



Prudential Standard LPS 112

Capital Adequacy: Measurement of Capital

Objectives and key requirements of this Prudential Standard

This Prudential Standard sets out the characteristics that an instrument must have to qualify for inclusion in the capital base of a life company and the various regulatory adjustments to be made to determine the capital base for each statutory fund, the general fund and the life company as a whole.

The ultimate responsibility for ensuring that the capital base of a life company and the capital bases of all of its funds meet the requirements of this Prudential Standard rests with its Board of directors.

The key requirements of this Prudential Standard are that a life company must:

- comply with minimum requirements regarding the size and composition of the capital base for the life company as a whole and for each of its funds;
- include in the appropriate category of capital (i.e. Common Equity Tier 1 Capital, Additional Tier 1 Capital or Tier 2 Capital) only those capital instruments that meet the detailed criteria for that category;
- ensure all capital instruments are capable of bearing loss; and
- make certain regulatory adjustments to capital, mainly from Common Equity Tier 1 Capital, to determine the capital base.

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Authority

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

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act¹, except where expressly noted otherwise.
3. A life company must apply this Prudential Standard separately:
 - (a) for a life company other than a friendly society: to each of its statutory funds, its shareholders' fund and the life company as a whole; and
 - (b) for a friendly society: to each of its approved benefit funds, its management fund and the friendly society as a whole.
4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** which is carried on through its Australian statutory funds but not otherwise.²
5. This Prudential Standard applies to life companies from 1 January 2013.

Interpretation

6. Terms that are defined in *Prudential Standard LPS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.
7. Unless otherwise indicated:
 - (a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;
 - (b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and
 - (c) the term 'fund' will be used to refer to a statutory fund or a general fund, as relevant.

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

² Refer to section 16ZD of the Act.

8. For the purposes of this Prudential Standard:
- (a) a 'component of capital' is any form of capital defined in this Prudential Standard as eligible for inclusion in the capital base;
 - (b) a 'category of capital' is a group of components of capital; and
 - (c) the 'net assets' of a statutory fund or general fund is a reference to the net assets of the fund determined under the life company's prudential reporting to APRA under the *Financial Sector (Collection of Data) Act 2001* (Collection of Data Act). It includes shareholders' capital and retained profits, unallocated benefit fund reserves³, other reserves and foreign currency translation reserves.

Capital base of a life company

9. The capital base must be assessed for the life company as a whole and for each of its funds. The requirements for statutory funds are specified in paragraphs 35 to 38. The requirements for general funds are specified in paragraphs 39 to 40. Paragraphs 10 to 34 set out the requirements for the life company as a whole.
10. The capital base of a life company consists of the following categories:
- (a) Tier 1 Capital, which comprises:
 - (i) Common Equity Tier 1 Capital; and
 - (ii) Additional Tier 1 Capital; and
 - (b) Tier 2 Capital.
11. A life company must ensure that at all times:
- (a) the Common Equity Tier 1 Capital for the life company exceeds 60 per cent of the **prescribed capital amount** of the life company;
 - (b) the Tier 1 Capital for the life company exceeds 80 per cent of the prescribed capital amount of the life company; and
 - (c) the capital base for the life company exceeds the **Prudential Capital Requirement** (PCR) of the life company.
12. APRA may require, by notice in writing, a life company to hold a higher percentage of its prescribed capital amount as Common Equity Tier 1 Capital and/or Tier 1 Capital.

³ This item only applies to friendly society benefit funds providing defined benefits. It includes unallocated surplus that must be transferred to the management fund and unallocated surplus that may either be transferred to the management fund or used for benefit enhancement under the benefit fund rules.

13. A life company must ensure that any component of capital included in its capital base satisfies, in both form and substance, all requirements in this Prudential Standard for the particular category of capital in which it is included.
14. A life company must not include a component of capital in a particular category of capital if that component, when considered in conjunction with other related transactions that affect its overall economic substance, could be reasonably considered not to satisfy the requirements of this Prudential Standard for that category of capital.
15. A life company must not include a capital instrument in a category of capital based on a future event, such as the future sale or issuance of a higher quality capital instrument, until such time as:
 - (a) the future event occurs, and
 - (b) the proceeds have been irrevocably received by the life company.
16. APRA may, in writing, require a life company to:
 - (a) exclude from its capital base any component of capital that in APRA's opinion is not a genuine contribution to the financial strength of the life company; or
 - (b) reallocate to a lower category of capital any component of capital that in APRA's opinion does not satisfy the requirements of this Prudential Standard for the category of capital to which it was originally allocated.
17. A life company may not, without obtaining APRA's prior written approval, enter into an arrangement where it may purchase, or provide financial assistance with a dominant purpose of facilitating the purchase by another party of, its own capital instruments. Any such arrangement, if approved by APRA, shall be subject to a limit agreed with APRA.
18. A life company must provide APRA, as soon as practicable, with copies of documentation associated with the issue of Additional Tier 1 Capital and Tier 2 Capital instruments.
19. Where the terms of an instrument depart from established precedent, a life company must consult with APRA on the eligibility of the capital instrument for inclusion in the life company's capital base in advance of the issuance of the capital instrument, and provide APRA with all information it requires to assess the eligibility of the capital instrument.
20. A life company must obtain APRA's written consent before the terms or conditions of an instrument are amended in a way that may affect its eligibility as a component of capital.

Common Equity Tier 1 Capital

21. Common Equity Tier 1 Capital comprises the highest quality components of capital that fully satisfy all of the following characteristics:
 - (a) provide a permanent and unrestricted commitment of funds;
 - (b) are freely available to absorb losses;
 - (c) do not impose any unavoidable servicing charge against earnings; and
 - (d) rank behind the claims of policy owners and other creditors in the event of winding-up of the issuer.

22. Common Equity Tier 1 Capital consists of the sum of:
 - (a) paid-up ordinary shares issued by a life company that meet the criteria in Attachment A;
 - (b) retained earnings;
 - (c) undistributed current year earnings (refer to paragraph 23);
 - (d) accumulated other comprehensive income and other disclosed reserves (refer to paragraph 25); and
 - (e) regulatory adjustments applied in the calculation of Common Equity Tier 1 Capital required under Attachment B.

23. Current year earnings must take into account:
 - (a) negative goodwill;
 - (b) expected tax expenses; and
 - (c) dividends when declared in accordance with **Australian Accounting Standards**.

24. Declared dividends for the purpose of paragraph 23(c) may be reduced by the expected proceeds, as agreed in writing by APRA, of a Dividend Reinvestment Plan (DRP) to the extent that dividends are used to purchase new ordinary shares issued by the life company. A life company must review every six months the expected subscription for new ordinary shares under its DRP having regard to experience over previous years and reasonable expectations of the level of subscription that might apply in future. If a life company identifies any material change in the expected level of future subscription for new ordinary shares under its DRP, it must notify APRA and obtain APRA's agreement to a new amount by which declared dividends may be reduced for regulatory capital purposes.

25. Accumulated other comprehensive income and other disclosed reserves include, but are not limited to:
- (a) unrealised gains or losses recognised on the balance sheet;
 - (b) reserves from equity-settled share-based payments (share or share options) granted to employees as part of their remuneration package provided that:
 - (i) the share or share options granted relate only to the ordinary shares of the life company;
 - (ii) the ordinary shares comprise only new ordinary shares to be issued by the life company, or new ordinary shares already issued by the life company for this specific purpose; and
 - (iii) there are no circumstances under which such remuneration can be converted into another form (e.g. cash).

Any other reserves associated with share-based payments must be excluded from the life company's capital base;
 - (c) foreign currency translation reserve;
 - (d) general reserves;
 - (e) cumulative unrealised gains or losses on hedges⁴ offsetting gains or losses included in Common Equity Tier 1 Capital (such as movements in the currency value of foreign-currency-denominated hedging instruments that offset movements in foreign-currency-denominated items recognised in the foreign currency translation reserve). This includes fair value gains or losses on derivatives representing effective economic hedges of assets; and
 - (f) any other gains and losses in accumulated other comprehensive income and other disclosed reserves that may be specified by APRA in writing.

Additional Tier 1 Capital

26. Additional Tier 1 Capital comprises high quality components of capital that satisfy the following essential characteristics:
- (a) provide a permanent and unrestricted commitment of funds;
 - (b) are freely available to absorb losses;
 - (c) rank behind the claims of policy owners and other more senior creditors in the event of winding up of the issuer; and

⁴ This includes cumulative unrealised gains or losses on effective cash flow hedges as defined in Australian Accounting Standards.

- (d) provide for fully discretionary capital distributions.
27. Additional Tier 1 Capital consists of:
- (a) instruments issued by a life company that are not included in Common Equity Tier 1 Capital and which meet:
 - (i) the criteria for inclusion in Additional Tier 1 Capital set out in Attachment C; and
 - (ii) the requirements for loss absorbency at the point of non-viability set out in Attachment G; and
 - (b) regulatory adjustments applied in the calculation of Additional Tier 1 Capital as required under Attachment B.
28. An Additional Tier 1 Capital instrument may be a stapled security structure provided the structure meets the criteria in Attachment D.

Tier 2 Capital

29. Tier 2 Capital includes other components of capital that, to varying degrees, fall short of the quality of Tier 1 Capital but nonetheless contribute to the overall strength of a life company and its capacity to absorb losses.
30. Tier 2 Capital consists of:
- (a) instruments issued by the life company that meet:
 - (i) the criteria for inclusion in Tier 2 Capital set out in Attachment E; and
 - (ii) the requirements for loss absorption at the point of non-viability set out in Attachment G; and
 - (b) regulatory adjustments applied in the calculation of Tier 2 Capital as required under Attachment B.

Additional Tier 1 or Tier 2 Capital issued overseas by the life company

31. Additional Tier 1 Capital instruments and Tier 2 Capital instruments may be issued by a life company, either in its country of incorporation or through a branch in another country, provided the instrument:
- (a) constitutes an obligation of the life company at all times;
 - (b) is freely available to absorb losses across all of the operations of the life company; and

- (c) meets all of the requirements of this Prudential Standard for inclusion in Additional Tier 1 or Tier 2 Capital.

Use of Special Purpose Vehicles to issue Additional Tier 1 and Tier 2 Capital instruments

- 32. Capital instruments issued through a **Special Purpose Vehicle** (SPV) must satisfy the requirements of Attachment F to be eligible Additional Tier 1 Capital or Tier 2 Capital.

Holding of capital instruments in group members by other group members

- 33. Direct investments in shares of a life company by an SPV (e.g. a trust) established under a share-based employee remuneration scheme may be included in the life company's Common Equity Tier 1 Capital only if:
 - (a) the shares issued to the SPV represent ordinary shares of the life company;
 - (b) the amount included in Common Equity Tier 1 Capital is matched by an equivalent charge to profit and loss of the life company for expensing the issue or funding the acquisition of ordinary shares by the vehicle; and
 - (c) the ordinary shares issued cannot be converted to payment in another form (e.g. cash).
- 34. If the requirements in paragraph 33 are not satisfied, the relevant capital instruments must be treated as holdings of own capital instruments and deducted from Common Equity Tier 1 Capital in accordance with paragraph 5 of Attachment B.

Capital base of a statutory fund

- 35. The capital base of a statutory fund is:
 - (a) the net assets of the fund; less
 - (b) all regulatory adjustments to the net assets of the statutory fund required under Attachment B; plus
 - (c) Tier 2 Capital as defined in paragraph 36.
- 36. The Tier 2 Capital of a statutory fund consists of:
 - (a) instruments that are a liability of that fund and meet the criteria for inclusion in Tier 2 Capital as set out in Attachment E; less
 - (b) all holdings by the fund of the life company's own Tier 2 Capital instruments.

37. A life company must ensure that, at all times:
- (a) the capital base less the Tier 2 Capital in accordance with paragraph 36 of each statutory fund exceeds 80 per cent of the prescribed capital amount of the fund; and
 - (b) the capital base of each statutory fund exceeds the PCR of the fund.
38. APRA may, by notice in writing to a life company, set a higher percentage for the capital base, net of Tier 2 Capital, for one or more statutory funds of the life company.

Capital base of a general fund

39. The capital base of a general fund is:
- (a) the net assets of the fund; less
 - (b) all regulatory adjustments to the net assets of the general fund required under Attachment B.
40. A life company must ensure that, at all times, the capital base of the general fund exceeds the PCR of the fund.

Adjustments and exclusions

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

Transition

42. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until 31 December 2014.

Attachment A

Criteria for classification as paid-up ordinary shares

1. To be classified as paid-up ordinary shares in Common Equity Tier 1 Capital, an instrument must satisfy the following criteria:
 - (a) the instrument represents the most subordinated claim in liquidation of the issuer;
 - (b) the instrument holder is entitled to a claim on the residual assets that is proportional to its share of issued capital, after all senior claims have been repaid in liquidation (i.e. there is an unlimited and variable claim, not a fixed or capped claim);
 - (c) the principal amount of the instrument is perpetual (i.e. it has no maturity date) and is never repaid outside of liquidation (other than discretionary repurchases subject to APRA approval);
 - (d) the issuer, and any other member of a group to which the issuer belongs, does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled and the statutory or contractual terms of the instrument do not include any feature that might give rise to such an expectation;
 - (e) distributions on the instrument are paid out of distributable items (retained earnings included) of the issuer, and the terms of the instrument do not provide for payment to investors other than in the form of a cash payment. The level of distributions must not be tied or linked to the amount paid up at issuance, or to the credit standing of the issuer, and must not be subject to a contractual cap, except to the extent that restrictions applied to the payment of distributions are in accordance with *Prudential Standard LPS 110 Capital Adequacy* (LPS 110);
 - (f) there are no circumstances under which the distributions are obligatory. Non-payment of a distribution does not trigger any restrictions on the issuer or any other member of the group to which the issuer belongs. Any waived distributions are non-cumulative (i.e. they are not required to be made up by the issuer at a later date). Non-payment of distributions must not be an event of default of the issuer or of any other member of the group to which the issuer belongs;
 - (g) distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. There are no preferential distributions, including in respect of other elements classified as Common Equity Tier 1 Capital;
 - (h) the instruments take the first and proportionately greatest share of any losses as they occur.⁵ Within Common Equity Tier 1 Capital, each

⁵ In cases where capital instruments have a permanent write-off feature, this criterion is still deemed to be met by ordinary shares.

instrument absorbs losses proportionately, and *pari passu*, with all the other instruments included in Common Equity Tier 1 Capital;

- (i) only the paid-up amount of the instrument, irrevocably received by the issuer, is recognised as equity capital (i.e. it is not recognised as a liability) for determining balance sheet insolvency;
 - (j) the paid-up amount of the instrument is classified as equity under relevant accounting standards;
 - (k) the instrument is directly issued by the issuer, and, except where otherwise permitted in this Prudential Standard, the issuer, any other member of a group to which the issuer belongs, or any 'related entity'⁶, cannot have purchased or directly or indirectly funded the purchase of the instrument;
 - (l) the paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of the issuer or a related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim. The instrument may not be subject to netting or offset claims on behalf of the holder or the issuer of the instrument;
 - (m) the instrument is only issued with the approval of the owners of the issuer, either given directly by the owners or, if permitted by applicable law, given by the Board or by other persons duly authorised by the owners; and
 - (n) the instrument is clearly and separately disclosed on the issuer's financial statements and, in any consolidated financial statements. Disclosure must be in line with the frequency with which a life company publishes its financial results.
2. Where an instrument is subject to the laws of a jurisdiction other than Australia or its territories, the life company must also ensure that the instrument satisfies all relevant qualifying criteria for Common Equity Tier 1 Capital under the laws of that jurisdiction. APRA may require the life company to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the expense of the life company, confirming that the instrument meets all or any of the criteria applied to Common Equity Tier 1 Capital instruments in this Prudential Standard.

⁶ A reference to 'related entity', which is a subset of a related party, in this Prudential Standard is one over which the life company or its parent exercises control or significant influence and includes a parent company, a sister company, a subsidiary or any other affiliate. A holding company is a related entity irrespective of whether it forms part of a corporate group. This does not preclude the parent entity of the life company holding the instrument where the instrument is directly issued by the life company to the parent.

Attachment B

Regulatory adjustments

General rules for regulatory adjustments

1. In determining the size of deductions from a life company's capital base, items must be valued on the same basis as a life company's accounts prepared in accordance with the Collection of Data Act.
2. For the purposes of regulatory adjustments to Additional Tier 1 Capital and Tier 2 Capital:
 - (a) where the amount of Additional Tier 1 Capital is insufficient to cover the amount of deductions required to be made from this category of capital, the shortfall must be deducted from Common Equity Tier 1 Capital; and
 - (b) where the amount of Tier 2 Capital is insufficient to cover the amount of deductions required to be made from this category of capital, the shortfall must be deducted from Additional Tier 1 Capital and, if Additional Tier 1 Capital is insufficient to cover the amount of the deductions required, the remaining amount must be deducted from Common Equity Tier 1 Capital.
3. Where a capital instrument is required to be deducted and it is not possible to determine whether it should be deducted from Common Equity Tier 1 Capital, Additional Tier 1 Capital or Tier 2 Capital, the regulatory adjustment must be made from Common Equity Tier 1 Capital. A life company must consult APRA if there is uncertainty about the category of capital against which a deduction must be made.

Exception for assets with values linked to the value of liabilities

4. If policy benefits can be reduced in response to a fall in the value of an asset listed in this Attachment, the asset does not have to be deducted. However, the asset will be subject to a 100 per cent capital charge when applying the default risk stress under *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge*. This treatment can only be applied if:
 - (a) the benefits under the policy are contractually linked to the performance of the asset;
 - (b) the extent of the exposure to the asset is consistent with the stated investment objectives; and
 - (c) there has been appropriate disclosure to policy owners of the risks to which they are exposed.

Holdings of own capital instruments

5. Unless otherwise indicated, a life company must deduct from the corresponding category of capital holdings of the life company's own capital instruments, whether held directly or indirectly, unless otherwise exempted in writing by

APRA or unless eliminated under Australian Accounting Standards from the relevant category of capital. This deduction must include any capital instruments that the life company could be contractually obliged to purchase and also all of the unused portion of any limit agreed with APRA under paragraph 17 of this Prudential Standard;

6. For the purposes of deducting holdings of Additional Tier 1 Capital and Tier 2 Capital instruments, a life company may net any specific provisions raised against the relevant exposures or holdings before making the necessary deductions from the relevant categories of capital.

Regulatory adjustments to Common Equity Tier 1 Capital

7. A life company must make the following regulatory adjustments to determine Common Equity Tier 1 Capital.

Deferred tax

8. Subject to paragraphs 9 and 10 of this Attachment, a life company must deduct deferred tax assets net of deferred tax liabilities.⁷
9. The netting of these items must be on a consistent basis. Where deferred tax liabilities exceed deferred tax assets, the excess of deferred tax liabilities cannot be added to Common Equity Tier 1 Capital (i.e. the net deduction is zero). Deferred tax assets and liabilities include any tax effects that would result from adjustments to policy liabilities.
10. The netting of deferred tax assets and deferred tax liabilities must only be applied where the life company has a legally enforceable right to set-off current tax assets against current tax liabilities where they relate to income taxes levied by the same taxation authority and the taxation authority permits the life company to make or receive a single net payment.
11. In order to apply the treatment in paragraph 8 of this Attachment, a life company must:
 - (a) have procedures in place to monitor changes in relevant laws and taxation practices that may affect the written opinions it is required to obtain covering netting of deferred tax assets and deferred tax liabilities; and
 - (b) ensure that the written opinions are updated in the event of changes in laws or taxation practices overseas that could materially impact on overseas taxation authorities continuing to allow netting of deferred tax assets and deferred tax liabilities.

⁷ Excluding any deferred tax liabilities that have already been netted off elsewhere in accordance with this Prudential Standard.

Fair value gains and losses arising from changes in own creditworthiness

12. A life company must eliminate all unrealised gains and losses that have resulted from changes in the fair value of liabilities (including capital instruments)⁸ due to changes in the life company's own creditworthiness.

Goodwill and other intangibles

13. Subject to paragraph 14 of this Attachment, a life company must deduct the following items⁹ net of any associated deferred tax liability that would be extinguished if the assets involved become impaired or derecognised under Australian Accounting Standards:
- (a) goodwill and any other intangible assets arising from an acquisition, net of adjustments to profit or loss reflecting any changes arising from 'impairment' of goodwill; and
 - (b) other intangible assets net of adjustments to profit or loss reflecting amortisation and impairment. Intangible assets are as defined in Australian Accounting Standards and include capitalised expenses and capitalised transaction costs. These expenses include:
 - (i) costs associated with debt raisings and other similar transaction-related costs that are capitalised as an asset;
 - (ii) costs associated with issuing capital instruments if not already charged to profit and loss;
 - (iii) capitalised information technology software costs; and
 - (iv) other capitalised expenses including capitalised expenses of a general nature such as strategic business development initiatives. These include, in addition to the above listed items, other forms of transaction costs and like costs that are required to be deferred/capitalised and amortised as part of the measurement of assets and liabilities under Australian Accounting Standards.
14. An investment in a subsidiary, joint venture¹⁰ or **associate** that:
- (a) is operationally independent;
 - (b) represents a genuine arm's length investment;
 - (c) is not subject to prudential capital requirements; and

⁸ Tier 2 Capital instruments must continue to be measured for capital adequacy purposes at their contractual values. Tier 2 Capital instruments may be hedged in accordance with accounting standards.

⁹ For the avoidance of doubt, this deduction, subject to paragraph 14 of this Attachment, must include goodwill and intangibles attributable to investments in subsidiaries, joint ventures and associates.

¹⁰ For the purposes of this Prudential Standard, a joint operation (as defined under *Australian Accounting Standard AASB 11 Joint Arrangements*) is to be treated as a joint venture.

- (d) does not undertake 'life insurance business' or business related to insurance business¹¹

does not have its intangible assets (including the intangible component that could arise after or outside of acquisition) deducted under paragraph 13 of this Attachment.

Superannuation funds

15. A life company must deduct any surplus in a defined benefit superannuation fund, of which the life company is an employer-sponsor, unless otherwise approved in writing by APRA. The surplus must be net of any associated deferred tax liability that would be extinguished if the assets involved become impaired or derecognised under Australian Accounting Standards. A life company may apply to APRA to include a surplus as an asset for capital adequacy purposes where the life company is able to demonstrate unrestricted and unfettered access to a fund surplus in a timely manner. Subject to APRA approval the life company may include the surplus in its capital base. This surplus will no longer be required to be deducted from Common Equity Tier 1 Capital.
16. A life company must deduct any deficit in a defined benefit superannuation fund of which a life company is an employer-sponsor and that is not already reflected in Common Equity Tier 1 Capital.

Reinsurance assets

17. A life company must deduct all reinsurance assets¹² (if positive) reported in relation to each reinsurance arrangement that, subject to a six month grace period from risk inception, does not comprise an executed and legally binding contract.

Investments in subsidiaries, joint ventures and associates

18. A life company must make a deduction for investments in subsidiaries, joint ventures and associates that are subject to regulatory capital requirements. The amount of the deduction is the lesser of the life company's share of the regulatory capital requirements¹³ and the value of the investment that is recorded on the life company's balance sheet after adjustment for any intangible component in accordance with paragraphs 13 and 14 of this Attachment. This deduction must be applied after any deduction for intangibles in the investment in accordance with paragraphs 13 and 14 of this Attachment.

¹¹ Entities that undertake business related to life insurance business include entities that provide a financing role to life insurance business, life insurance intermediaries and service companies.

¹² For the purposes of this Prudential Standard, 'reinsurance assets' refers to reinsurance assets net of doubtful debts.

¹³ The life company's share of the regulatory capital requirements is determined by applying the ownership of the subsidiary, joint venture or associate (as relevant) to the total regulatory capital requirement of the investment.

19. For the purposes of the deduction in paragraph 18 of this Attachment, the regulatory capital requirement of the investment is:
 - (a) the prescribed capital amount if the investment is in a life company as defined under the Act; or
 - (b) the equivalent amount to the prescribed capital amount if the investment is an entity carrying on life insurance business in a foreign jurisdiction; or
 - (c) a comparable regulatory capital requirement as agreed with APRA.¹⁴
20. If the investment subject to the deduction in paragraph 18 of this Attachment is a **non-operating holding company** (NOHC), the life company must 'look-through' the investment to the value and regulatory capital requirements of the entity/entities owned by the NOHC.

Assets under a fixed or floating charge

21. A life company must deduct all assets of the life company that are under a fixed or floating charge¹⁵, mortgage or other security to the extent of the indebtedness secured on those assets. This deduction may be reduced by the amount of any liability for the charge that is recognised on the life company's balance sheet.

Difference between the adjusted policy liabilities and the sum of policy liabilities and policy owners' retained profits

22. A life company must deduct the difference between the **adjusted policy liabilities** and the sum of the **policy liabilities**¹⁶ and policy owners' retained profits disclosed in the **statutory accounts** together with any tax effects that would result from these adjustments. This difference can be positive or negative. Policy liabilities must be net of reinsurance. The method of determining the adjusted policy liabilities is specified in Attachment H;

Fair value adjustments

23. A life company must deduct the difference between fair value and the reported value of each asset. This deduction can be a negative amount (that is, an addition to Common Equity Tier 1 Capital) if fair value exceeds reported value.
24. A life company must make any other deduction required by APRA in writing where APRA considers that fair values are not prudent or reliable.

¹⁴ Examples of the entities that are subject to a comparable regulatory capital requirement are **authorised deposit-taking institutions**, general insurers and health insurers.

¹⁵ 'Charge' means a charge created in any way and includes a mortgage or an agreement to give or execute a charge or mortgage, whether upon demand or otherwise.

¹⁶ For friendly societies, the policy liabilities referred to in this paragraph must include unallocated surpluses held within approved benefit funds if those surpluses must be used for benefit enhancement under the approved benefit fund rules.

Other adjustments

25. A life company must make any other deductions required under any other Prudential Standard.

Regulatory adjustments to the net assets of a statutory fund or general fund

26. The amount of net assets to be included in the capital base of a statutory fund or general fund of a life company must be calculated after making the following deductions:
 - (a) all regulatory adjustments to Common Equity Tier 1 Capital required under this Attachment; and
 - (b) for a friendly society management fund, seed capital that is a receivable from an approved benefit fund.
27. In determining the deduction for deferred tax assets net of deferred tax liabilities, a life company may assume that tax benefits in one fund can be offset against deferred tax liabilities in another statutory fund or the general fund, subject to the offset only being used once in the calculation of the capital base for both funds.
28. For a friendly society approved benefit fund, 'seed capital' may be added to the net assets of the fund.

Attachment C

Criteria for inclusion in Additional Tier 1 Capital

1. To qualify as Additional Tier 1 Capital, an instrument must satisfy the following minimum criteria:
 - (a) the instrument must be paid-up and the amount must be, irrevocably received by the issuer;
 - (b) the instrument represents, prior to any conversion to Common Equity Tier 1 Capital (refer to Attachment G), the most subordinated claim in liquidation of the issuer after Common Equity Tier 1 Capital instruments;
 - (c) the paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the holder's claim.¹⁷ The instrument may not be secured or otherwise subject to netting or offset claims on behalf of the holder or the issuer of the instrument;
 - (d) the principal amount of the instrument is perpetual (i.e. it has no maturity date);
 - (e) the instrument contains no step-ups or other incentives to redeem. The issuer and any other member of a group to which the issuer belongs must not create an expectation at issuance that the instrument will be bought back, redeemed or cancelled. The contractual terms of the instrument must not provide any feature that might give rise to such an expectation¹⁸;
 - (f) the instrument may only be callable at the initiative of the issuer and only after a minimum of five years from the date on which the issuer irrevocably receives the proceeds of payment for the instrument. The issuer:
 - (i) must receive prior written approval from APRA to exercise a call option;
 - (ii) must not do anything that creates an expectation that a call will be exercised; and
 - (iii) must not exercise a call unless:

¹⁷ This would preclude any provision of support (including contribution of reserves) to any SPV used to issue capital instruments that form part of a life company's issue of Additional Tier 1 and Tier 2 Capital instruments.

¹⁸ Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in the credit spread is not considered an incentive to redeem. However, the life company must not otherwise do anything to create an expectation that the call will be exercised.

- (A) the issuer, prior to or concurrent with the exercise of the call, replaces the instrument with a capital instrument of the same or better quality, and the replacement of the instrument is done under conditions that are sustainable for the income capacity of the issuer; or
- (B) the life company meets the requirements relating to reductions in capital in LPS 110.

An instrument may provide for multiple call dates after five years. However, the specification of multiple call dates must not act to create an expectation that the instrument will be redeemed upon any call date;

- (g) issuers must not assume, or create market expectations, that supervisory approval will be forthcoming for the issuer to redeem, call or purchase an instrument;
- (h) an issuer must:
 - (i) have full discretion at all times to cancel distributions/payments on the instrument. Any waived distributions are non-cumulative (i.e. are not required to be made up by the issuer at a later date). The instrument must not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time, or a reduced dividend or interest rate if such payments are made on time;
 - (ii) ensure that cancellation of discretionary distributions/payments is not an event of default. Holders of the instruments must have no right to apply for the winding-up or administration of the issuer, or cause a receiver, or receiver and manager, to be appointed in respect of the issuer on the grounds that the issuer fails to make, or is or may become unable to make, a distribution on the instruments;
 - (iii) have full access to cancelled distributions/payments to meet obligations as they fall due; and
 - (iv) ensure that cancellation of distributions/payments do not impose restrictions on the issuer, or any other member of the group to which the issuer belongs, except in relation to distributions/payments or redemptions/buybacks on Common Equity Tier 1 Capital instruments;
- (i) distributions on the instrument are paid out of distributable items of the issuer, and the instrument must not provide for payments to investors other than in the form of a cash payment. The level of distributions must not be tied or linked to the credit standing of the issuer;
- (j) the instrument cannot have a credit sensitive distribution/payment feature (i.e. a distribution/payment that is based in whole or part on the credit standing of the issuer or the group or any other member of the group to

which it belongs). However, an instrument may utilise a broad index as a reference rate for distribution or payments calculation purposes. Where an issuer is a reference entity in the determination of the reference rate, the reference rate must not exhibit any significant correlation with the issuer's credit standing. APRA will not allow inclusion of an instrument as part of Additional Tier 1 Capital where it considers that the reference rate is sensitive to the credit standing of the issuer;

- (k) the instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of any national insolvency law applying in the jurisdiction of issue. In such cases, the issue documentation must specify that the insolvency law that applies is the place of incorporation of the issuer¹⁹;
- (l) the paid-up amount of the instrument is classified as equity under relevant accounting standards;
- (m) the instrument is directly issued by the issuer, and, except where otherwise permitted in this Prudential Standard, the issuer, any other member of a group to which the issuer belongs, or any related entity cannot have purchased or directly or indirectly funded the purchase of the instrument;
- (n) the instrument has no features that hinder recapitalisation of the issuer, or any other members of the group to which the issuer belongs. This includes features that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe;
- (o) where the terms of the instrument provide the ability (even in contingent circumstances) to substitute the issuer (i.e. to replace the life company with another party), the relevant documentation must set out the mechanism to ensure that there will be a simultaneous capital injection into the life company to replace the transferred capital instrument. Any replacement capital injection must occur at least simultaneously with the substitution and must be unconditional. The capital injection must be of equal or better quality capital and at least the same amount as the original issue, unless otherwise approved by APRA in writing;
- (p) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA's ability to resolve any problems encountered by the issuer;
- (q) the rate of dividend or interest on the instrument, or the formulae for calculating dividend or interest payments, must be predetermined and set out in the issue documentation;
- (r) where an issue of an instrument involves the use of an SPV, the issue of the instrument is subject to Attachment F;

¹⁹ If an overseas branch of a life company in a foreign jurisdiction where insolvency law is different from the jurisdiction where the parent entity is based, issue documentation must specify that the insolvency law in the parent's jurisdiction will apply.

- (s) the instrument includes provisions addressing loss absorption at the point of non-viability as required by Attachment G;
 - (t) the instrument is clearly and separately disclosed in the issuer's financial statements and in any consolidated financial statements; and
 - (u) issue documentation clearly indicates:
 - (i) the subordinated nature of the instrument and that neither the issuer nor the holder of the instrument is allowed to exercise of any contractual rights of set-off; and
 - (ii) the application of requirements for loss absorption at the point of non-viability under Attachment G.
2. In accordance with paragraph 1(h) of this Attachment, failure to make a distribution or payment must not trigger any restrictions on the issuer other than its ability to pay a distribution on Common Equity Tier 1 Capital instruments or to redeem such instruments. Such 'stopper' provisions must not:
- (a) impede the full discretion of the issuer at all times to cancel distributions/payments on the instrument or act in a way that could hinder the recapitalisation of the issuer;
 - (b) prevent payment on another instrument where such payment was not fully discretionary;
 - (c) prevent distribution to holders of Common Equity Tier 1 Capital instruments for a period that extends beyond the point in time the distributions/payments on the Additional Tier 1 Capital instruments are resumed; or
 - (d) impede the normal operation of the issuer or any restructuring activity (including acquisitions or disposals).
- A 'stopper' provision may, however, act to prohibit actions that are equivalent to payment of dividend or interest, such as a life company undertaking discretionary buybacks of ordinary shares.
3. An instrument must not include any provision that permits an optional distribution or payment to be made. Any structuring of a distribution or payment as a bonus payment to make up for unpaid distributions or payments is also prohibited.
4. For the purposes of paragraph 1(e) of this Attachment, an incentive or expectation to call or otherwise redeem an Additional Tier 1 Capital instrument includes, but is not limited to:
- (a) a call option combined with a requirement, or an investor option, to convert the instrument into ordinary shares if the call is not exercised; or

- (b) a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (i.e. the fixed rate paid to the call date to receive the second reference rate).
5. A call option and a provision to convert into ordinary shares will not constitute an incentive to redeem provided there is at least two years from the date upon which the life company may have an option to call the instrument to the nearest subsequent date upon which that conversion option may be exercised.
 6. Calling an instrument and replacing it with an instrument with a higher credit spread or that is otherwise more expensive may create the expectation that the issuer will exercise a call option on other outstanding Additional Tier 1 Capital instruments or Tier 2 Capital instruments with call options, unless the issuer can satisfy APRA as to the economic and prudential rationale and that such an action will not create an expectation that other instruments will be called in similar circumstances.
 7. An instrument may only provide for a call within the first five years of issuance as a result of a tax or regulatory event. APRA will not permit such a call if it forms the view that the life company was in a position to anticipate the tax or regulatory event when the instrument was issued. In order for a call to be exercised the issuer must comply with the provisions in paragraph 1(f)(i) to (iii) of this Attachment.
 8. Where an Additional Tier 1 Capital instrument provides for conversion into ordinary shares²⁰, the issue documentation must:
 - (a) specify the number of ordinary shares to be received upon conversion, or specify the conversion formula for determining the number of ordinary shares received;
 - (b) provide for the number of ordinary shares to be received under the formula specified in (a) to be fixed; and
 - (c) set the maximum number of ordinary shares received so as not to exceed the price of the Additional Tier 1 Capital instrument at the time of its issue divided by 20 per cent of the life company's²¹ ordinary share price²² at the same time. In calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits, bonus issues and similar transactions.

²⁰ Conversion must be into the ordinary shares of the life company or its parent entity, which must be listed at the time of issue. For an unlisted life company with no listed upstream entity at the time the instrument is issued, the instrument is to be converted into unlisted ordinary shares of the life company. Where an unlisted life company issues the instrument to its listed parent entity, conversion may be into unlisted ordinary shares of the life company.

²¹ Reference to life company captures any entity whose ordinary shares are issued as a result of conversion provisions.

²² For an unlisted life company that has no listed parent entity at the time of issue, the ordinary share price is based on the book value per share at the time of issue.

9. Conversion must generate an unequivocal addition to Common Equity Tier 1 Capital of the life company under Australian Accounting Standards.
10. The instrument must not include a mechanism that would require a holder to sell the instrument to the issuer or a related entity of the issuer other than as part of a call option or redemption of the instrument. A mechanism that requires a holder to sell the instrument to a nominated party other than the issuer or a related entity of the issuer will not constitute an incentive to redeem provided there is at least two years from the date upon which the holder is required to sell the instrument to the nearest subsequent date upon which conversion may be exercised.
11. Where an instrument is drawn down in a series of tranches, it must meet the requirements in this Prudential Standard as if each tranche is a separate Additional Tier 1 Capital instrument in its own right.
12. There must be no cross-default clauses in the documentation of any debt or other capital instrument of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise.
13. The instrument must be marketed in accordance with its prudential treatment and must not include any 'repackaging' arrangements that have the effect of compromising the quality of the capital raised. If a prospectus or other offer documentation, or marketing of the instrument could be reasonably held to suggest to investors that the instrument has attributes of a lower level of capital than claimed by the issuer for prudential purposes, the instrument will be ineligible to be included in the life company's Additional Tier 1 Capital.
14. The instrument may be subject to the laws of a jurisdiction other than Australia or its territories, except that the terms and conditions of the instrument that relate to non-viability conversion or write-off must be subject to the laws of Australia.
15. Where the instrument is subject to the laws of a jurisdiction other than Australia or its territories, the life company must also ensure that the instrument satisfies all relevant qualifying criteria for Additional Tier 1 Capital under the laws of that jurisdiction.
16. APRA may require the life company to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the life company's expense, confirming that the instrument meets the requirements in paragraphs 14 and 15 of this Attachment.

Attachment D

Additional Tier 1 Capital: Stapled security structure

1. A stapled security structure consisting of the issue of a preference share and a stapled instrument of another form may be included in Additional Tier 1 Capital, subject to satisfying the following additional minimum criteria:
 - (a) the preference share is issued directly by a life company and is 'stapled' to securities issued directly by an overseas branch of the life company. The stapled structure must not involve use of SPVs and must be simple and transparent;
 - (b) at least one of the preference share and the security to which it is stapled must be fully paid-up. Any partly paid preference share or stapled security is eligible only to the extent that it has been paid-up;
 - (c) the preference share and the instrument to which it is stapled must each individually satisfy the criteria in this Prudential Standard for an Additional Tier 1 Capital instrument;
 - (d) the terms and conditions of the stapled security must substantially mirror those of the preference share such that the stapled security operates effectively as if it was a preference share;
 - (e) the preference share and the instrument to which it is stapled must not be traded separately and are to remain stapled together until an 'unstapling event' occurs;
 - (f) 'unstapling' at the option of the issuer is permitted. The instrument documentation must clearly stipulate the events that will cause the preference share to be 'unstapled' resulting in the stapled security being extinguished, leaving the holder of the stapled security holding the preference share instead. 'Unstapling' must take place if:
 - (i) a non-viability trigger event occurs in accordance with Attachment G; or
 - (ii) proceedings for the liquidation of the life company have commenced; or
 - (iii) APRA issues a recapitalisation direction to the life company in accordance with sub-section 230AB(1) of the Act; or
 - (iv) the Court orders that the life company, or part of the business of the life company, be placed under judicial management pursuant to section 158 or 159 of the Act;
 - (g) to reduce the inherent legal risk associated with 'unstapling' of the structure, the issue documentation must ensure the clarity, consistency and

certainty with which the contractual terms and conditions are specified, and specifically that:

- (i) all entities involved in the stapled structure have the capacity and power to issue the instruments and perform obligations under them;
- (ii) the rights and obligations created by the preference share and the stapled security are legally valid, binding and enforceable on all parties in all jurisdictions where they are issued;
- (iii) the stapled security will be extinguished and holders of the stapled security will hold the underlying preference share upon the occurrence of an 'unstapling event'; and
- (iv) the 'unstapling' mechanism will take effect as contemplated in the issue documentation even if the life company or another entity has become, or is likely to become, insolvent, including where it is in administration, receivership, winding up or where a judicial manager has been appointed under the Act.

Where necessary, APRA may require a life company to obtain independent legal opinion confirming the above; and

- (h) adequate internal policies and controls must be in place such that the 'unstapling' procedures are correctly followed.
2. A preference share and instrument to which it is stapled must be issued by the same issuer but they need not be issued in the same jurisdiction.

Attachment E

Criteria for inclusion in Tier 2 Capital

1. To qualify as Tier 2 Capital, an instrument must satisfy the following minimum criteria:
 - (a) the instrument must clearly indicate that is subordinate to the interests of policy owners of a particular statutory fund in the liquidation of the life company;
 - (b) the instrument must be paid-up and the amount must be irrevocably received by the relevant statutory fund;
 - (c) the paid-up amount of the instrument must be classified as a liability of the relevant statutory fund under the relevant accounting standards;
 - (d) the instrument represents, prior to any conversion to Common Equity Tier 1 Capital (refer to Attachment G), the most subordinated claim in liquidation of the issuer after Common Equity Tier 1 Capital instruments and Additional Tier 1 Capital instruments;
 - (e) the paid-up amount of the instrument, or any future payments related to the instrument, is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim.²³ The instrument may not be secured or otherwise subject to netting or offset of claims on behalf of the holder or the issuer of the instrument;
 - (f) the principal amount of the instrument:
 - (i) has a minimum maturity of at least five years; and
 - (ii) is only recognised in Tier 2 Capital (and so in the capital base) in the five years prior to maturity on a straight-line amortised basis (refer to paragraph 2 of this Attachment);
 - (g) the instrument contains no step-ups or other incentives to redeem. The issuer and any other member of a group to which the issuer belongs must not create an expectation at issuance that the instrument will be bought back, redeemed or cancelled before its contractual maturity. The

²³ This would preclude any provision of support (including contribution of reserves) to any SPV used to issue capital instruments that form part of the life company's issue of Additional Tier 1 and Tier 2 Capital instruments.

contractual terms of the instrument must not provide any feature that might give rise to such an expectation²⁴;

- (h) the instrument may only be callable at the initiative of the issuer and only after a minimum of five years from the date on which the issuer irrevocably receives the proceeds of payment for the instrument. The issuer:
 - (i) must receive prior written approval from APRA to exercise a call option;
 - (ii) must not do anything that creates an expectation that a call will be exercised; and
 - (iii) must not exercise a call unless:
 - (A) the issuer, prior to or concurrent with the exercise of the call, replaces the instrument with a capital instrument of the same or better quality, and the replacement of the instrument is done at conditions that are sustainable for the income capacity of the issuer; or
 - (B) the life company meets the requirements relating to reductions in capital in LPS 110.

An instrument may provide for multiple call dates after five years. However, the specification of multiple call dates must not act to create an expectation that the instrument will be redeemed upon any call date;

- (i) issuers must not assume, or create market expectations, that supervisory approval will be forthcoming for the issuer to redeem, call or purchase an instrument;
- (j) the instrument must confer no rights on holders to accelerate the repayment of future scheduled payments (coupon or principal) except in bankruptcy (including wind-up) and liquidation. Wind-up of the life company must be irrevocable (that is, either by way of a court order or an effective resolution by the members of a friendly society). The making of an application to wind-up or the appointment of a judicial manager, liquidator or other external administrator including the exercise of APRA's powers under Part 8 of the Act, must not be sufficient to accelerate repayment of the instrument;
- (k) the instrument must not provide for payment to investors other than in the form of a cash payment;

²⁴

Conversion from a fixed rate to a floating rate (or vice versa) in combination with a call option without any increase in the credit spread is not considered an incentive to redeem. However, the life company must not otherwise do anything to create an expectation that the call will be exercised.

- (l) the instrument cannot have a credit sensitive distribution/payment feature (i.e. a distribution/payment that is based in whole or part on the credit standing of the issuer or the group or any other member of the group to which it belongs). However, an instrument may utilise a broad index as a reference rate for distribution or payments calculation purposes. Where an issuer is a reference entity in the determination of the reference rate, the reference rate must not exhibit any significant correlation with the issuer's credit standing. APRA will not allow inclusion of an instrument as part of Tier 2 Capital where it considers that the reference rate is sensitive to the credit standing of the issuer;
- (m) the instrument is directly issued by the issuer, and, except where otherwise permitted in this Prudential Standard, the issuer, any other member of a group to which the issuer belongs, or any related entity cannot have purchased or directly or indirectly funded the purchase of the instrument;
- (n) the instrument has no features that hinder recapitalisation of the issuer, or any other members of the group to which the issuer belongs. This includes features that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified timeframe;
- (o) where the terms of the instrument provide the ability (even in contingent circumstances) to substitute the issuer (i.e. to replace the life company with another party), the relevant documentation must set out the mechanism to ensure that there will be a simultaneous capital injection into the life company to replace the transferred capital instrument. Any replacement capital injection must occur at least simultaneously with the substitution and must be unconditional. The capital injection must be of equal or better quality capital and at least the same amount as the original issue, unless otherwise approved by APRA in writing;
- (p) the instrument does not contain any terms, covenants or restrictions that could inhibit the issuer's ability to be managed in a sound and prudent manner, particularly in times of financial difficulty, or restrict APRA's ability to resolve any problems encountered by the issuer;
- (q) the rate of dividend or interest on the instrument, or the formulae for calculating dividend or interest payments, must be predetermined and set out in the issue documentation;
- (r) where an issuer defaults under the terms of the instrument, remedies available to the holders must be limited to actions for specific performance, recovery of amounts currently outstanding or the winding-up of the issuer. The amounts that may be claimed in the event that the issuer defaults may include any accrued unpaid dividends and interest, including payment of market interest on these unpaid amounts. All such unpaid dividends and interest must be subordinated to the claims of the policy owners and other creditors of the nominated statutory fund;

- (s) the instrument must not provide for payment of a higher dividend or interest rate if dividend or interest payments are not made on time, or a reduced dividend or interest rate if such payments are made on time;
 - (t) where an issue of an instrument involves the use of an SPV, the issue of the instrument is subject to Attachment F;
 - (u) the instrument includes provisions addressing loss absorption at the point of non-viability in accordance with Attachment G;
 - (v) the instrument is clearly and separately disclosed in the issuer's financial statements; and
 - (w) issue documentation clearly indicates:
 - (i) the subordinated nature of the instrument, and that neither the issuer nor the holder of the instrument is allowed to exercise any contractual rights of set-off; and
 - (ii) the application of requirements relating to loss absorption at the point of non-viability under Attachment G.
2. The amount of the instrument eligible for inclusion in Tier 2 Capital is to be amortised on a straight-line basis at a rate of 20 per cent per annum over the last four years to maturity as follows:

Years to Maturity	Amount Eligible for Inclusion in Tier 2 Capital
More than 4	100 per cent
Less than and including 4 but more than 3	80 per cent
Less than and including 3 but more than 2	60 per cent
Less than and including 2 but more than 1	40 per cent
Less than and including 1	20 per cent

3. Where an instrument is drawn down in a series of tranches, it must meet the requirements in this Prudential Standard as if each tranche is a separate Tier 2 Capital instrument in its own right and the minimum original maturity of each tranche must be five years from the time proceeds of the issue are irrevocably received by the issuer.

4. For the purposes of paragraph 1(g) of this Attachment, an incentive or expectation to call or otherwise redeem a Tier 2 Capital instrument includes, but is not limited to:
 - (a) a call option combined with a requirement, or an investor option, to convert the instrument into ordinary shares if the call is not exercised; or
 - (b) a call option combined with a change in reference rate where the credit spread over the second reference rate is greater than the initial payment rate less the swap rate (i.e. the fixed rate paid to the call date to receive the second reference rate).
5. A call option and a provision to convert into ordinary shares will not constitute an incentive to redeem provided there is at least two years from the date upon which the life company may have an option to call the instrument to the nearest subsequent date upon which that conversion option may be exercised.
6. Calling an instrument and replacing it with an instrument with a higher credit spread or that is otherwise more expensive may create the expectation that the issuer will exercise a call option on other outstanding Tier 2 Capital instruments and Additional Tier 1 Capital instruments with call options, unless the issuer can satisfy APRA as to the economic and prudential rationale and that such an action will not create an expectation that other instruments will be called in similar circumstances.
7. An instrument may only provide for a call within the first five years of issuance as a result of a tax or regulatory event. APRA will not permit such a call if it forms the view that the life company was in a position to anticipate the tax or regulatory event when the instrument was issued. In order for a call to be exercised the issuer must comply with the provisions in paragraph 1(f)(i) to (iii) of this Attachment.
8. Where a Tier 2 Capital instrument provides for conversion into ordinary shares²⁵, the issue document must:
 - (a) specify the number of ordinary shares to be received upon conversion or specify the conversion formulae for determining the number of ordinary shares received
 - (b) provide for the number of ordinary shares to be received under the formula specified in (a) to be fixed; and
 - (c) set the maximum number of ordinary shares received so as not to exceed the price of the Tier 2 Capital instrument at the time of its issue divided by

²⁵ Conversion must be into the ordinary shares of the life company or its parent entity, which must be listed at the time of issue. For an unlisted life company with no listed upstream entity at the time the instrument is issued, the instrument is to be converted into unlisted ordinary shares of the life company. Where an unlisted life company issues the instrument to its listed parent entity, conversion may be into unlisted ordinary shares of the life company.

20 per cent of the life company's²⁶ ordinary share price²⁷ at the same time. In calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits, bonus issues and share consolidations.

9. Conversion must generate an unequivocal addition to Common Equity Tier 1 Capital of the life company under Australian Accounting Standards.
10. The instrument must not include a mechanism that would require a holder to sell the instrument to the issuer or a related entity of the issuer other than as part of a call option or redemption of the instrument. A mechanism that requires a holder to sell the instrument to a nominated party other than the issuer or related entity of the issuer will not constitute an incentive to redeem provided there is at least two years from the date upon which the holder is required to sell the instrument to the nearest subsequent date upon which conversion may be exercised.
11. There must be no cross-default clauses in the documentation of any debt or other capital instrument of the issuer linking the issuer's obligations under the instrument to default by the issuer under any of its other obligations, or default by another party, related or otherwise.
12. The instrument must be marketed in accordance with its prudential treatment and must not include any 'repackaging' arrangements that have the effect of compromising the quality of the capital raised. If a prospectus or other offer documentation or marketing of the instrument could be reasonably held to suggest to investors that the instrument has attributes other than those claimed by the issuer for prudential purposes, the instrument is ineligible to be included in the life company's Tier 2 Capital.
13. The instrument may be subject to the laws of a jurisdiction other than Australia or its territories, except that the terms and conditions of the instrument that relate to non-viability conversion or write-off must be subject to the laws of Australia.
14. Where the instrument is subject to the laws of a jurisdiction other than Australia or its territories, the life company must also ensure that the instrument satisfies all relevant qualifying criteria for Tier 2 Capital under the laws of that jurisdiction.
15. APRA may require the life company to provide an independent expert opinion, addressed to APRA by a firm or practitioner of APRA's choice and at the life company's expense, confirming that the instrument meets the requirements in paragraphs 13 and 14 of this Attachment.

²⁶ Reference to life company in this context captures any entity whose ordinary shares are issued as a result of conversion provisions.

²⁷ For an unlisted life company that has no listed parent entity at the time of issue, the ordinary share price is based on the book value per share at the time of issue.

Attachment F

Criteria for capital issues involving special purpose vehicles

1. The following requirements must be met for capital instruments issued through an SPV to qualify as capital:
 - (a) the SPV issuing the instrument is a single purpose non-operating entity established for the sole purpose of raising capital for the life company;
 - (b) capital instruments issued by the life company to the SPV, and capital instruments issued by the SPV to investors, must meet the requirements of this Prudential Standard for Additional Tier 1 and Tier 2 Capital set out in Attachment C and Attachment E of this Prudential Standard, as appropriate;
 - (c) capital instruments issued by the SPV must not be funded, directly or indirectly, by the life company. Similarly, the life company to which it belongs may not provide any funding to the SPV itself, other than to cover its administrative operating expenses;
 - (d) the only asset²⁸ of the SPV is its investment in capital instruments issued by the life company for which it raises capital. The SPV must have no material liabilities other than its issued capital instruments;
 - (e) instruments issued by the life company to the SPV, and by the SPV to 'third party'²⁹ investors, must:
 - (i) be of the same category of regulatory capital (e.g. both Additional Tier 1 Capital instruments, or both Tier 2 Capital instruments);
 - (ii) if Tier 2 Capital instruments, have the same maturity; and
 - (iii) have terms and conditions that mirror each other;
 - (f) the proceeds from the issue of the capital instrument by the SPV must be immediately and directly invested in and available without limitation to the life company.
 - (g) where a non-viability trigger event occurs (Attachment G), the instruments issued to the SPV, and by the SPV to investors, must be subject to conversion or write off into ordinary shares in accordance with the requirements in Attachment G. In such circumstances, investors in instruments issued by the SPV irrevocably cease to have any claims on the SPV or the life company;

²⁸ Assets that relate to the operation of the SPV may be excluded from this assessment if they are *de minimis*.

²⁹ For the purposes of this Prudential Standard, a 'third party' is defined as an entity that is not the life company or a **related body corporate** of the life company.

- (h) where capital instruments issued by an SPV are converted into ordinary shares of the life company or ultimate holding company, such conversions are subject to the requirements (including limits) covering conversion set out in Attachments C, E and G; and
 - (i) the main features of the instrument issued by the SPV and the structure of the issue are transparent and capable of being understood by investors. An issue is not eligible for inclusion in a life company's Additional Tier 1 Capital or Tier 2 Capital where the complexity of its structure raises doubt over the legal and regulatory risk associated with it.
2. An SPV may be established to issue tranches of one instrument where the only change in the terms and conditions of the tranches is a variation in distribution or payments to be made on the instrument. An SPV may not issue different forms of an instrument even if they belong to the same category of capital instruments.

Attachment G

Loss absorption at the point of non-viability: Additional Tier 1 and Tier 2 Capital instruments

1. An Additional Tier 1 Capital or Tier 2 Capital instrument must include a provision under which, on the occurrence of a 'non-viability trigger event' (as defined in paragraphs 3 and 4 of this Attachment), it will be immediately and irrevocably:
 - (a) converted into the ordinary shares of the life company or its parent entity, which must be listed³⁰ at the time the instrument is issued³¹; or
 - (b) written off.
2. The amount of an instrument that may be recognised in the life company's Tier 1 Capital and capital base on the occurrence of a non-viability trigger event is the minimum level of Common Equity Tier 1 Capital that would be generated by a full conversion or write-off of the instrument. Where an instrument provides for write-off as the primary loss absorption mechanism, the amount recognised must account for potential taxation liabilities or other potential offsets at the time of issuance. Adjustments must be updated over time to reflect the best estimates of the offset value.
3. A non-viability trigger event in relation to a life company is the earlier of:
 - (a) the issuance of a notice in writing by APRA to the life company that conversion or write-off of capital instruments is necessary because, without it, APRA considers that a particular fund or the life company would become non-viable; or
 - (b) a determination by APRA, notified to the life company in writing, that without a public sector injection of capital, or equivalent support, a particular fund or the life company would become non-viable.
4. A non-viability trigger event in relation to a locally incorporated subsidiary life company of a foreign life company is the earlier of:
 - (a) the issuance of a notice by the home regulator of the foreign life company to the foreign life company that conversion or write-off of capital instruments issued by a locally incorporated subsidiary life company is necessary because, without it, the foreign life company or its subsidiary life company would become non-viable; or

³⁰ For the purposes of this paragraph, 'listed' refers to an institution admitted to, and not removed from, a stock exchange.

³¹ For an unlisted life company with no listed upstream entity at the time the instrument is issued, the instrument is to be converted into unlisted ordinary shares of the life company. Where an unlisted life company issues the instrument to its listed parent entity, conversion may be into unlisted ordinary shares of the life company.

- (b) a determination by the home regulator of the foreign life company, that without a public sector injection of capital, or equivalent support, the foreign life company or its subsidiary life company would become non-viable.
5. Conversion or write-off need only occur to the extent necessary to enable APRA to conclude that the life company is viable without further conversion or write off. In such circumstances, conversion or write-off would need to fully exhaust Additional Tier 1 Capital instruments before involving Tier 2 Capital instruments. APRA will not approve partial conversion or partial write-off in those exceptional circumstances where a public sector injection of funds is deemed necessary.
 6. The amount of conversion or write-off of capital instruments undertaken in accordance with this Attachment will be subject to the requirements applied by the relevant regulator.
 7. A life company may provide for Additional Tier 1 Capital instruments to be converted or written-off prior to any conversion or write-off of Tier 2 Capital instruments. In these circumstances, conversion or write-off of Tier 2 Capital instruments will only be necessary to the extent that conversion of Additional Tier 1 Capital instruments has not resulted in APRA withdrawing the notice issued to the life company under paragraph 3 or paragraph 4 of this Attachment, as appropriate.
 8. Conversion or write-off must generate an unequivocal addition to Common Equity Tier 1 Capital of the life company under Australian Accounting Standards.
 9. Where an Additional Tier 1 or Tier 2 Capital instrument provides for conversion into ordinary shares, the life company must ensure that at the time of issue and on a continuing basis, there are no legal or other impediments to issuing the relevant number of shares and all necessary authorisations have been obtained to effect conversion.
 10. Where, following a trigger event, conversion of a capital instrument:
 - (a) is not capable of being undertaken; or
 - (b) is not irrevocable; or
 - (c) will not result in an immediate and unequivocal increase in Common Equity Tier 1 Capital of the life company

the amount of the instrument must immediately and irrevocably be written off in the accounts of the life company and result in an unequivocal addition to Common Equity Tier 1 Capital.

11. Where an Additional Tier 1 or Tier 2 Capital instrument provides for conversion into ordinary shares when a non-viability trigger event occurs, the issue documentation must:
 - (a) specify the number of ordinary shares to be received upon conversion, or specify the conversion formula for determining the number of ordinary shares received;
 - (b) provide for the number of ordinary shares to be received under the formula specified in (a) to be fixed; and
 - (c) set the maximum number of ordinary shares received so as not to exceed the price of the Additional Tier 1 or Tier 2 Capital instrument at the time of its issue divided by 20 per cent of the life company's³² ordinary share price³³ at the same time. In calculating the ordinary share price at time of issue, adjustments may be made for subsequent ordinary share splits, bonus issues and share consolidations.
12. Where issue documentation provides for a hierarchy of conversion or write-off, the terms attached to such a hierarchy must not impede the ability of the capital instrument to be immediately converted or written-off.
13. Issuing Additional Tier 1 or Tier 2 Capital instruments may, within each category of capital:
 - (a) differentiate between instruments as to whether an instrument is required to convert or be written off in the first instance; and
 - (b) provide for a ranking under which Additional Tier 1 and Tier 2 Capital instruments will be converted or written off.
14. For the purposes of conversion or write off of an Additional Tier 1 or Tier 2 Capital instrument, the amount to be converted or written off will be the face value of the instrument recorded in the books of the life company.
15. Where an Additional Tier 1 or Tier 2 Capital instrument provides for a write-off mechanism, this mechanism must be structured so that:
 - (a) the claim of the instrument on liquidation of the issuer is reduced to, or below, the value of the written off instrument;
 - (b) the amount of the instrument that may be paid if a call is exercised is irrevocably reduced to the written off amount of the instrument;
 - (c) there is an immediate and unequivocal addition to the Common Equity Tier 1 Capital of the life company; and

³² Reference to life company captures any entity whose ordinary shares are issued as a result of conversion provisions.

³³ For an unlisted life company that has no listed parent entity at the time of issue, the ordinary share price is based on the book value per share at the time of issue.

- (d) the distribution/payments payable on the instrument must be permanently reduced (i.e. distributions/payments must be calculated at no more than the rate set for the written off value of the instrument).
16. The contractual terms and conditions of the issue of an instrument must not provide for any residual claims on the issuer that are senior to ordinary shares of the life company, or the parent entity, in the event that a conversion or write off is undertaken.

Attachment H

Definition of Adjusted Policy Liabilities

Non-participating benefits

1. For each statutory fund, the adjusted policy liabilities for **non-participating benefits** without entitlement to **discretionary additions** are the greater of:
 - (a) the total **risk-free best estimate liability** (RFBEL) for all policies; and
 - (b) the total **termination values** for all policies.
2. For each statutory fund, the adjusted policy liabilities for non-participating benefits with entitlement to discretionary additions are the greater of:
 - (a) the total RFBEL for all policies; and
 - (b) the total termination values plus, if it is greater than zero, the **investment fluctuation reserve** (IFR).

The 'greater of' must be determined at sub-group level if the policy benefits for a sub-group of policies are determined by reference to the performance of particular assets that the life company has allocated to the liabilities for that sub-group.

3. The adjusted policy liabilities must be increased if the amount determined using the formula above would be insufficient to meet all guarantees and obligations implied by the promotional material of the company, and policy owners' reasonable benefit expectations based on past company practice.

Definition of RFBEL

4. For both **life insurance contracts** and **life investment contracts**, the RFBEL is determined by using the methods used to determine the **best estimate liability**, as specified in *Prudential Standard LPS 340 Valuation of Policy Liabilities*, but with the gross investment yield and gross discount rate set equal to the **risk-free discount rate** plus the **illiquidity premium**.
5. An illiquidity premium must only be added to the risk-free discount rate for policies that are:
 - (a) **immediate life annuities**;
 - (b) immediate **term certain annuities**;

- (c) other types of annuities where there are no insurance risks other than longevity and servicing expenses;
 - (d) **fixed term/rate business**; and
 - (e) **funeral bond business**.
6. If an illiquidity premium is added to the risk-free discount rate for a policy, the RFBEL must not be less than the **minimum termination value** or the contractual minimum surrender value for that policy.
7. The illiquidity premium (in basis points) added to the risk-free forward rates for the first 10 years after the reporting date is:

$$\text{Illiquidity premium} = 15\% \times \text{AA spread} + 15\% \times \text{A spread}$$

The spreads must be obtained from 'Table F3 Capital Market Yields and Spreads – Non-Government Instruments' published by the RBA on its website. 'AA spread' and 'A spread' are the spreads over bonds issued by the Australian Government for corporate bonds with broad credit ratings (as determined by Standard and Poor's) of AA and A respectively.

If the RBA ceases to publish this information, an alternative method of calculating the illiquidity premium may be used with the prior written approval of APRA.

The maximum illiquidity premium is 150 basis points and the minimum is zero.

The illiquidity premium added to risk-free forward rates more than 10 years after the reporting date is 20 basis points.

The same illiquidity premium applies to both Australian and overseas liabilities.

8. For business where tax is based only on profits, the RFBEL must exclude the value of future tax payments. Business is considered to be taxed on profits if an increase in policy liabilities would result in a deduction from the company's taxable income.
9. The RFBEL and termination values must be determined net of reinsurance.

Participating benefits

10. For each statutory fund, the adjusted policy liabilities for **participating benefits** are the greater of:
- (a) the total **participating policy liabilities** (PPL) for all policies, where $PPL = RFBEL + \max\{RFVFB + PRP, 0\}$; and
 - (b) the total termination values for all policies, increased if necessary so that, if all termination values were paid immediately, the remaining PRP³⁴ would not be greater than zero.

where:

- (i) RFBEL is defined in the same way as for non-participating benefits;
 - (ii) RFVFB is the risk-free value of future **bonuses** calculated at the bonus rates supported by the policy liabilities³⁵ using the **best estimate assumptions** but with the gross investment yield and discount rate set equal to the risk-free discount rate (plus the illiquidity premium if this is used in determining the RFBEL);
 - (iii) PRP is policy owners' retained profits (only relevant for life companies that are not friendly societies); and
 - (iv) the 'greater of' must be determined at sub-group level if the policy benefits for a sub-group of policies are determined by reference to the performance of particular assets that the life company has allocated to the liabilities for that sub-group.
11. All amounts must include allowance for bonuses declared as at the reporting date and are net of reinsurance.
12. The adjusted policy liabilities must be increased if the amount determined using the formula above would be insufficient to meet all guarantees and obligations implied by the promotional material of the company, and policy owners' reasonable benefit expectations based on past company practice.

Liability options and asymmetries

13. The adjusted policy liabilities must not be less than the mean of the distribution of the potential liability outcomes. If the benefits being valued contain options

³⁴ For friendly societies, replace the reference to PRP in this subparagraph with 'unallocated surplus that must be used for benefit enhancement under the approved benefit fund rules'.

³⁵ For friendly societies, the policy liabilities referred to in this paragraph must include unallocated surpluses held within approved benefit funds if those surpluses must be used for benefit enhancement under the approved benefit fund rules.

that may potentially be exercised against the company, or the potential liability outcomes have an adverse asymmetrical distribution, then the adjusted liability must include an appropriate value in respect of those options and/or asymmetries. For this purpose, the benefits being valued must allow for the distribution of all investment fluctuation reserves and policy owners' retained profits.

Friendly societies

14. Friendly society benefits are neither participating nor non-participating. The adjusted policy liabilities for approved benefit funds where there is a provision for distribution of unallocated surpluses to policy owners are to be valued as if they were participating. The adjusted policy liabilities for approved benefit funds where there is no provision for distribution of unallocated surpluses to policy owners are to be valued as if they were non-participating.