capital if the limit on the deduction is the value of the investment on the balance sheet of the parent insurer.

APRA has therefore amended the prudential standards to limit the deduction of the regulatory capital requirement to the value of the investment as recorded on the balance sheet of the insurer.

10 Note that an insurer that records the investment as backing the insurance liabilities must record the investment at fair value. Note also that life insurers are required to make an adjustment to their capital base to value the investment at fair value.

3.1.4 Clarifications

APRA has clarified in the draft prudential standards that the deduction of assets under a fixed or floating charge does not apply if the fixed or floating charge is recorded as a liability on the balance sheet.

APRA also confirms that the deduction of holdings of own instruments does not apply to holdings on behalf of third parties or holdings of instruments issued by related parties.

3.2 Other matters relating to the composition of the capital base

3.2.1 Relevant law for issuance of capital instruments

The December 2011 response paper proposed consistent capital definitions across ADIs and insurers. Draft GPS 112 and LPS 112 provide further detail on the minimum criteria for capital instruments, including the ability for Additional Tier 1 Capital and Tier 2 Capital to bear loss at the point of non-viability. When APRA considers an insurer has reached the point of non-viability, it will be critical that the subsequent conversion and/or write-off of Additional Tier 1 Capital and/or Tier 2 Capital can be implemented within a short timeframe under the relevant law. APRA is proposing to accomplish this by requiring all Additional Tier 1 and Tier 2 capital instruments to be subject to Australian law. APRA invites feedback on this proposal, and, in particular, any practical difficulties in implementing this requirement and other suggested mechanisms that would achieve similar certainty of outcome.

3.2.2 Treatment of joint arrangements[11]

APRA proposes to clarify the capital treatment for joint arrangements as a result of the accounting requirements in *Australian Accounting Standard AASB 11 Joint Arrangements* (AASB 11).[12] AASB 11 effectively requires 'proportional consolidation' for joint operators in joint operations.[13] In contrast, joint ventures[14] continue to be accounted for using the 'equity method'.[15]

When 'proportional consolidation' is followed by a joint operation, the insurer may not have freely available access to the assets of the joint operation. Furthermore, the liabilities of a joint operation that are proportionately consolidated may also give rise to a larger exposure from a prudential perspective.

APRA proposes that, for the purposes of prudential capital requirements, insurers treat joint operations as joint ventures (i.e. the 'equity method'). This means that an insurer does not subject its interest in the underlying assets of the joint operation to the asset risk charge. Instead, the equity investment in the joint operation should be treated as a joint venture in accordance with paragraphs 14, 15, 19 and 20 of Attachment B of GPS 112 and LPS 112.

3.2.3 Minority interests and capital held by third parties (Level 2 insurance groups only)

The December 2011 response paper indicated APRA's intention to align the treatment of minority interests and capital held by third parties for Level 2 insurance groups with that for ADIs. This section sets out further details on the implementation of this proposal for Level 2 insurance groups. APRA invites comments from industry on the proposed approach.

11 Joint arrangements are defined in AASB 11 as either a joint venture or a joint operation.

12 AASB 11 applies to annual reporting periods beginning on or after 1 January 2013.

13 A joint operation is defined in Appendix A of AASB 11 as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement.

14 A joint venture is defined in Appendix A of AASB 11 as a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement.

15 Equity method is defined in *Australian Accounting Standard AASB 128 Investments in Associates and Joint Ventures.*

Minority interests in ordinary equity of subsidiaries

The current calculation of the capital base of a Level 2 insurance group gives full recognition of minority interests of third parties in ordinary equity of fully consolidated subsidiaries. There is an inherent weakness in this treatment as the surplus capital within that subsidiary is not entirely available to the parent. Any payment of dividends from the subsidiary would result in a portion being paid to the third party investors. APRA therefore proposes to reduce the capital base of the group by the surplus capital that is attributable to third parties. Draft GPS 112 reflects this proposed treatment.

Additional Tier 1 Capital and Tier 2 Capital issued by subsidiaries

The current calculation of the capital base of a Level 2 insurance group also gives full recognition of non-ordinary equity (currently referred to as Residual Tier 1 Capital) and Tier 2 Capital issued by fully consolidated subsidiaries. As for minority interests in ordinary equity, there is an inherent weakness in this treatment as these instrument holders may have a priority call, when compared to the parent, to the assets of the fully consolidated subsidiary in a wind-up. This is particularly the case for instruments that do not have the non-viability write-off or conversion provisions. As a result, APRA proposes that instruments that are currently on issue that do not meet the criteria for Additional Tier 1 Capital and Tier 2 Capital instruments will be subject to transition. Attachment H of draft GPS 112 sets out the proposed approach to transition.

Under the new criteria for Additional Tier 1 Capital and Tier 2 Capital instruments, these instruments must have the non-viability write-off and/or conversion provisions to receive any recognition in the capital base of the subsidiary or the parent. This means that, if the subsidiary or another group member was to become non-viable, the instruments can be converted into ordinary equity of the listed parent and those investors would become subordinate to the policyholders and senior creditors of the group. APRA therefore proposes that a Level 2 insurance group may recognise in full any Additional Tier 1 Capital or Tier 2 Capital instrument issued by a fully consolidated subsidiary as long as the instrument meets all of the relevant criteria in the prudential standard. Draft GPS 112 reflects this proposed treatment.

3.2.4 Interim arrangements for capital issues before 1 January 2013

To provide certainty for insurers wishing to issue capital instruments before the final standards come into effect on 1 January 2013, interim arrangements will apply for Additional Tier 1 Capital and Tier 2 Capital instruments issued from the date of this paper. These interim arrangements are identical to those applying to ADIs. Insurers that are considering issuing capital instruments between now and 1 January 2013 are encouraged to contact their APRA supervisor in the early stages of their considerations.

Subject to APRA's approval, an Additional Tier 1 Capital or Tier 2 Capital instrument issued from the date of this paper that complies with draft GPS 112/LPS 112 may be fully recognised in the relevant category of capital until its first call date (or, where there is no call date within a reasonable period, another appropriate date as determined by APRA). If APRA then determines that the instrument complies with the final GPS 112/LPS 112, it will continue to be recognised in the relevant category of capital.

Where an instrument issued in compliance with draft GPS 112/LPS 112 is assessed as not complying with the final GPS 112/LPS 112, it must be derecognised in the relevant category of capital from its first call date (or, where there is no call date within a reasonable period, another appropriate date as determined by APRA).

For general insurers, these instruments will not be covered by the transition arrangements set out in Attachment H of draft GPS 112, and will not be included in the base amount defined in that Attachment.

Chapter 4 – Consequential amendments to non-capital prudential standards for general insurers

The December 2011 response paper proposed that a number of APRA prudential standards would be amended to reflect the proposed changes to the capital framework for general insurers and Level 2 insurance groups. These standards are referred to as the non-capital prudential standards. This chapter discusses the proposed amendments to each of these prudential standards. APRA invites submissions from industry on the proposed amendments.

APRA is also proposing to make an amendment to the prudential framework for general insurers in relation to the reinsurance declaration and this is set out in section 4.4 below.

The proposed amendments include the following:

- cross-referencing has been updated for consistency with the final capital standards released with this paper. In addition, references to the audit and actuarial standards have been updated as these standards have been split into separate standards for consistency with the life insurance prudential standards;
- terminology has been updated to reflect the revised capital framework;
- the standards have been amended to contain standard paragraphs on 'Interpretation', 'Adjustments and exclusions' and preservation of 'Determinations made under previous prudential standards';
- definitions for certain terms in these prudential standards have been included in the updated draft of GPS 001; and
- the non-capital prudential standards for general insurers and Level 2 insurance groups have been combined, consistent with the final capital standards. As a result, the draft non-capital prudential standards being released with this paper refer to 'regulated institutions' when setting out requirements that apply for both general insurers and Level 2 insurance groups.[16]

All substantive changes to the prudential requirements in the standards are shown in mark-up.

16 Note that Level 2 insurance groups are not required to comply with GPS 120 and as such it remains applicable to general insurers only.

Draft general insurance prudential standards

The following revised general insurance prudential standards are being released for consultation:

- *Prudential Standard GPS 113 Capital Adequacy: Internal Model-based Method* (GPS 113)
- *Prudential Standard GPS 120 Assets in Australia* (GPS 120)
- *Prudential Standard GPS 220 Risk Management* (GPS 220)
- *Prudential Standard GPS 230 Reinsurance Management* (GPS 230)
- *Prudential Standard GPS 310 Audit and Related Matters* (GPS 310)
- *Prudential Standard GPS 320 Actuarial and Related matters* (GPS 320)

Specific amendments proposed to be made in respect of each non-capital prudential standard as a result of the revised capital framework are outlined below.

In addition, APRA will need to update a small number of footnotes in the cross-industry prudential standards to reflect the amended prudential standards for general insurers. APRA proposes to amend the following prudential standards:

- *Prudential Standard CPS 231 Outsourcing* (footnote 7 on page 6);
- *Prudential Standard CPS 232 Business Continuity Management* (footnote 6 on page 5 and footnote 9 on page 8);
- *Prudential Standard CPS 510 Governance* (footnote 11 on page 11, footnote 14 on page 15 and footnote 21 on page 17); and
- *Prudential Standard CPS 520 Fit and Proper* (footnote 8 on page 4 and footnote 16 on page 8).

4.1 Prudential Standard GPS 113 Internal Model-based Method

Draft GPS 113 sets out the requirements that general insurers and Level 2 insurance groups must meet to use an internal model-based method (IMB Method) for calculating the prescribed capital amount of the general insurer or Level 2 insurance group. The proposed changes to GPS 113 include:

- clarification that general insurers or Level 2 insurance groups that use the IMB Method must comply with the disclosure requirements in GPS 110; and
- updating of references to GPS 112, including eligibility of components of the capital base of an insurer or Level 2 insurance group.

4.2 Prudential Standard GPS 120 Assets in Australia

Draft GPS 120 specifies certain assets that are excluded as being 'assets in Australia' for the purposes of section 28 of the *Insurance Act 1973.* The proposed changes to GPS 120 include:

- alignment of the treatment of dividends for Category C insurers to that for locally incorporated insurers and ADIs, whereby only dividends that have been declared are deducted from the adjusted net assets of the Category C insurers; and
- removal of historical transition arrangements for custody agreements and other transition arrangements prior to 2007.

4.3 Prudential Standard GPS 220 Risk Management

Draft GPS 220 sets out the minimum requirements relating to the risk management framework of an insurer and Level 2 insurance group. The proposed changes to GPS 220 combine the general insurer and Level 2 insurance group risk management standards. The specific adjustments to the prudential standard for Level 2 insurance groups are set out in an attachment to draft GPS 220. The proposed changes include:

- the addition of paragraphs to clarify the interaction between the risk management framework and the ICAAP. The paragraphs clarify APRA's expectation that the two requirements combine to produce an integrated approach to risk and capital management, so that an insurer's capital is commensurate with its risk profile and risk appetite. The prudential standard also clarifies how the documentation requirements interact, noting that there is no requirement to duplicate content between the Risk Management Strategy, the ICAAP summary statement and ICAAP report;
- alignment of the list of material risks that must be covered under the risk management framework with the categorisation of risks used under the revised capital framework. This is expected to facilitate closer alignment between capital management and risk management;
- clarification of where certain requirements can be satisfied on an insurance group basis; and
- removal of the specific requirements relating to capital management as this is now covered by the proposed ICAAP requirements in GPS 110.[17]

17 A run-off insurer is not required to have an ICAAP and as such the capital management requirements for run-off insurers have been retained in draft GPS 220.

4.4 Prudential Standard GPS 230 Reinsurance Management

Draft GPS 230 sets out the minimum requirements relating to an insurer's reinsurance management framework. The proposed changes to GPS 230 combine the general insurer and Level 2 insurance group requirements relating to reinsurance. The specific adjustments to the prudential standard for Level 2 insurance groups are set out in an attachment to draft GPS 230. The proposed changes to GPS 230 include:

- clarification of where certain requirements can be satisfied on an insurance group basis;
- detail on the matters to be addressed in the ReMS as a result of the requirements of GPS 116;
- clarification that the reinsurance management framework must be consistent with the ICAAP;
- clarification that reinsurance assets that fail to comply with the two month and six month rules and the governing law requirement will be deducted from CET1 (previously Tier 1 Capital); and
- removal of historical transition paragraphs for arrangements in place prior to 2006.

As a result of the review of GPS 230, APRA has identified a refinement that should be made to the prudential framework relating to the reinsurance declaration. APRA invites comments from industry on this proposed refinement.

APRA has identified that there is some inconsistency between insurers regarding the reinsurance arrangements to which the attestation relates. This has resulted in some reinsurance declarations being completed on a retrospective basis, whilst others are being completed on a prospective basis. The reinsurance declaration is due four months after the insurer's year-end, which means that in some cases where the declaration is being completed on a prospective basis, an insurer can only attest that it intends to comply with the six-month rule. In addition, because the reinsurance declaration relates to the reinsurance arrangements of the insurer, it would be more meaningful to provide the declaration at the same time as the Reinsurance Arrangements Statement.

APRA is therefore proposing that the reinsurance declaration continue to be made on an annual basis and be provided to APRA at the same time as the Reinsurance Arrangements Statement. The reinsurance declaration is proposed to cover all reinsurance arrangements as set out in the current and previous Reinsurance Arrangements Statements.[18] This ensures that:

- the declaration attests that reinsurance from the previous treaty year complied with the six-month rule;
- there is consistency in the content of the declaration between insurers; and
- the insurer is given an opportunity to confirm that any gaps identified in the previous year have since been rectified.

18 Where an insurer is required to provide two Reinsurance Arrangements Statements to APRA on an annual basis, it would need to provide the declaration with only one of those Statements. The declaration would cover the last two Reinsurance Arrangements Statements as well as the current Reinsurance Arrangements Statements.

4.5 Prudential Standard GPS 310 Audit and Related Matters

Draft GPS 310 sets out the roles and responsibilities of the Appointed Auditor and Group Auditor, and the obligations of an insurer to ensure that the auditors can undertake those roles and responsibilities. The proposed changes to GPS 310 combine the general insurer and Level 2 insurance group requirements relating to audit matters. The specific adjustments to the prudential standard for Level 2 insurance groups are set out in an attachment to draft GPS 310. Consistent with the proposal in the December 2011 response paper, draft GPS 310 no longer contains details relating to actuarial matters as these have been set out in draft GPS 320.

No significant changes to the roles and responsibilities of an Appointed Auditor or Group Auditor, or the insurer or Level 2 insurance group's obligations in relation to audit requirements, have been made.

4.6 Prudential Standard GPS 320 Actuarial and Related Matters

Draft GPS 320 sets out the roles and responsibilities of an Appointed Actuary and Group Actuary, and the obligations of an insurer or Level 2 insurance group to make arrangements to enable its Actuary to fulfil those roles and responsibilities. These requirements were previously contained in GPS 310 and *Prudential Standard GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups*. The proposed changes to these two standards combine the general insurer and Level 2 insurance group requirements relating to actuarial matters. The specific adjustments to the prudential standard for Level 2 insurance groups are set out in an attachment to draft GPS 320. The proposed changes include:

- details of the additional responsibilities of the Appointed Actuary and Group Actuary under the revised capital framework, including calculation of certain components of the prescribed capital amount and assessment of gross uncertainty in the liability valuation;
- the revised deadline for the submission of the ILVR and FCR (as discussed in Chapter 2);
- consolidation of the requirements for valuation of insurance liabilities into an attachment;
- updating of the risk-free discount rates to be used by the Appointed Actuary and Group Actuary; and
- removal of paragraphs relating to 'material net written premiums' and the calculation of the prescribed capital amount for this business (as these are now contained in GPS 115).

Chapter 5 – Consequential amendments to non-capital prudential standards for life insurers

The December 2011 response paper proposed that a number of APRA prudential standards would be amended to reflect the proposed changes to the capital framework for life insurers. These standards are referred to as the non-capital prudential standards. This chapter discusses the proposed consequential amendments to each of these prudential standards. APRA invites submissions from industry on the proposed changes to these prudential standards.

All proposed amendments include the following:

- cross-referencing has been updated for consistency with the final capital standards released with this paper;
- terminology has been updated to reflect the revised capital framework;
- the prudential standards have been amended to contain standard paragraphs on 'Interpretation', and 'Adjustments and exclusions'; and
- definitions for certain terms in these prudential standards have been included in the updated draft of LPS 001.

APRA is also proposing a number of other amendments to the prudential framework for life insurers and these are set out in Chapter 6.

Except where otherwise indicated, all substantive changes to the prudential requirements in the prudential standards are shown in mark-up.

Draft life insurance prudential standards

The following revised life insurance prudential standards are being released for consultation:

- *Prudential Standard LPS 220 Risk Management* (LPS 220)
- *Prudential Standard LPS 320 Actuarial and Related Matters* (LPS 320)
- *Prudential Standard LPS 340 Valuation of Policy Liabilities* (LPS 340)
- *Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values* (LPS 360)
- *Prudential Standard LPS 370 Cost of Investment Performance Guarantees* (LPS 370)
- *Prudential Standard LPS 600 Statutory Funds* (LPS 600)
- *Prudential Standard LPS 700 Friendly Society Benefit Funds* (LPS 700)

Prudential Standard LPS 310 Audit and Related Matters (LPS 310) is not being released by APRA at this time as there are no proposed changes to the audit requirements. In addition, *Prudential Standard LPS 350 Contract Classification for the Purpose of Regulatory Reporting* (LPS 350) is proposed to be revoked as the provisions of this prudential standard are included in LPS 340.

Specific amendments proposed to be made in respect of LPS 220, LPS 320, LPS 370 and LPS 700 as a result of the revised capital framework are outlined below. The proposed amendments to LPS 340, LPS 360 and LPS 600 are set out in Chapter 6.

5.1 Prudential Standard LPS 220 Risk Management

Draft LPS 220 sets out the minimum requirements relating to the risk management framework of a life insurer. The proposed changes to LPS 220 include:

- the addition of paragraphs to clarify the interactions between the risk management framework and the ICAAP. This wording clarifies APRA's expectation that the two requirements combine to produce an integrated approach to risk and capital management, so that a life insurer's capital is commensurate with its risk profile and risk appetite. The standard also clarifies how the documentation requirements interact, noting that there is no requirement to duplicate content between the Risk Management Strategy, and the ICAAP summary statement and ICAAP report;
- alignment of the list of material risks that must be covered under the risk management framework with the categorisation of risks used under the revised capital framework. This is expected to facilitate closer alignment between capital management and risk management; and
- removal of obsolete transition paragraphs.

5.2 Prudential Standard LPS 310 Audit and Related Matters

LPS 310 sets out the roles and responsibilities of a life insurer's Auditor and the obligations of a life insurer to ensure that the Auditor can undertake those roles and responsibilities. The only change proposed to be made to LPS 310 is to update the table at Attachment A that specifies the auditable annual returns, so that it refers to the revised reporting arrangements. APRA's consultation on the revised reporting framework will indicate the revised audit arrangements for APRA reporting. As such, a revised version of LPS 310 is not being released at this time.

5.3 Prudential Standard LPS 320 Actuarial and Related Matters

Draft LPS 320 sets out the roles and responsibilities of a life insurer's Appointed Actuary and the obligations of a life insurer to make arrangements to enable its Appointed Actuary to fulfil those roles and responsibilities. The proposed changes to LPS 320 include:

- the principle that responsibility for determining the prescribed capital amount and the capital base lies with the life insurer and, ultimately, its Board;
- the requirement that all reporting of the prescribed capital amount and the capital base to APRA (whether quarterly, annual or *ad hoc*) be made in accordance with a documented methodology that has been the subject of advice provided by the Appointed Actuary. A life insurer would need to provide to APRA an explanation of any areas where the advice of the Appointed Actuary regarding this methodology is not adopted. The existence of a documented methodology is intended to help ensure that the life insurer, the Appointed Actuary and APRA have a common understanding of the approach taken to capital measurement; and
- the requirement that the Appointed Actuary advise a value for the prescribed capital amount and the capital base in the FCR including documenting the assumptions and methodologies adopted for the purpose of the calculations. Where a life insurer does not adopt the amounts advised by its Appointed Actuary in its annual reporting to APRA, it would be required to explain any differences to APRA.

5.4 Prudential Standard LPS 370 Cost of Investment Performance Guarantees

Draft LPS 370 is the updated version of *Prudential Standard LPS 5.02 Cost of Investment Performance Guarantees* (LPS 5.02). LPS 5.02 prescribes the principles and methodology for calculating the cost of investment performance guarantees provided in association with investment-linked contracts.

LPS 5.02 relied on the resilience reserve calculated under the current *Prudential Standard LPS 3.04 Capital Adequacy Standard* for determining the cost of any investment performance guarantees. Under the revised capital framework, the resilience reserve will no longer be calculated. APRA has considered a range of options for calculating the cost of performance guarantees. In APRA's view, an appropriate basis can be derived from the policy liability valuation, being the increase in the fair value of the financial instrument element that is attributable to the presence of the investment performance guarantee. The fair value would be assessed in accordance with the relevant accounting standards.

Note that this prudential standard has not been released with substantive changes in mark-up due to the restructuring of this standard as set out in Chapter 6.

5.5 Prudential Standard LPS 700 Friendly Society Benefit Funds

Draft LPS 700 sets out the requirements for the establishment, structure and operation of an approved benefit fund of a friendly society so that it is fair and equitable for its policy owners. The proposed changes to LPS 700 reflect consequential changes as a result of the revised capital framework.

Chapter 6 – Other prudential refinements for life insurers

In addition to the changes proposed as a consequence of the revised capital framework, APRA has taken the opportunity to more generally review some of the content of the existing prudential standards. As a result, APRA is proposing to simplify and enhance the readability of a number of life insurance prudential standards. APRA is also proposing to make an amendment to the prudential framework for life insurers in relation to the role of the Appointed Actuary. APRA invites comments from industry on these proposed refinements.

6.1 Role of the Appointed Actuary

Under the revised capital framework, responsibility for determining the prescribed capital amount and the capital base lies with the life insurer, with consideration of advice from the Appointed Actuary. Consistent with that approach, APRA is proposing to amend the prudential framework so that responsibility for determining other prudential amounts lies with the life insurer rather than the Appointed Actuary. The methodology for valuing these amounts would be documented and would be the subject of advice from the Appointed Actuary. The Appointed Actuary would still be required to advise a value for the policy liabilities in the FCR.

APRA is therefore proposing to amend the prudential standards to place responsibility for determining policy liabilities, surrender values, paid-up values, the cost of investment performance guarantees and for making certain assessments in relation to statutory funds on the life insurer rather than the Appointed Actuary. This proposed change results in a consistent position across the life insurance prudential framework so that the life insurer is responsible for compliance with the prudential standards and the Appointed Actuary provides advice to assist the insurer in complying with those requirements.

In all cases, where the life insurer does not accept the advice of the Appointed Actuary, the insurer will be required to explain the areas of difference to APRA, including details of alternative assumptions and methodologies used.

As a result of the above proposal, the Appointed Actuary would be required in the FCR to:

- provide a valuation of the policy liabilities;
- assess whether the insurer has appropriate systems for ensuring compliance with LPS 360; and
- assess the cost of any investment performance guarantees and whether each investment-linked statutory fund has complied with LPS 370 during the financial year.

6.2 Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values

The existing structure and wording of *Prudential Standard LPS 4.02 Minimum Surrender Values and Paid-up Values* (LPS 4.02) had resulted from incremental amendments over a period of several years. APRA has taken the opportunity to amend the structure and wording of LPS 4.02 to enhance the readability and clarity of the standard. APRA has also renumbered the standard and updated its title. The material proposed changes include:

- modification to a number of definitions to reflect the changed role for termination values under the revised capital framework;
- a requirement that, where the minimum termination value for a type of policy is not specified in the prudential standard, the life insurer must obtain the approval of APRA for the proposed approach to determining the minimum termination value. This proposal enhances the flexibility of the prudential standard to address innovative product structures where necessary; and

- amendment to the definition of unbundled business in LPS 001 by removing the reference to deferred annuities. Older style deferred annuities that are investment-linked or investment account business during the deferral period would continue to be regarded as unbundled business and the rules for determining their minimum termination values would be unchanged. However, deferred annuities that are neither investment-linked nor investment account would not be treated as unbundled business. Under the proposed approach, APRA would need to approve the minimum termination values for these types of deferred annuities.

6.3 Changes to other standards originally issued by the Life Insurance Actuarial Standards Board

APRA proposes to also update *Prudential Standard LPS 1.04 Valuation of Policy Liabilities* (LPS 1.04), LPS 360 (previously LPS 4.02) and *Prudential Standard LPS 5.02 Cost of Investment Performance Guarantees* to align with the structure of APRA's prudential standards. These standards were originally issued by the Life Insurance Actuarial Standards Board using a different form and structure to that adopted by APRA.

These standards contained a mixture of requirements and associated guidance. In transferring this material into prudential standard format, APRA proposes to not incorporate some aspects of the previous wording that were purely guidance and description. Some changes have also been made to the wording to enhance readability and clarify the structure. APRA has also updated the numbering of these prudential standards. The updated versions of these standards are LPS 340 (previously LPS 1.04), LPS 360 (previously LPS 4.02) and LPS 370 (previously LPS 5.02). Note that these prudential standards have not been released with substantive changes in mark-up due to the restructuring of the standards.

The substance of the requirements is largely unchanged, except for the proposed changes to LPS 360 outlined in section 6.2.

In addition, APRA is proposing to update LPS 340 to incorporate relevant material from LPS 350. APRA does not consider there to be a need for a separate prudential standard that sets out the requirements on classification and unbundling and has incorporated these into LPS 340. The substance of the requirements remains unchanged. LPS 350 will be revoked with effect from 1 January 2013.

6.4 Prudential Standard LPS 600 Statutory Funds

APRA proposes to make minor wording changes to LPS 600 to reduce and simplify the material setting out the calculation of starting amounts for the purpose of section 61(1) of the Life Act. APRA also proposes to clarify requirements regarding when a restructure of statutory funds has effect and the consequences of transfer between statutory funds by way of endorsement of a policy.

Chapter 7 – Cost-benefit analysis information

To improve the quality of regulation, the Australian Government requires all proposals to undergo a preliminary assessment to establish whether it is likely that there will be business compliance costs. In order to perform a comprehensive cost-benefit analysis, APRA welcomes information from interested parties on the financial impact of the changes proposed under this review and any other substantive costs associated with the proposed reforms. These costs could include the impact on balance sheets, profit and loss, and capital.

As part of the consultation process, APRA also requests respondents to provide an assessment of the compliance impact of the proposed changes. Given that APRA's proposed requirements may impose some compliance and implementation costs, respondents may also indicate whether there are any other regulations relating to general insurers or life insurers that should be improved or removed to reduce compliance costs. In doing so, please explain what they are and why they need to be improved or removed.

Respondents are requested to use the Business Cost Calculator (BCC) to estimate costs to ensure that the data supplied to APRA can be aggregated and used in an industry-wide assessment. APRA would appreciate being provided with the input to the BCC as well as the final result. The BCC can be accessed at www.finance.gov.au/obpr/bcc/index.html.

Appendix 1 – Prudential standards for general insurers

The final suite of prudential standards effective from 1 January 2013 for general insurers will be:

Proposed framework of prudential standards	Released for consultation	Final version released
GPS 001 Definitions	December 2011 and May 2012	September – October 2012
GPS 110 Capital Adequacy	December 2011	May 2012
GPS 112 Capital Adequacy: Measurement of Capital	May 2012	September – October 2012
GPS 113 Capital Adequacy: Internal Model-based Method	May 2012	September – October 2012
GPS 114 Capital Adequacy: Asset Risk Charge	December 2011	May 2012
GPS 115 Capital Adequacy: Insurance Risk Charge	December 2011	May 2012
GPS 116 Capital Adequacy: Insurance Concentration Risk Charge	December 2011	May 2012
GPS 117 Capital Adequacy: Asset Concentration Risk Charge	December 2011	May 2012
GPS 118 Capital Adequacy: Operational Risk Charge	December 2011	May 2012
GPS 120 Assets in Australia	May 2012	September – October 2012
GPS 220 Risk Management	May 2012	September – October 2012
GPS 230 Reinsurance Management	May 2012	September – October 2012
CPS 231 Outsourcing	No change	September – October 2012*
CPS 232 Business Continuity Management	No change	September – October 2012*
GPS 310 Audit and Related matters	May 2012	September – October 2012
GPS 320 Actuarial and Related matters	May 2012	September – October 2012
GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers	No change	No change
CPS 510 Governance	No change	September – October 2012*
CPS 520 Fit and Proper	No change	September – October 2012*

Prudential standards to be revoked from 1 January 2013
GPS 111 Capital Adequacy: Level 2 insurance groups
GPS 221 Risk Management: Level 2 insurance groups
GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 insurance groups

* These cross-industry prudential standards will have a small number of footnotes updated to reflect the amended prudential standards for general insurers.

Appendix 2 – Prudential standards for life insurers

The final suite of prudential standards effective from 1 January 2013 for life insurers will be:

New prudential standards effective from 1 January 2013	Released for consultation	Final version released
LPS 001 Definitions	December 2011 and May 2012	September – October 2012
LPS 110 Capital Adequacy	December 2011	May 2012
LPS 112 Capital Adequacy: Measurement of Capital	December 2011 and May 2012	September – October 2012
LPS 114 Capital Adequacy: Asset Risk Charge	December 2011	September – October 2012
LPS 115 Capital Adequacy: Insurance Risk Charge	December 2011	May 2012
LPS 117 Capital Adequacy: Asset Concentration Risk Charge	December 2011	May 2012
LPS 118 Capital Adequacy: Operational Risk Charge	December 2011	May 2012
Existing prudential standards		
LPS 220 Risk Management	May 2012	September – October 2012
LPS 230 Reinsurance	No change	No change
CPS 231 Outsourcing	No change	September – October 2012*
CPS 232 Business Continuity Management	No change	September – October 2012*
LPS 310 Audit and Related Matters	June 2012	October 2012
LPS 320 Actuarial and Related Matters	May 2012	September – October 2012
LPS 340 Valuation of Policy Liabilities (previously named LPS 1.04 and now includes LPS 350 provisions)	May 2012	September – October 2012
LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values (previously named LPS 4.02)	May 2012	September – October 2012
LPS 370 Cost of Investment Performance Guarantees (previously named LPS 5.02)	May 2012	September – October 2012
CPS 510 Governance	No change	September – October 2012*
CPS 520 Fit and Proper	No change	September – October 2012*
LPS 600 Statutory Funds	May 2012	September – October 2012
LPS 700 Friendly Society Benefit Funds	May 2012	September – October 2012

Prudential standards to be revoked from 1 January 2013
PS 3 Prudential Capital Requirement
LPS 2.04: Solvency Standard
LPS 3.04: Capital Adequacy Standard
LPS 6.03: Management Capital Standard
LPS 7.02: General Standard
LPS 350 Contract Classification for the Purpose of Regulatory Reporting

* These cross-industry prudential standards will have a small number of footnotes updated to reflect the amended prudential standards for general insurers.

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