



# Response to Submissions

## Supervision of conglomerate groups

### 2. Risk management and capital adequacy


9 May 2013

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## Preamble

In March 2010, APRA released a discussion paper that outlined proposals for a Level 3 framework for the supervision of conglomerate groups (Level 3 groups). In December 2012, APRA released a consultation package that included a response to submissions received on APRA's proposals for the group governance and risk exposures components of the framework, and related prudential standards. This consultation package covers the final two components of the Level 3 framework: risk management and capital adequacy. The package includes a response to submissions on APRA's proposals on these components of the framework. APRA is also releasing five draft prudential standards that detail the proposed requirements for these components.

Three of the prudential standards are Level 3-specific and are attached to this package. The fourth standard is a new cross-industry risk management standard that will apply to all authorised deposit-taking institutions (ADIs), general insurers and life insurers at Levels 1, 2 and 3 where applicable. The fifth standard is the cross-industry governance standard, which has been amended to reflect APRA's current thinking on risk management-related aspects of governance. Since the latter two standards affect all ADIs, general insurers and life insurers, they are contained in a separate risk management consultation package. The extension of these proposals to Level 3 groups is, however, addressed in this Level 3 consultation package.

Later in 2013, APRA will also consult on a set of prudential practice guides, reporting standards, reporting forms and instructions and consequential amendments to other prudential standards to give effect to the Level 3 framework. APRA expects to finalise the prudential standards, prudential practice guides, reporting forms and instructions during the remainder of 2013, prior to the proposed implementation date for the Level 3 framework on 1 January 2014.

Written submissions on this package should be sent to [Level3Framework@apra.gov.au](mailto:Level3Framework@apra.gov.au) by 5 July 2013 and addressed to:

Mr Neil Grummitt,  
General Manager, Policy Development  
Policy, Research and Statistics  
Australian Prudential Regulation Authority  
GPO Box 9836  
SYDNEY NSW 2001

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## Glossary

ADI	An authorised deposit-taking institution under the <i>Banking Act 1959</i> (Banking Act)
Additional Tier 1 Capital	Capital instruments that provide loss-absorption but do not satisfy all of the criteria for inclusion in Common Equity Tier 1 Capital
Authorised NOHC	A non-operating holding company authorised under the Banking Act or the <i>Insurance Act 1973</i> (Insurance Act) or registered under the <i>Life Insurance Act 1995</i> (Life Insurance Act)
APRA	Australian Prudential Regulation Authority
APRA beneficiary	A depositor of an ADI, a policyholder (including policy owner) of an general insurer or life insurer, or a beneficiary of an RSE
APRA-regulated institution	An ADI, extended licensed entity (ELE), general insurer, life insurer, RSE licensee or authorised NOHC
Common Equity Tier 1 (CET1) Capital	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
December 2012 response paper	Response to Submissions, <i>Supervision of conglomerate groups</i> . 1. <i>Group governance and risk exposures</i> , December 2012
FM	Funds management
General insurer	A general insurer authorised under the Insurance Act
ICA	Internal capital allocation
ICAAP	Internal Capital Adequacy Assessment Process
Insurer	A general insurer or a life insurer
ITEs	Intra-group transactions and exposures
Level 1 institution	An individual operating company authorised to undertake activities within a single APRA-regulated industry (ADIs, general insurers, life insurers and RSE licensees)
Level 2 group	A consolidated group within a single APRA-regulated industry, headed by an ADI, general insurer or authorised non-operating holding company
Level 3 EC	Eligible capital (EC) held by a Level 3 group that APRA recognises for capital adequacy purposes
Level 3 group	A conglomerate group, containing an APRA-regulated institution, with operations across more than one APRA-regulated industry and/or including material non-APRA-regulated activities
Level 3 Head	An APRA-regulated institution heading a Level 3 group
Level 3 institution	An institution within the Level 3 group
Level 3 PCR	Level 3 Prudential Capital Requirement (PCR), determined as the Level 3 prescribed capital amount plus any Level 3 supervisory adjustment

Level 3 prescribed capital amount	Prescribed capital amount determined in accordance with the quantitative rules as set out in the capital standards, before any Level 3 supervisory adjustment is applied
Level 3 supervisory adjustment	An adjustment that APRA may require to be included in the Level 3 PCR
Life insurer	A life company, including a friendly society, registered under the Life Insurance Act
March 2010 discussion paper	Discussion Paper, <i>Supervision of conglomerate groups</i> , March 2010
May 2013 risk management discussion paper	Discussion Paper, <i>Harmonising cross-industry risk management requirements</i> , May 2013
NOHC	Non-operating holding company
Non-APRA-regulated institution	An institution other than an APRA-regulated institution
ORFR target amount	The operational risk financial requirement (ORFR) target amount determined for RSE licensees in accordance with <i>Prudential Standard SPS 114 Operational Risk Financial Requirement</i>
QIS	Level 3 quantitative impact study (completed in February 2011)
RC	Required capital
RSE	A registrable superannuation entity as defined in the <i>Superannuation Industry (Supervision) Act 1993</i> (SIS Act)
RSE licensee	A registrable superannuation entity licensee as defined in the SIS Act
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 do not satisfy the criteria for Common Equity Tier 1 Capital or Additional Tier 1 Capital

# Executive summary

## Background

In March 2010, APRA released a discussion paper, *Supervision of conglomerate groups*, outlining its proposed prudential framework for the supervision of such groups (Level 3 framework).<sup>1</sup> The Level 3 framework consists of four components: group governance, risk exposure, risk management and capital adequacy. In December 2012, APRA released a consultation package covering the first two components of the framework.<sup>2</sup> This second consultation package focuses on APRA's requirements for risk management and capital adequacy for Level 3 groups. It summarises the main issues raised in submissions on the March 2010 discussion paper on these areas and in subsequent interactions with potential Level 3 groups, and provides APRA's response to these issues.

## Cross-industry risk management and governance standards

APRA is seeking comments on five draft prudential standards that implement the proposed requirements for these two components of the Level 3 framework. One of these standards, the draft cross-industry *Prudential Standard CPS 220 Risk Management* (CPS 220), is proposed to also apply to Level 1 authorised deposit-taking institutions (ADIs), general insurers and life insurers and Level 2 groups and will supersede the existing general and life insurance risk management standards. CPS 220 continues APRA's commitment to harmonise and consolidate requirements across APRA-regulated industries where appropriate. APRA proposes to strengthen its current risk management requirements to align with its heightened expectations in this area, and this is reflected in the draft CPS 220 released as part of this consultation package.

A consequence of the development of CPS 220 has been the evolution of APRA's thinking on aspects of governance related to risk management. As a result, changes are proposed to the current cross-industry

*Prudential Standard CPS 510 Governance* (CPS 510) and this amended standard is also being released for consultation. CPS 510 currently applies to Level 1 ADIs, general insurers and life insurers and Level 2 groups.

As CPS 220 and CPS 510 apply not only to Level 3 groups but also to all ADIs, general insurers, life insurers and Level 2 groups, a separate consultation package is being released simultaneously with this consultation package.<sup>3</sup> That consultation package includes a Discussion Paper, *Harmonising cross-industry risk management requirements*, as well as drafts of CPS 220 and of the amended CPS 510. The implications of these cross-industry standards for Level 3 groups are addressed in this consultation package.

## Key risk management requirements

APRA proposes to require Level 3 groups to develop and maintain a group-wide risk management framework. The framework must include a risk appetite statement, a risk management strategy and a risk management function that address risks across the group. APRA's objective is to ensure Boards of Level 3 groups have oversight of the material risks to the group, whether these risks emerge from APRA-regulated or non-APRA-regulated institutions within the group. Ultimately, APRA expects the Board of a Level 3 group to ensure there are no risk management 'blind spots' within the group.

## Key capital adequacy requirements

APRA proposes that a Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions of the group.

The proposed Level 3 capital adequacy framework consists of two tests:

- a Level 3 group must at all times have eligible capital (Level 3 EC) in excess of its Prudential Capital Requirement (Level 3 PCR); and

<sup>1</sup> <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/Supervision-of-conglomerate-groups-2010.aspx>

<sup>2</sup> <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/Supervision-of-conglomerate-groups-2012.aspx>

<sup>3</sup> <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/May-2013-Consultation-Risk-Management.aspx>



- a Level 3 group must have sufficient unrestricted surplus capital to cover any shortfall in eligible capital held by non-APRA-regulated institutions within the group.

APRA proposes that the Level 3 PCR must reflect all material risks to APRA beneficiaries of the Level 3 group, including contagion risks from non-APRA-regulated activities. The Level 3 PCR is determined by aggregating the requirements of six industry blocks: four APRA-regulated blocks based on APRA's prudential requirements and two non-APRA-regulated blocks. If there are prudential reasons for doing so, APRA may include a supervisory adjustment in the Level 3 PCR. APRA proposes that Level 3 EC be determined on a consolidated basis.

## Disclosure

APRA proposes to publish a register of Level 3 Heads on its website but APRA does not propose to prescribe any public disclosure on capital adequacy at this time. While APRA will not prohibit a Level 3 group from publishing information on its Level 3 capital adequacy, APRA intends to review the group's approach to such disclosures prior to its first release, and whenever there are material changes to the group's disclosure policy, to ensure that the disclosure does not inadvertently reveal confidential prudential information. APRA will review its position on Level 3 disclosure once the framework has been implemented.

## Timetable

The Level 3 framework is intended to become effective from 1 January 2014. Over the course of 2013, APRA will consult on a set of prudential practice guides (PPGs), reporting standards, reporting forms and instructions and consequential amendments to other prudential standards to give effect to the Level 3 framework.

# Chapter 1 – Introduction

## 1.1 Background

In March 2010, APRA released a discussion paper, *Supervision of conglomerate groups*, outlining its proposed prudential framework for the supervision of such groups (Level 3 framework). Conglomerate groups (Level 3 groups) are groups that perform material activities across more than one APRA-regulated industry and/or in one or more non-APRA-regulated industries. The framework is designed to complement APRA's existing industry-based Level 1 and Level 2 frameworks. At the same time, the Level 3 framework will provide common measures and tools through which group-wide risk profiles and supervisory assessments can be made.

APRA received 18 formal submissions on the March 2010 discussion paper. The December 2012 Level 3 consultation package included a response paper that dealt with the group governance and risk exposures components of the framework. This consultation package covers the remaining two components, risk management and capital adequacy. It summarises the main issues raised in submissions on these areas, along with APRA's response. In addition, the consultation package outlines proposed revisions to APRA's risk management and capital adequacy prudential standards to give effect to the Level 3 framework.

## 1.2 The need for a Level 3 framework

As was detailed in the December 2012 response paper, APRA's primary objective in implementing the Level 3 framework is to ensure that its supervision adequately captures the risks to which APRA-regulated institutions within a Level 3 group are exposed and which are not adequately captured by the existing prudential arrangements at Level 1 or Level 2. The Level 3 framework sets APRA's requirements for the Board of the Level 3 Head to provide oversight of the material risks faced by the Level 3 group. This will be supported by the implementation of a number of prudential standards. These prudential standards establish the following overarching requirements:

- a Level 3 group must have a robust governance framework that is applied appropriately throughout the group;

- the intra-group exposures and external aggregate exposures of a Level 3 group must be transparent and prudently managed;
- a Level 3 group must have an effective group-wide risk management framework in place; and
- a Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group.

APRA's thoughts on capital adequacy have evolved since the December 2012 response paper, which has resulted in changes to the wording of the fourth requirement. The changed wording reflects APRA's focus on maintaining the prudential strength of the APRA-regulated institutions within Level 3 groups. The implications of this change are discussed in the capital adequacy sections of this paper.

## 1.3 The principles of the Level 3 framework

The December 2012 response paper discussed the high-level principles guiding the requirements of the governance and risk exposures components of the Level 3 framework. The high-level principles underpinning the requirements in the risk management and capital adequacy prudential standards in relation to Level 3 groups are:

- A Level 3 group must understand and prudently manage the risks arising from its business including its non-APRA-regulated activities. It must have a risk management framework and strategy that is appropriate to the nature and scale of its operations. This includes having adequate systems, processes, structures, policies and people for identifying, assessing, managing and monitoring risks.
- The purpose of Level 3 capital adequacy requirements is to ensure that a Level 3 group has sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group. Capital management must be an integral part of a Level 3 group's risk management, requiring the alignment of the group's risk appetite and risk profile with its capacity to absorb losses. A Level 3 group must, at all times, have eligible capital in excess of its Prudential Capital Requirement.

## 1.4 Draft prudential standards

The draft prudential standards giving effect to the risk management and capital adequacy components of the Level 3 framework comprise a new cross-industry risk management prudential standard, CPS 220, and two capital adequacy standards, *Prudential Standard 3PS 110 Capital Adequacy* (3PS 110) and *Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital* (3PS 111), that will apply to the Level 3 Head. CPS 220 will also apply to Level 1 ADIs, general insurers and life insurers and Level 2 groups.

Two additional draft prudential standards, a Level 3-specific definitions standard *Prudential Standard 3PS 001 Definitions* (3PS 001) and a cross-industry governance standard, CPS 510, which were released as part of the December 2012 response paper, are being re-released for consultation. 3PS 001 has been updated to incorporate capital adequacy definitions, and certain definitions that were previously proposed are amended. APRA is proposing changes to CPS 510 to ensure risk management governance principles are aligned with CPS 220. APRA is seeking responses to these proposed changes.

As noted above, the cross-industry risk management and governance standards apply not only to Level 3 groups but also to all ADIs, general insurers, life insurers and Level 2 groups. Hence, a separate consultation package is being released simultaneously with this consultation package. This package includes a Discussion Paper, *Harmonising cross-industry risk management requirements*, and draft versions of CPS 220 and CPS 510. The implications of these standards for Level 3 groups are addressed in this package.

The following list identifies the proposed prudential standards that are included in this consultation package and/or were included in the December 2012 response paper.

### Proposed new prudential standards

*Prudential Standard 3PS 110 Capital Adequacy*

*Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital*

*Prudential Standard CPS 220 Risk Management*<sup>4</sup>

### Standards released as part of the December 2012 consultation package and now amended

*Prudential Standard 3PS 001 Definitions*

*Prudential Standard CPS 510 Governance*

### Standards released as part of the December 2012 consultation package

*Prudential Standard 3PS 001 Definitions*

*Prudential Standard 3PS 221 Aggregate Risk Exposures*

*Prudential Standard 3PS 222 Intra-group Transactions and Exposures*

*Prudential Standard 3PS 310 Audit and Related Matters*

*Prudential Standard CPS 231 Outsourcing*

*Prudential Standard CPS 232 Business Continuity Management*

*Prudential Standard CPS 510 Governance*

*Prudential Standard CPS 520 Fit and Proper*

## 1.5 Timetable

The Level 3 framework is intended to become effective on 1 January 2014. During the remainder of 2013, APRA will consult on a set of PPGs, reporting standards, reporting forms and instructions and consequential amendments to other prudential standards that give effect to the Level 3 framework proposals. If necessary, APRA will also undertake a second round of consultation on the draft Level 3 prudential standards during that time.

<sup>4</sup> Draft prudential standards CPS 220 and CPS 510 are released with the May 2013 'Harmonising cross-industry risk management requirements' discussion paper.

## 1.6 Transition arrangements

As stated in the December 2012 response paper, any relevant transitional arrangements in place for Level 1 and/or Level 2 institutions that are part of a Level 3 group will also be recognised for Level 3 purposes. Transitional relief specific to the implementation of the Level 3 framework will be considered by APRA on a case-by-case basis. Where a Level 3 group believes it cannot meet the 1 January 2014 implementation date for the Level 3 framework, it should include in its submission detailed reasons as to which specific requirements of the framework it would not be able to comply with and why, along with a timeframe on which it believes it will be able to meet the requirements.

## 1.7 Structure of this paper

Chapter 2 describes the key requirements of the cross-industry risk management standard relating to Level 3 groups. Chapter 3 outlines the tenets underpinning the Level 3 capital adequacy framework, and Chapters 4 and 5 describe proposals relating to the calculation of the Level 3 Prudential Capital Requirement (Level 3 PCR) and Level 3 eligible capital (Level 3 EC), respectively. Chapter 6 discusses public disclosure and Chapter 7 requests affected APRA-regulated institutions to provide cost-benefit analysis information.

## Chapter 2 – Risk management

This chapter covers APRA's approach to risk management requirements in relation to Level 3 groups.

Risk management is a fundamental discipline for any APRA-regulated institution. APRA's existing risk management standards<sup>5</sup> currently apply to general insurers and life insurers at Level 1 and, where relevant, at Level 2 for general insurers. APRA's risk management requirements for ADIs at Level 1 and Level 2 are currently dispersed throughout the ADI prudential standards. The March 2010 discussion paper proposed to extend risk management requirements to the Level 3 Head. Specifically, APRA proposed to require the Level 3 Head to ensure that the Level 3 group's material non-APRA-regulated institutions were captured by an overarching group-wide risk management framework. The purpose of this group-wide framework was to ensure that the Board of the Level 3 Head had clear and effective oversight of the material risks of the group, whether they emerge from APRA-regulated or non-APRA-regulated institutions.

Submissions and feedback received since the March 2010 discussion paper have been supportive of APRA's proposals for risk management at Level 3, with a number of submissions suggesting that the proposed requirements are already largely met through existing group policies. APRA has therefore not changed its proposal to require a group-wide risk management framework.

APRA has, however, refined its proposal from requiring all *material non-APRA-regulated institutions* to meet APRA's risk management requirements, to now require the risk management framework to capture the *material risks* that non-APRA-regulated institutions pose to the Level 3 group. The refinement reflects APRA's view that material risks may emerge from a non-APRA-regulated institution irrespective of the materiality of that institution to the group. In essence, the relative size of the non-APRA-regulated institution's business activities may be small, but the potential risks to the group from these activities could be material.

Since 2010, APRA has harmonised and consolidated a number of prudential standards relating to outsourcing, business continuity management, governance and fitness and propriety that apply to ADIs, insurers, and authorised NOHCs. APRA proposes to continue this process of harmonisation by creating a cross-industry risk management standard, CPS 220, that will apply to Level 1 ADIs and insurers, and Level 2 groups. CPS 220 incorporates APRA's proposal to extend the risk management requirements to Level 3 groups. This is similar to the proposal in the December 2012 Level 3 consultation package to extend the existing cross-industry prudential standards to Level 3 groups. Under its principles-based approach to the application of CPS 220, APRA would not prescribe the manner in which a particular risk must be dealt with (except as required under other prudential standards).

CPS 220 will supersede GPS 220 and LPS 220. However, consistent with the existing cross-industry standards, a superannuation-specific risk management standard will apply to Level 1 registrable superannuation entity (RSE) licensees in due course.

Further, APRA proposes to enhance its risk management requirements to reflect its heightened expectations in this area and to better align with continued developments observed in industry. Many of these enhancements are consistent with emerging good practice and requirements globally, particularly following lessons learned in the global financial crisis. APRA is also proposing additional changes to CPS 510 that would also apply to Level 3 Heads. Details of these enhancements are set out in APRA's separate May 2013 consultation package – *Harmonising cross-industry risk management requirements*.

### 2.1 Level 3 risk management requirements

#### Comments received

A number of submissions on the March 2010 discussion paper acknowledged that group-wide risk management is already in place, and were

<sup>5</sup> Prudential Standard GPS 220 Risk Management (GPS 220) and Prudential Standard LPS 220 Risk Management (LPS 220).

supportive of the consolidation of risk management requirements. One submission suggested a potential for overlap of APRA and non-APRA regulatory requirements for non-APRA-regulated institutions that are part of a conglomerate group.

### **APRA's response**

The discussion paper outlined APRA's intention to apply its risk management requirements to Level 3 Heads, which would need to apply these requirements to material entities in the group. APRA has refined this proposal to now require Level 3 Heads to be responsible for establishing and maintaining an overarching group-wide risk management framework that addresses all material risks across the group, including the material risks emanating from non-APRA-regulated institutions within the Level 3 group.

APRA views it as appropriate that the Level 3 Head be required to develop an overarching group-wide risk management framework that encompasses all Level 3 institutions within the group. However, the purpose of the framework is to ensure the Board of a Level 3 Head has clear and effective group-wide oversight of the material risks arising from the group's aggregate business activities. To ensure effective Board oversight, the risk management framework needs to have adequate systems, processes, structures, policies and people for identifying, aggregating<sup>6</sup>, assessing, managing and monitoring risks. As noted in the March 2010 discussion paper, APRA will not prescribe the manner in which particular risks must be dealt with under the risk management framework beyond what is required by other prudential standards. APRA acknowledges that institutions currently manage risks through group-wide risk management policies and procedures, and it expects these new requirements to merely formalise current industry practice.

APRA's proposals place the ultimate responsibility of group risk management on the Board of the Level 3 Head. The Board is required to establish a group-wide risk management framework that is appropriate to the size, business mix and complexity of the

group. As Level 3 groups may contain non-APRA-regulated institutions that are subject to regulatory requirements of other agencies, an appropriate risk management framework must ensure that these other regulatory requirements are met. Where Level 3 institutions are subject to non-APRA regulatory requirements, it is proposed that the Board be able to demonstrate to APRA that the Level 3 group is meeting the higher of the APRA or non-APRA regulatory requirements. APRA sees no reason why a Level 3 institution should not be captured by the group-wide risk management framework, nor why the Level 3 Head should not require a non-APRA-regulated institution to meet the higher risk management standards, where its business activities pose a material risk to the group.

<sup>6</sup> Refer to APRA's proposed *Prudential Standard 3PS 221 Aggregate Risk Exposures* and *Prudential Standard 3PS 222 Intra-group Transactions and Exposures*.

## Chapter 3 – Group capital adequacy

This chapter discusses APRA’s proposed overarching approach to Level 3 capital adequacy. Chapters 4 and 5 discuss in greater detail the determination of the Level 3 PCR and Level 3 EC, respectively.

Capital adequacy is an integral component of the proposed Level 3 framework. Ensuring that a Level 3 group is adequately capitalised limits the likelihood that difficulties in any institution in the group will have an adverse impact on the group’s APRA beneficiaries.

Submissions generally accepted the need for adequate capital for Level 3 groups and were supportive of the proposal to apply Level 3 capital requirements. However, some concerns were raised about aspects of the proposals.

### 3.1 Capital adequacy tenets

The revised capital adequacy proposals set out in this paper and in the draft prudential standards are underpinned by eight tenets, as set out below.

#### 1. Level 3 ICAAP

A Level 3 group must have an Internal Capital Adequacy Assessment Process (ICAAP). The ICAAP must:

- include processes for assessing the risks arising from the group’s activities;
- ensure that capital held is commensurate with the level of risk; and
- include a strategy for maintaining adequate capital over time, including the setting of capital targets consistent with the risk profile of the group, and the risk appetite and regulatory capital requirements of the group.

#### 2. Capital adequacy requirements

A Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group. APRA will determine a minimum prudential capital requirement (Level 3 PCR) that reflects all material risks to the group’s APRA beneficiaries, including contagion risks from non-APRA-regulated activities.

Operational separation or separability of non-APRA-regulated institutions can reduce contagion risk to APRA beneficiaries, thereby potentially reducing the Level 3 PCR that is appropriate. A Level 3 group may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of non-APRA-regulated institutions. In considering the appropriateness of the Level 3 group’s assessment, APRA will consider a number of indicators, which are discussed in section 4.4.

The Level 3 PCR must be covered by high quality loss-absorbing eligible capital (Level 3 EC). The effect of group structure is already taken into account in the determination of the Level 3 PCR. Therefore, the proposals for Level 3 EC are determined consistently across the group and are not differentiated based on group structure.

#### 3. Equity-equivalent capital

The Level 3 capital adequacy framework is a Common Equity Tier 1 (CET1) framework. Both Level 3 EC and the Level 3 PCR will be based on CET1-equivalent criteria.

#### 4. Capital adequacy tests

The Level 3 capital adequacy framework will consist of two tests:

- a Level 3 group must at all times have Level 3 EC in excess of its Level 3 PCR. This aligns with APRA’s approach to capital requirements at Level 1 and Level 2; and
- a Level 3 group must have sufficient unrestricted surplus capital to cover any shortfall in eligible capital held by non-APRA-regulated institutions. APRA does not require a non-APRA-regulated institution itself to hold Level 3 EC to cover its contribution to the Level 3 PCR. However, where there is a shortfall, the group must be able to demonstrate that other Level 3 institutions are able to transfer sufficient eligible capital to cover this shortfall within a short timeframe.

Sections 3.3 and 3.4 provide further detail.

## 5. Level 3 PCR

The Level 3 PCR is determined by aggregating the requirements for six 'industry blocks':

- four APRA-regulated blocks: ADI, general insurance, life insurance and superannuation. Required capital for APRA-regulated blocks is based on the industry-specific CET1 requirements; and
- two non-APRA-regulated blocks: funds management and other activities. Required capital for these blocks is determined by the Level 3 group using its internal capital allocation.

## 6. Intra-group transactions and exposures

The Level 3 PCR must reflect all external risks that the group faces and must exclude intra-group transactions and exposures (ITEs), which are eliminated on consolidation. However, ITEs with Level 3 institutions that are operationally separate or separable must not be excluded.

## 7. Level 3 EC

Level 3 EC is determined on a consolidated basis. As a result, any capital upgrading and/or multiple gearing will be eliminated.

## 8. Supervisory adjustment

If APRA considers that there are prudential reasons for doing so, it may determine a supervisory adjustment to be included in the Level 3 PCR. This is consistent with APRA's ability to adjust capital requirements at Levels 1 and 2.

The remainder of this chapter and the following two chapters discuss submissions to the overarching capital adequacy approach set out in the March 2010 discussion paper.

## 3.2 Equity-equivalent capital

The March 2010 discussion paper proposed an equity-equivalent approach to defining capital at Level 3. It considered that:

- the equity-equivalent approach is broadly consistent with the basis on which market judgments of capital adequacy of most financial services institutions and groups are made;
- it will ensure that capital is easily identifiable across both APRA-regulated and non-APRA-regulated institutions;
- it will minimise unnecessary complexity in the calculation of capital at Level 3; and
- it focuses on the highest quality and most fungible form of capital available to a group, which is particularly important for managing risks during times of financial stress.

APRA proposed that the Level 3 PCR be based on Tier 1 capital requirements for institutions within the group. For Level 3 EC, equity-equivalent would broadly correspond to ordinary shares, retained earnings and reserves, subject to relevant definitions in the ADI prudential standards and with limited recognition of capital other than ordinary equity.

## Comments received

Submissions commented that allowing only the highest quality of capital for the group would reduce the flexibility and ability of companies to respond to adverse circumstances, which may increase risk, and that a wider range of eligible capital should be defined for Level 3. Requirements for the highest quality of capital could be retained at Levels 1 and 2.

## APRA's response

APRA notes that, in response to the global financial crisis, global regulatory reform has sharpened the focus on high-quality capital. Notably, the Basel III capital reforms for ADIs introduce a definition of capital giving greater weight to common equity than was the case under the Basel II framework. Basel III also tightens the criteria for inclusion of other instruments in Tier 1 and Tier 2 Capital and takes a stricter approach to regulatory adjustments than Basel II. APRA's recent review of the capital adequacy requirements for insurers<sup>7</sup> has broadly aligned the regulatory framework for insurers with the Basel III approach for ADIs.<sup>8</sup>

<sup>7</sup> <http://www.apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-October-2012.aspx>

<sup>8</sup> <http://www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-capital-reforms-in-Australia-September-2012.aspx>



As set out in tenet 3, in recognition of these developments APRA now proposes to align the concept of equity-equivalent capital for Level 3 groups with a CET1 concept. APRA proposes to base:

- Level 3 EC on the CET1 definitions that already apply to ADIs and insurers; and
- the Level 3 PCR on the CET1 capital requirements for APRA-regulated institutions within the group and on the internal capital allocation for the non-APRA-regulated institutions.

While this recognises a lower amount of eligible capital at Level 3 than groups may have on a Tier 1 basis, the regulatory capital requirement will similarly be reduced. The overall impact on group capital adequacy is expected to be limited.

### 3.3 Test 1: Capital adequacy

As set out in tenet 4, the Level 3 capital adequacy framework consists of two tests. The first test relates to capital adequacy.

The proposals for Level 3 capital adequacy in the March 2010 discussion paper sought to capture the risks and activities of all material institutions within the group. As set out in the December 2012 response paper, APRA now proposes that Level 3 capital adequacy must capture *material risks* rather than *risks of material institutions* of the group.

APRA proposes that the Level 3 capital adequacy requirements be based on:

- Level 3 PCR, which is the minimum capital that APRA requires a Level 3 group to hold; and
- Level 3 EC, which is the loss-absorbing capital held by a Level 3 group that APRA recognises for capital adequacy purposes.

APRA proposes that a Level 3 Head must ensure that, at all times, the Level 3 group holds Level 3 EC in excess of the Level 3 PCR. Both Level 3 EC and the Level 3 PCR will be calculated as dollar amounts. There will be no specific quantitative levels or thresholds for the size of this excess. However, APRA notes that the Level 3 PCR reflects only a minimum figure and groups also need to consider the capital shortfall assessment (refer to section 3.4), which

reflects restrictions on capital transfers within the group due to factors such as capital triggers in Level 1 and Level 2 ICAAPs and the ADI capital conservation buffer. Furthermore, the Level 3 ICAAP requires the Level 3 Head to set specific capital targets above the Level 3 PCR. The difference between Level 3 EC and the Level 3 PCR therefore does not provide a measure of freely distributable capital.

The location of capital in excess of the Level 3 PCR within the group will be at the discretion of the Level 3 Head, taking into account any impediments to its transferability.

APRA-regulated institutions within the group must continue to meet industry-specific requirements at Levels 1 and 2.

### 3.4 Test 2: Capital shortfall assessment

The second test from tenet 4 relates to a capital shortfall assessment.

The March 2010 discussion paper proposed that a Level 3 Head must determine on a regular basis the amount of transferable surplus capital available to the group. This transferability assessment should exclude those components of surplus capital that may not be freely transferable within the group due to legal, regulatory or other impediments. APRA proposed that a sufficient portion of surplus capital must be transferable.

#### Comments received

Submissions sought further detail regarding the criteria for transferability and what would constitute a 'sufficient' amount of surplus capital. Submissions further suggested that the transferability criteria may not recognise that capital may be transferable within a Level 2 group, and sought clarification on whether the proposed assessment was suggesting Level 2 groups return to a Level 1 framework in order to determine transferability.

Some submissions disagreed with the suggestion in the March 2010 discussion paper that capital held by individual institutions in the Level 3 group in order to meet their internal capital targets may not be transferable; it was noted that these targets may

include buffers set for reasons other than prudential or legal ones. It was also felt that the exclusion of internal buffers would be inconsistent with APRA's approach of encouraging APRA-regulated institutions to maintain buffers at prudent levels.

## **APRA's response**

### **Sufficient surplus capital**

APRA proposes to simplify and streamline the transferability assessment set out in the March 2010 discussion paper. Rather than requiring an assessment of the location and fungibility of capital for all institutions in the conglomerate group, APRA considers that this assessment can be limited to:

1. identifying non-APRA-regulated institutions in a Level 3 group that have insufficient Level 3 EC capital to cover their contribution to the Level 3 PCR; and
2. assessing whether there is sufficient unrestricted surplus capital held elsewhere in the group that may be transferred to the institutions identified under 1. as and when the need arises.

Where a Level 3 group is headed by a NOHC authorised under the Banking Act or Insurance Act or registered under the Life Insurance Act (authorised NOHC) that is not part of a Level 2 group, this assessment must also be performed for that authorised NOHC as, unlike other APRA-regulated institutions, it is not subject to Level 1 or Level 2 capital adequacy requirements.

Capital that would be subject to restrictions on its transferability is set out in the draft 3PS 110 and includes capital relating to, or needed to cover:

- APRA PCRs and capital requirements set by other regulators;
- the ADI capital conservation buffer;
- capital needed to cover the lowest trigger above the Level 1 and Level 2 institutions' PCRs identified in their respective ICAAPs; and
- any legal restrictions on transfers between institutions such as exchange or currency controls, shareholder rights, policyholder rights or general contractual obligations.

Additionally, APRA proposes that, to be regarded as transferable, the Level 3 group must be able to transfer the capital within five business days and must take into account any costs associated with the transfer.

### **Transferability of capital within a Level 2 group**

Capital is ultimately held within a legal entity. Identifying which institutions in the group have surplus capital is therefore a legal entity assessment, subject to the 'sub-consolidation' section below. If the legal entity is regulated by APRA, APRA proposes that the entity must take into account any relevant Level 1 and Level 2 restrictions on its ability to transfer capital.

### **Internal capital targets**

As noted above, APRA is proposing that capital needed to cover the lowest ICAAP trigger above the Level 1 and Level 2 institutions' PCRs not be regarded as unrestricted surplus capital. The lowest ICAAP trigger is effectively the point at which APRA would expect the institution to take steps to restore its capital position. For the purposes of Level 3 requirements, capital in excess of this level may be considered available to cover shortfalls or losses arising elsewhere in the group. This approach also ensures that the Level 3 framework does not discourage the setting of prudent ICAAP target amounts at Levels 1 and 2.

### **Sub-consolidation**

The capital shortfall assessment is a legal entity assessment and is the difference between a Level 3 institution's contribution to Level 3 EC and its contribution to the Level 3 PCR. APRA recognises that this assessment may require significant effort from a Level 3 group. In order to reduce the effort required, APRA proposes that Level 3 groups may request that they be allowed to 'sub-consolidate' non-APRA-regulated institutions for the purposes of the capital shortfall assessment. In determining the appropriateness of such a request, APRA will consider whether there are restrictions on the movement of capital within the proposed sub-consolidation and whether it includes material institutions or material risks. If APRA agrees, the Level 3 group may

consolidate these institutions for the purposes of the capital shortfall assessment.

For example, a Level 3 group may be able to demonstrate that an intermediate holding company and its subsidiaries, which are all located in the Other Activities block, are not subject to any restrictions on the transferability of capital between these entities and are not material to the group.

### **Interaction with Level 1 and Level 2 ICAAPs**

APRA proposes that, subject to its approval, an APRA-regulated institution in a Level 3 group that is subject to an ICAAP target amount at Level 1 or Level 2 may hold the part of this target amount that meets the transferability criteria in an APRA-regulated institution of which it is a subsidiary. The Level 3 Head must satisfy APRA in such a case that the capital is expressly held for that subsidiary only; it may not be utilised for other purposes.

APRA intends to provide guidance on the capital shortfall assessment in a PPG.

## **3.5 Internal Capital Adequacy Assessment Process**

The March 2010 discussion paper proposed to require a Level 3 Head to establish and maintain an appropriate capital management plan to manage and monitor its risks, capital requirements, group relationships and the disposition of capital across the group. The Board of the Level 3 Head would be required to approve the group capital management plan and regularly monitor and review it. Remedial action would be required by APRA where a fall in capital threatened the target surplus.

### **Comments received**

Submissions disagreed that remedial action should be required by APRA, as suggested in the March 2010 discussion paper, where a fall in capital threatens the target surplus. It was claimed that this would create a new regulatory floor resulting in a 'buffer on a buffer'.

### **APRA's response**

APRA wishes to clarify its approach to the target surplus. To align with the recently revised prudential requirements for ADIs and insurers<sup>9</sup>, APRA proposes to require the Level 3 Head to establish and maintain an ICAAP appropriate to the size, business mix and complexity of the Level 3 group's operations and structure. The establishment of target capital levels will form part of the ICAAP. The Level 3 Head must, on an annual basis, provide a report on the implementation of the Level 3 ICAAP to APRA.

The specific requirements for the ICAAP are based on the revised prudential requirements for ADIs and insurers and, in addition, will require the Level 3 group to perform a capital shortfall assessment as outlined in section 3.4.

The proposed ICAAP would include the Level 3 Head's assessment of capital needs as well as capital projections relative to target levels. The group's capital targets would be set to reflect the risk appetite of the Board of the Level 3 Head. APRA would not prescribe an approach to setting target capital; it could be a range or a single target level. However, APRA expects that the target levels will be informed by the Level 1 and Level 2 ICAAP target levels for APRA-regulated institutions. The Level 3 Head would be expected to manage the group's capital according to the ICAAP and its target capital policy.

It is expected that, at times, the actual capital of a Level 3 group may be below target levels. To clarify, APRA believes this is acceptable as long as the situation is addressed by the group's ICAAP and managed accordingly. The intensity of APRA's supervisory attention will increase as the group's capital level approaches the Level 3 PCR. The Level 3 PCR and the capital shortfall assessment comprise the regulatory minimum and any breach can be expected to generate immediate supervisory action.

<sup>9</sup> Refer to footnotes 7 and 8.

### 3.6 Prior notification of reductions in Level 3 capital

APRA's recently revised prudential requirements for ADIs and insurers include a requirement to obtain APRA's written approval prior to making any planned reduction in capital, e.g. where the aggregate amount of dividend payments on ordinary shares exceeds the institution's after-tax earnings. At Level 3, capital held in non-APRA-regulated institutions in the group could be taken out of the group without requiring APRA's prior consent, which may adversely impact upon the group's capital adequacy. To address this and to be consistent with the requirements at Levels 1 and 2, APRA proposes that the Level 3 Head must obtain APRA's written approval prior to making any planned reduction in Level 3 EC.

### 3.7 Notification requirements

APRA proposes that, consistent with the notification requirements for ADIs and insurers, a Level 3 Head must inform APRA as soon as practicable of:

- any breach or prospective breach of the Level 3 PCR;
- any significant departure from the group's ICAAP;
- any breach of the requirement that the group must have sufficient unrestricted surplus capital to cover the capital shortfall in non-APRA-regulated institutions in the group;
- any indication of significant adverse changes in market pricing of, or trading in, the capital instruments of Level 3 institutions in the group; or
- any other significant adverse changes in Level 3 EC.

The notice must include any remedial actions taken or planned to be taken to address the situation, and the timing of these actions.

### 3.8 NOHC activities

The Level 3 Head may be an authorised NOHC. APRA proposes to include in 3PS 110 limitations on the activities an authorised NOHC may perform where it is not part of a Level 2 group. Permitted activities include:

- holding investments in subsidiaries;
- raising funds to invest in, or provide support to, subsidiaries; and
- providing executive leadership across the group.

NOHCs forming part of a Level 2 group are not captured by this proposal but may be subject to limitations on their activities under their Level 2 NOHC authorisation.

### 3.9 Definitions prudential standard

The draft definitions prudential standard (3PS 001) has been updated to incorporate capital adequacy definitions, and the determination of the Level 3 Head has been relocated to 3PS 110, paragraph 2. The definition of 'APRA-regulated institution' has been amended in response to submissions to the first consultation package as it was noted that the reference to subsidiary within the meaning of the Insurance Act is inconsistent with the *Corporations Act 2001*. The amended definition resolves this issue. Furthermore, the definition of 'Level 3 group' has been amended to clarify that a Level 3 group may be a sub-group of a wider conglomerate group.

## Chapter 4 – Level 3 Prudential Capital Requirement

This chapter addresses APRA's proposals for the calculation of the Level 3 PCR and its response to issues raised in submissions. It also outlines the proposed revised requirements for determining the Level 3 PCR.

### 4.1 Building block approach

The March 2010 discussion paper proposed that, for the purpose of determining the Level 3 PCR, Level 3 institutions be assigned to one of seven 'industry blocks': four blocks for the APRA-regulated industries, an authorised NOHC block, an unregulated funds management (FM) block and an unregulated other block.

The Level 3 PCR would be the sum of the required capital (RC) of these seven blocks, be adjusted for ITEs and, where applicable, include a supervisory adjustment.

In the 2011 QIS, potential Level 3 groups were asked to assign only APRA-regulated institutions and material non-APRA-regulated institutions to these blocks.

#### Comments received

Several potential Level 3 groups requested guidance on the identification of material non-APRA-regulated institutions within their groups. It was also noted that including certain institutions in the group but excluding others posed significant challenges and created a potential for double-counting adjustments.

One submission noted that the building block approach does not align with the group's reporting processes, and suggested that the industry blocks should be as broad as possible, e.g. allowing a group dominated by one APRA-regulated industry to have two blocks, one for that industry and the other for the remaining activities of the group.

#### APRA's response

APRA acknowledges that some flexibility in the identification of the industry blocks may be desirable.

However, APRA considers it important that RC for APRA-regulated institutions in the Level 3 group is based on the Level 1 and Level 2 requirements. As these institutions are already required to report on a Level 1 entity and, where relevant, Level 2 group basis, APRA is not convinced that assigning APRA-regulated institutions to industry-specific blocks is a material burden. As FM activities are prevalent in financial conglomerates and are akin to APRA-regulated activities, notably superannuation and investment-linked business in life insurers, APRA considers it appropriate to split non-APRA-regulated institutions between FM and non-FM business. To simplify the structure of the blocks, however, APRA proposes to merge the authorised NOHC block and the unregulated other block into a single other activities (OA) block.

For the purposes of determining the Level 3 PCR, APRA proposes that all Level 3 institutions be assigned to one of the following blocks:

- **ADI block** – the ADI Level 2 group, or, where none is present, the ADI and equivalent overseas deposit-taking institutions;
- **GI block** – the general insurance Level 2 group, or, where none is present, the general insurers and equivalent overseas general insurers;
- **LI block** – the companies (including friendly societies) and equivalent overseas institutions engaged in life insurance business;
- **Super block** – the RSE licensees;
- **FM block** – all institutions conducting FM activities not captured in the ADI, LI or Super blocks (including the non-superannuation FM activities of dual licensed entities<sup>10</sup>); and
- **OA block** – all other Level 3 institutions.

APRA proposes that all institutions in a Level 2 group (other than its non-consolidated subsidiaries) must be assigned to the ADI or GI block, as appropriate. Dual licensed entities must be split between the Super and FM blocks, and any institutions in the Super or FM

<sup>10</sup> A dual licensed entity means an entity that is both licensed as an RSE licensee and a responsible entity of a registered scheme as defined in the *Corporations Act 2001*.

blocks that perform non-APRA-regulated activities must have the risks associated with these activities addressed in the OA block.

APRA proposes that the FM and OA blocks must address *material risks* of all institutions not assigned to any of the other blocks, rather than all *risks of material institutions* not assigned to any of the other blocks.

APRA proposes that the Level 3 PCR is determined as the Level 3 prescribed capital amount plus any applicable Level 3 supervisory adjustment. The Level 3 prescribed capital amount is calculated by summing the required capital of the six industry blocks.

## 4.2 ADI, GI and LI blocks

In the March 2010 discussion paper, RC for the ADI, GI and LI blocks was proposed to be determined as follows:

- $RC_{ADI} = 50\%$  (or a higher percentage as specified by APRA)  $\times$  PCR  $\times$  risk-weighted assets;
- $RC_{GI} = 50\%$  (or a higher percentage as specified by APRA)  $\times$  Minimum Capital Requirement (MCR); and
- $RC_{LI}$  = the sum of:
  - shareholders' fund: prudential capital requirement; and
  - statutory funds: capital adequacy reserve minus subordinated debt and, for friendly societies, minus seed capital.

### Comments received

Several submissions noted an inconsistency in the March 2010 discussion paper's treatment of life insurers compared with ADIs and general insurers. In the case of ADIs and general insurers, the RC formulae assume that the institutions fully maximise their Tier 2 capacity; that is, as they are allowed to cover up to 50 per cent of their PCR or MCR with Tier 2 Capital, the formula assumes that they have covered exactly 50 per cent of their requirement with Tier 2 Capital. If the institution were in reality to hold all its capital as Tier 1, however, part of that Tier 1 Capital is

needed to cover the individual institution's requirement and cannot be considered surplus capital, leading to an overestimation of Level 3 EC in excess of the Level 3 PCR.

For life insurers, on the other hand, this recognition is limited to the amount actually held. If a life insurer holds no lower quality capital, the formula recognises that it must meet its entire requirement with high-quality capital and increases the LI block's RC accordingly.

One submission noted that allowing for this overestimation could provide an incentive for ADIs and general insurers to utilise multiple leverage or capital upgrading.

### APRA's response

As noted in Chapter 3, APRA proposes to base RC for the ADI, GI and LI blocks on the recently revised prudential requirements for ADIs and insurers. The basis for the calculations will be the Level 1 and Level 2 CET1 PCRs. For insurers, the 'CET1 PCR' should be understood as 60 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

APRA is proposing that RC for the ADI, GI and LI blocks at Level 3 will be the greater of<sup>11</sup>:

- CET1 PCR;
- Tier 1 PCR – Additional Tier 1 Capital<sup>12</sup>; and
- Total Capital PCR – Additional Tier 1 Capital – Tier 2 Capital.

This approach ensures that if at Level 1 or Level 2 part or all of the difference between the CET1 PCR and the Tier 1 PCR or Total Capital PCR must be met with CET1 Capital, this amount is added to the block's RC figure. The RC figures for the ADI, GI and LI blocks will therefore reflect the actual amount of CET1 Capital the regulated institutions in the block are required to hold to meet their Level 1 or Level 2 requirements. For the purpose of determining the capital requirements for these blocks at Level 3, the PCRs (in the case of ADIs, the risk-weighted assets) are net of any ITEs (refer to section 4.3).

<sup>11</sup> For ADIs the PCRs should be multiplied with the risk-weighted assets to arrive at a dollar amount.

<sup>12</sup> For insurers, the 'Tier 1 PCR' should be understood as 80 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

### ADI capital conservation buffer

The recently revised ADI capital requirements include a capital conservation buffer which, from 1 January 2016, imposes constraints on an ADI's distributions of capital if the ADI holds less capital than needed to meet its PCR plus the capital conservation buffer. The ADI must meet this buffer with CET1 Capital only. As the buffer provides a capital distribution constraint and is not part of the ADI PCR, APRA proposes to exclude the capital conservation buffer from the determination of the Level 3 PCR. APRA proposes, however, that capital needed to meet the buffer would not be regarded as available to cover any capital shortfall in non-APRA-regulated institutions (refer to section 3.4).

### Overseas equivalent institutions

As noted in section 4.1, overseas equivalent ADI or insurance institutions that do not form part of a Level 2 group are included in the relevant industry block on a standalone basis for the purposes of determining RC. APRA proposes that for the purposes of determining RC for the relevant block, the Level 3 group must use the minimum capital required in the host jurisdiction. However, APRA may direct a Level 3 Head to instead apply a proxy based on APRA's industry-specific requirements if APRA considers that the host jurisdiction's minimum capital requirement is not appropriate for the purposes of the Level 3 capital adequacy calculation.

## 4.3 Intra-group transactions and exposures

The March 2010 discussion paper proposed that the RC figures be adjusted for ITEs. That is, where the Level 1 or Level 2 PCR includes RC for an exposure to another institution in the Level 3 group, this requirement should be removed as the exposure nets out at a consolidated level. The QIS clarified that this adjustment should be made within the industry blocks rather than as an ad hoc step.

The QIS further specified that securitisation special purpose vehicles (SPVs) originated by the Level 3 group need to be assessed against the criteria in Attachment B of *Prudential Standard APS 120*

*Securitisation (APS 120)*, taking into account all exposures from all institutions in the Level 3 group, to assess whether the securitisation SPV meets the operational requirements for regulatory capital relief. A securitisation SPV failing to meet these criteria from a Level 3 perspective must be consolidated back into the originating institution and be treated as part of the Level 3 group. A securitisation SPV meeting the operational requirements for regulatory capital relief from a Level 3 perspective must be treated as external to the Level 3 group and capital requirements associated with any remaining exposures to the securitisation SPV would remain applicable at Level 3.

### Comments received

Potential Level 3 groups argued that they have a large number of derivative exposures between the industry blocks that net out on consolidation. Submissions suggested that these market risk hedges relating to intra-group trades should not be treated as ITEs if the related market risks net out at Level 3; reversing such ITEs could require the Level 3 institutions involved to address the risks of the unhedged position in their block's RC figure and thereby artificially increase the Level 3 PCR.

One potential Level 3 group disagreed with APRA's proposal that the group's exposure to a securitisation SPV be reassessed from a Level 3 perspective and consolidated back into the originator's balance sheet if it fails to meet the criteria of APS 120. It suggested instead that the purchaser rather than the originator should hold capital against the investment risk. It also suggested that attempts to ensure a clean sale at Level 3 could inadvertently be nullified by other Level 3 institutions investing in these securities, or even by an external funds manager investing on behalf of institutions in the group.

During the QIS exercise, potential Level 3 groups noted that the reversal of insurance-related ITEs was challenging. For example, where an ADI insures its business with a general insurer in the group, the proposals required the general insurer to remove this exposure and the ADI to include the risks relating to the exposure in its RC as these risks are still present in the group and need to be accounted for in the

Level 3 PCR. Potential Level 3 groups were unclear on how to make this adjustment, as the ADI capital adequacy requirements do not lend themselves easily to risk-weighting insurance risks.

## APRA's response

### Market risk hedges

APRA agrees that ITEs that are market risk hedges that net out on consolidation should not be reversed as this could artificially increase the Level 3 PCR. APRA therefore proposes that, where a Level 3 institution hedges market risks with another institution in the Level 3 group, the latter institution must include the associated investment risk in the determination of its block's RC at Level 3 as it is ultimately exposed to the external risk. The former institution will therefore not be required to include the investment risk in its RC at Level 3.

### Securitisation SPVs

APRA does not agree with the alternative proposal that the purchaser rather than the originator within the group hold capital against the investment risk of securitisation SPVs as it does not adequately address the potential contagion risks at Level 3 from selling securities through SPVs to other institutions in the group. APRA considers that the inadvertent build-up of exposures to securitisation SPVs is a clear example of contagion risk that Level 3 is designed to address. Therefore, APRA does not propose to amend its requirement that the Level 3 group reassess from a Level 3 perspective its exposure to securitisation SPVs that it has originated.

### Insurance risk

APRA considers that insurance risk is best captured by the general and life insurance regulatory frameworks. Therefore, APRA proposes that insurance risk charges for insurers that relate to intra-group exposures should not be reversed.

In the example discussed above, the general insurer would not reverse the ITE with the ADI and would include the risk charge in RC for the GI block. The ADI would not adjust its risk-weighted assets to include

this risk; that is, the ADI block would exclude this insurance risk.

### Operational separation

APRA proposes in section 4.4 below that a Level 3 group may be able to reduce its Level 3 PCR by operationally separating non-APRA-regulated institutions. The contagion risks to APRA beneficiaries from these institutions would be reduced where, for example, the group clearly indicates that its APRA-regulated institutions will not support operationally separated or separable institutions if they were to experience severe financial difficulties. As a result, an exposure from an APRA-regulated institution to an operationally separated or separable institution should be treated as equivalent to an exposure to an entity that is not part of the Level 3 group. Therefore, where a Level 3 institution that is not operationally separated or separable has an ITE with a Level 3 institution that is operationally separated or separable, it is proposed that this ITE must not be reversed.

### Significant effort

APRA proposes that, where significant effort would be required to accurately determine a specific ITE adjustment, a Level 3 Head may, subject to APRA's agreement:

- use a conservative approximation for the impact on the Level 3 PCR of the ITE adjustment; or
- choose not to take the adjustment into account, where adjusting for the ITE would lead to a net reduction in the Level 3 PCR.

## 4.4 Operational separation or separability

As noted in tenet 2 (refer to section 3.1), operational separation or separability of non-APRA-regulated institutions can reduce contagion risk to APRA beneficiaries, thereby potentially reducing the Level 3 PCR that is appropriate. A Level 3 group may demonstrate to APRA that it has credibly reduced the risk to APRA beneficiaries through the operational separation or separability of non-APRA-regulated institutions.



In order to assess the appropriateness of the Level 3 group's determination, APRA will consider, among other things, whether:

- there is structural separation (or whether this can readily be achieved, including in stressed scenarios);
- ITEs from APRA-regulated institutions in the group to operationally separated or separable institutions are subject to more stringent exposure limits;
- Boards and senior management of operationally separated or separable institutions are effectively independent from APRA-regulated institutions;
- the operationally separated or separable institutions have group badging and product distribution arrangements clearly separate from APRA-regulated institutions; and
- there is a recovery plan that demonstrates that the group can readily dispose of the operationally separated or separable institutions should it face financial distress.

As a general rule, the more indicators that a Level 3 group meets, the more credible the separation and the lower the risk the relevant institutions pose to the APRA beneficiaries. However, APRA considers it highly unlikely that operational separation or separability can reduce the contagion risk to APRA beneficiaries to zero.

### **ITE limits**

To avoid an indirect exposure to contagion risk, there must be specific limits on ITEs from APRA-regulated institutions in the group to operationally separated or separable non-APRA-regulated institutions. These restrictions must be outlined in the group's ITE policy as proposed in the draft *Prudential Standard 3PS 222 Intra-group Transactions and Exposures* (3PS 222) and must be more stringent than the general requirements set out in the Level 3 group's ITE policy. APRA proposes to include a requirement for more stringent limits on ITEs with operationally separated or separable Level 3 institutions in 3PS 222.

As noted in section 4.3, ITEs from Level 3 institutions that are not operationally separated or separable to Level 3 institutions that are operationally separated or separable must not be reversed for the purposes of calculating the Level 3 PCR.

### **Systemically important ADIs**

APRA considers that there is a serious risk that financial markets will expect an ADI that dominates its group to cover losses sustained by group members, even if the affected members are operationally separated or separable from the ADI. If this market expectation is not met, markets could form the view that the ADI is unable rather than unwilling to cover these losses. This loss in market confidence could adversely affect the ADI's liquidity position and, ultimately, its viability. Accordingly, APRA considers that systemically important ADIs should not be exposed to this risk given the significant impact should this risk materialise. APRA is therefore proposing that Level 3 groups containing systemically important ADIs will not be able to reduce their Level 3 PCR through operational separation or separability of their non-APRA-regulated group members.

This proposed treatment of systemically important ADIs that are members of a Level 3 group is intended to form part of APRA's broader framework for domestic systemically important ADIs. APRA is developing this broader framework and will consult on it in due course.

### **Interaction with the components of the Level 3 framework**

APRA emphasises that the impact of operational separation or separability on the application of the Level 3 framework is limited to capital adequacy. All Level 3 institutions in the group, regardless of group structure, will be subject to all requirements of the other three components of the Level 3 framework: group governance, risk exposures and risk management.

## 4.5 Funds management activities

The March 2010 discussion paper proposed a consistent approach to the calculation of capital requirements in respect of FM activities that was broadly based on APRA's requirements for the life insurance industry. It proposed that RC for FM activities by RSE licensees and non-APRA-regulated institutions engaged in FM activities be based on the greater of:

- 0.25 per cent of funds under management on account balances not invested in life insurance policies or bank deposits of a related party;
- any regulatory capital requirement of the institution; or
- the capital requirement as calculated by the Level 3 group's internal capital allocation (ICA).

In the QIS, APRA requested participants to provide FM assets on both a gross and net basis. A group's gross FM assets included assets that are passed from one institution engaged in FM activities to another such institution within the Level 3 group, whereas net FM assets excluded such internal pass-through and reflected only the FM assets received from third party investors.

The QIS also differentiated between funds under management (FUM) assets and funds under administration (FUA) assets, and excluded from these definitions custodial services and advisory business.

### Comments received

Many submissions commented on APRA's proposals relating to FM. Some respondents requested combining the FUM and FUA definitions as they found it challenging to separate the two types of assets, though others preferred to keep the two concepts. Respondents strongly opposed measuring RC on a gross basis. It was argued that this approach assumes that the pass-through of funds within the group is as risky to the group as the receipt of external funds to be managed; respondents felt that the additional risk to the group of pass-through was marginal and that the risks to the group from its FM

activities would be more appropriately reflected by measuring RC on a net basis. Some submissions argued that the movement of funds from one Level 3 group to another does not create additional risk from an industry-wide perspective and that this double-counting of capital across the financial industry should be avoided.

In relation to the proposed 0.25 per cent charge on fund balances, submissions argued that this requirement lacked risk-sensitivity as it:

- is a flat requirement that does not recognise economies of scale, with the additional risks of an additional dollar under management decreasing as the total funds under management increase;
- does not recognise, and provides no incentive for, risk mitigation techniques; and
- is an arbitrary charge with no sound academic basis.

Respondents proposed that the 0.25 per cent floor be removed and that groups be allowed to determine the RC for non-APRA-regulated FM business using their ICA. Certain respondents argued that, as an alternative, Level 3 groups that include an ADI with an APRA-approved Advanced Measurement Approaches operational risk model under the Basel II framework<sup>13</sup> should be allowed to replace the 0.25 per cent floor with an outcome determined using this model.

Potential Level 3 groups were concerned that they would be at a competitive disadvantage as the Level 3 requirements for non-APRA-regulated FM institutions within Level 3 groups would be substantially higher than the existing regulatory requirements for non-APRA-regulated institutions. It was noted that in overseas markets in particular, groups may compete with funds managers that face no capital requirements at all. Further, groups argued that the full deduction of all intangible assets would have a negative impact on the ability of Level 3 groups to grow their FM business and that funds management rights created on acquisition contain expected profits that should be recognised. The deduction of intangible assets is addressed in Chapter 5.

<sup>13</sup> Prudential Standard APS 115 Capital Adequacy: Advanced Measurement Approaches to Operational Risk.

## APRA's response

### Definition

APRA considers that the definition of FM assets could be simplified by removing the distinction between FUM and FUA. The draft standards propose to define FM activities as:

- for institutions in the ADI, LI and FM blocks, the provision of investment and related services for the management of investors' funds, excluding custodial services and advisory business; and
- for institutions in the Super block, the management of the total balances of RSEs.

### Measuring risk on a gross versus net basis

APRA considers that some amount of additional operational risk arises from the pass-through of funds within the group, but acknowledges that the additional risk is less than for third-party investments with the group. In the interest of simplicity, APRA proposes to measure the risks to a Level 3 group of its FM activities on a net basis. In particular, APRA proposes that a Level 3 group be required to reflect in its Level 3 PCR only the risks relating to external funds at the point of entry into the group.

As an example, where funds enter the group as investment-linked policies through the LI block and are then passed through to an institution in the FM block, RC for the LI block would include the investment-linked policies but RC for the FM block would exclude these funds. Were the situation reversed, RC for the FM block would include these funds but RC for the LI block would exclude the policies. Similarly, where an institution in the FM block passes funds through to other institutions in the FM block, RC for the FM block would count these funds only once.

Where an institution not engaged in FM activities invests funds through an institution (within the same Level 3 group) that is engaged in FM activities, APRA proposes that the former institution reflect the risks relating to the investment in its RC whereas the institution engaged in FM activities exclude these funds. As an example, where a general insurer invests assets through a related FM institution, the GI block

would reflect all risks relating to the investment and the FM block would exclude these funds, as they are not external to the group but are instead a form of internal pass-through.

APRA does not agree that pass-through of FM assets between independent groups does not increase the riskiness of the financial system. Moving funds from one Level 3 group to another with wholly separate management, systems and processes will give rise to additional risks in the financial system. It is therefore appropriate to apply a capital requirement to both Level 3 groups in such circumstances.

### Required capital

With the implementation of the Stronger Super reforms, APRA proposes to base RC for the Super block on the operational risk financial requirement (ORFR) target amount set out in *Prudential Standard SPS 114 Operational Risk Financial Requirement* (SPS 114), adjusted for internal pass-through as set out above. The draft *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement* (SPG 114) proposes that there is some scope, in limited circumstances, to adjust the ORFR target amount set at Level 1 in order to take into account the impact of any duplication of financial requirements with a related APRA-regulated institution. APRA notes that this proposal may interact with the Level 3 adjustments for internal pass-through and will consider this issue further following publication of the final SPG 114.

APRA has considered the arguments with respect to the 0.25 per cent floor for the FM block and proposes to remove this floor. RC for the FM block will be determined as the greater of:

- the sum of applicable non-APRA regulatory capital requirements; or
- the capital requirement as calculated by the Level 3 group's ICA.

Similar to SPS 114 for RSE licensees, to ensure a consistent approach APRA will set out in a PPG its expectations regarding the typical level of capital held for risks arising from FM activities. The 0.25 per cent floor included in the March 2010 discussion paper was based on APRA's capital requirement for life

insurance investment-linked business. As Level 3 has moved from a Tier 1 framework to a CET1 framework, and acknowledging that life insurers need only meet 60 per cent of the capital requirement for investment-linked business with CET1 Capital, APRA considers that 0.15 per cent (60 per cent of 0.25 per cent) of net FM assets is an appropriate expectation for the level of capital held for the risks in the FM block.

Some respondents noted the difference in risk profile between FUM and FUA. APRA proposes that Level 3 groups take these differences into account when setting their ICA figure for the FM block so that a Level 3 group could potentially assign FUA a lower risk profile than FUM. However, if funds were to enter the group as FUA but are then passed through to another FM institution in the group as FUM (or to a life insurer as investment-linked policies), the risk profile of those funds has increased. In that case, APRA would expect the group to take this increased risk profile into account when determining the ICA for these assets.

#### **Operational separation of FM institutions**

Where a Level 3 group has adequately demonstrated that an FM institution in the FM block is operationally separated or separable from the APRA-regulated institutions in the group, this reduced risk to APRA beneficiaries may lead to a lower RC figure for the external funds received by the FM institution. However, if these funds are then passed through to an institution in the group that is not operationally separated or separable, the risks to the beneficiaries have correspondingly increased. To account for this, APRA proposes that the risks associated with those funds be included in the latter institution's RC figure rather than in the operationally separated or separable institution's RC figure.

As an example, where funds enter the group through an operationally separated or separable FM institution but are then passed through to a life insurer in the same group, the risks associated with these funds must be reflected in the life block's RC figure and the FM block's RC figure will exclude these funds.

#### **Competitive aspects**

APRA must weigh the competitive impact of its proposals against its primary statutory obligation to ensure the financial soundness of APRA-regulated institutions. The complexity and, in many cases, significant size of Level 3 groups warrant APRA's particular attention to potential contagion risks within these groups.

APRA expects that its proposals to remove the 0.25 per cent floor from the FM block's RC calculation, to base RC on net rather than gross assets and to include an adjustment relating to operational separation or separability of non-APRA-regulated institutions will alleviate concerns regarding the competitive impact of the Level 3 framework.

The move from a 0.25 per cent floor to a 0.15 per cent expectation for the FM block means that Level 3 requires a lower level of capitalisation for the FM block than it does for equivalent business within the LI and Super blocks. While a life insurer need only meet 60 per cent of its 0.25 per cent requirement with CET1 Capital it is still required to hold qualifying capital (which may be CET1 Capital) to cover the remaining 40 per cent. There is, however, no such obligation on an FM institution.

### **4.6 Internal capital allocation**

The March 2010 discussion paper proposed that the capital requirement for RSE licensees and non-APRA-regulated institutions in the group be based on the group's ICA. Where APRA considered the capital allocation to be inadequate, it could determine a capital level for the non-APRA-regulated institutions that the group would be required to hold.

#### **Comments received**

Several submissions argued that it is not appropriate to adopt the ICA as the minimum regulatory requirement as the ICA is used for risk-adjusted performance purposes and includes a surplus or buffer above what the group internally considers to be RC, e.g. for maintaining a target credit rating. Submissions noted, in particular, the interaction

between the ICA including a buffer and the target surplus policy required under the proposed ICAAP; as target surplus is designed to provide a buffer to avoid breaching regulatory requirements, including it in the calculation of the Level 3 PCR would lead to a 'buffer on a buffer'. Submissions also argued in favour of a prescribed minimum confidence level to assist groups in determining the appropriate ICA as this would ensure a level playing field.

### **APRA's response**

The ICA for the purpose of Level 3 RC is the minimum amount of capital needed to cover all material risks to which institutions in the FM or OA block are exposed. APRA considers that the ICA to be used in the Level 3 group's capital adequacy could differ from the outcome of the economic capital model (ECM) that the group uses for internal capital management purposes. The Level 3 group may decide there are valid reasons for the ICA to differ from the ECM result.

APRA proposes to include in 3PS 110 minimum requirements on the determination of the ICA. The Board of a Level 3 Head must ensure that the Level 3 group develops and maintains a process for determining the ICAs for the FM and OA blocks. This process must ensure that the ICAs:

- reflect all material risks to APRA beneficiaries that arise from the activities undertaken by Level 3 institutions in the relevant industry block;
- do not incorporate expected future profits and future management actions;
- are based on a rigorous and robust methodology;
- reflect the risk appetite, as stated in the Level 3 group's ICAAP, of the Board of the Level 3 Head; and
- have regard to the impact of institutions in the FM and OA blocks on the ability of the Level 3 group's APRA-regulated institutions to meet their obligations to APRA beneficiaries, including through contagion risks.

APRA proposes that the ICA must be a positive amount.

ICAs will also be subject to supervisory review. Where APRA considers that the ICA determined by a Level 3 Head is not adequate, it may impose a supervisory adjustment that will remain in place until its concerns have been addressed (refer to section 4.8).

### **Required capital for the FM and OA blocks**

Capital adequacy for FM institutions will be based on the Level 3 group's ICA as these institutions are not APRA-regulated. APRA expects RC for such institutions to be determined in accordance with the proposals set out in section 4.5.

Instead of prescribing a confidence level for the ICA against activities in the OA block, APRA will consider market benchmarks and industry ratios for the relevant commercial industries to determine the appropriateness of the RC result. As creditors of these institutions may consider that the APRA-regulated group to which they belong will provide a back-stop to any potential losses in the institution, they may allow the institution to operate with less equity than they would accept of a similar institution that is not part of an APRA-regulated group. The comparison with market benchmarks and industry ratios will assist APRA in identifying any situations where such a potential undercapitalisation at the legal entity level may occur. As noted in section 4.5, RC for the FM block will have a floor based on the sum of applicable non-APRA regulatory capital requirements. APRA proposes a similar floor for the OA block.

Whether the FM or OA block contains operationally separated or separable institutions would also inform the determination of the block's ICA.

With the release of APRA's superannuation prudential standards, APRA will no longer require an ICA to be set for RSE licensees. APRA proposes that RC for the Super block be determined in accordance with the approach set out in section 4.5.

APRA intends to provide guidance on its expectations regarding ICAs in a PPG.

## 4.7 Cross-block diversification benefits

The March 2010 discussion paper proposed that the RC figures for each block would be summed to arrive at a Level 3 PCR and that no cross-block diversification benefits would be allowed.

### Comments received

A number of submissions suggested that cross-block (i.e. group-wide) diversification benefits should be permitted at Level 3, arguing that:

- the existence of diversification benefits is an advantage of being part of a conglomerate group; and
- Level 3 groups have in place group-wide capital models of an appropriate standard capable of capturing cross-block diversification benefits.

One submission noted that the March 2010 discussion paper appears to contradict the recently revised capital adequacy requirements for insurers, which allow for diversification benefits between risks to which an insurer is exposed.

### APRA's response

APRA agrees that benefits may arise from group membership and, indeed, its proposals allow for the recognition of diversification benefits within industry blocks. However, APRA considers that it is important to recognise that group membership may also lead to increased contagion risk. Furthermore, contagion risks increase during periods of extreme stress as correlations become stronger; recent international experience has highlighted the complexities inherent in the interaction of risks in the financial system. Therefore, APRA does not propose to change its current position of not allowing cross-block diversification benefits at Level 3.

APRA disagrees that its Level 3 proposals contradict the capital adequacy requirements for insurers; these requirements relate to the diversification of risks within one industry. At Level 3, diversification benefits within industry blocks are recognised to the extent that the individual block's RC determination allows for diversification effects. In the case of the insurance

requirements, these intra-block diversification effects are recognised in the determination of RC for the GI block and the LI block.

## 4.8 Level 3 supervisory adjustment

The March 2010 discussion paper proposed that, where there are prudential reasons for doing so, APRA may impose additional requirements on a Level 3 Head or on APRA-regulated institutions in the group on a case-by-case basis. These include, but are not limited to, additional capital, risk management or reporting requirements. Where APRA has prudential concerns with the Level 3 group, it would typically seek to have its concerns addressed in the first instance in consultation with the senior management of the Level 3 group and Board of the Level 3 Head, as appropriate.

### Comments received

Submissions noted the similarity of the approach to the ADI supervisory review process. They expected supervisory adjustments to be rare and that APRA would first engage in discussions with the Board of the Level 3 Head on their perception of risk and the group's risk appetite.

### APRA's response

APRA confirms that the process for setting the proposed Level 3 supervisory adjustment will be similar to the process for ADIs and insurers. APRA intends to provide in a PPG considerations it will take into account that may lead it to determine a Level 3 supervisory adjustment.

## Chapter 5 – Level 3 Eligible Capital

This chapter addresses APRA's proposals for the calculation of Level 3 EC and its response to issues raised in submissions. It also outlines the proposed revised requirements for determining Level 3 EC.

### 5.1 Measurement of eligible capital at Level 3

In the March 2010 discussion paper, APRA stated that it was considering two methods for measuring Level 3 EC:

- Method 1 ('top down'), where Level 3 EC is based on the consolidated accounts of the Level 3 group net of all adjustments; and
- Method 2 ('building block'), where Level 3 EC is based on the sum of eligible capital for each industry block, net of all adjustments.

The discussion paper noted that both methods would generally arrive at the same result, and that it was not clear at that stage which method would result in the most appropriate measure of a Level 3 group's EC.

#### Comments received

As part of the QIS exercise, potential Level 3 groups were asked to calculate Level 3 EC using both methods and to provide a reconciliation of the results where they differed. They were also given the opportunity to comment on the appropriateness of the methods.

All participating potential Level 3 groups expressed a strong preference for Method 1. In particular, groups noted that, when compared with the 'top down' approach, Method 2:

- is more complex, imposing a greater regulatory burden;
- has a greater risk of errors due to the need to reverse and then deduct certain items at Level 1 and Level 2 to ensure a consistent approach at Level 3; and
- suffers from ongoing problems relating to the exclusion of non-material institutions.

It was felt that Method 1, on the other hand:

- is more transparent, as it relies on consolidated accounts that for listed Level 3 Heads will be publicly available;
- provides complete coverage of all capital within the group and will automatically eliminate intra-group transactions, removing the potential for multiple leverage or capital upgrading; and
- has significant administrative benefits as it relies on one set of consolidated accounts rather than a large number of subsidiary accounts and intra-group adjustments.

#### APRA's response

APRA proposes to base the Level 3 EC calculation on the Method 1 ('top down') approach.

### 5.2 Determining eligible capital

As noted in Chapter 3, APRA proposes to move from a Tier 1-equivalent approach to a CET1-equivalent approach at Level 3. This is in line with the greater global focus on high-quality capital. Subject to the criteria set out in the draft 3PS 111, Level 3 EC will be the sum of:

- paid-up ordinary shares issued by the Level 3 Head;
- retained earnings;
- undistributed current year earnings;
- accumulated other comprehensive income and other disclosed reserves;
- minority interests determined in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) and *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112);
- for general insurers in the group, technical provisions in surplus or deficit of those required by *Prudential Standard GPS 320 Actuarial and Related Matters*<sup>14</sup>; and
- certain regulatory adjustments.

<sup>14</sup> For life insurers in the group, the adjustment for the difference between the adjusted policy liabilities and the sum of the policy liabilities and policy owners' retained profits disclosed in the statutory accounts is included as a regulatory adjustment.

APRA has considered extending the recognition of minority interests to other entities or industries, but concluded after an initial review that the additional complexity would outweigh the benefits of a more accurate assessment of loss-absorbing capital. However, APRA is willing to review its position on this issue and requests feedback in particular on how to appropriately determine the loss-absorbing portion of minority interests in a Level 3 cross-industry context.

The regulatory adjustments largely mirror the regulatory adjustments listed in APS 111, GPS 112 and *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*. The following sections discuss three specific regulatory adjustments: goodwill and other intangible assets, equity holdings by a Level 3 group in third party institutions, and operational risk reserves held by RSEs.

### 5.3 Goodwill and other intangible assets

The March 2010 discussion paper proposed to deduct all goodwill and intangible assets at Level 3.

#### Comments received

Submissions argued that goodwill and other intangible assets hold economic value even in distressed circumstances. While acknowledging that full deduction may be warranted for goodwill and other intangible assets held by APRA-regulated institutions, submissions argued that full deduction was not appropriate for commercial businesses. In particular, submissions considered that funds management rights provide a stable series of expected cash flows for which a full deduction from Level 3 EC is unwarranted.

#### APRA's response

APRA's view is that goodwill and other intangible assets do not hold economic value in distressed circumstances. Consequently, it has a longstanding principle of requiring APRA-regulated institutions to deduct these assets. As noted in tenet 2 (refer to section 3.1), Level 3 EC is required to cover all

risks to APRA beneficiaries. It must be determined consistently across the group and must not differentiate based on group structure as the effects of operational separation and separability are already reflected in the Level 3 PCR. As a consequence, APRA proposes to extend its requirement to deduct goodwill and other intangible assets to Level 3. These assets must be deducted regardless of their location in the group.

### 5.4 Equity holdings in third-party financial and commercial institutions

APRA notes that the ADI and insurance prudential standards have different approaches to equity holdings by APRA-regulated institutions in third parties, i.e. in entities that are not part of the Level 3 group. ADIs are required to deduct all equity exposures and other capital support provided to financial and commercial (non-financial) institutions, whereas for insurers the risks associated with these exposures must be reflected in the PCR.<sup>15</sup> APRA's view is that these differences are appropriate due to the fundamental differences between these industries' business models. Accordingly, APRA proposes to apply the ADI rules to equity holdings by ADIs in the Level 3 group and the insurance rules to exposures held by insurers in the group.

In relation to such holdings by institutions located in the FM and OA blocks, APRA proposes to differentiate the treatment for holdings in financial institutions from the treatment of similar holdings in commercial institutions:

- to avoid double-counting of capital in the financial system, holdings by institutions in the FM and OA blocks in financial institutions<sup>16</sup> must be deducted; and
- risks related to holdings by institutions in the FM and OA blocks in commercial (non-financial) institutions are not deducted but must instead be reflected in the group's Level 3 PCR through the relevant block's ICA (refer to section 4.6).

<sup>15</sup> Investments in joint ventures and associates must be partially deducted from the insurer's CET1 Capital.

<sup>16</sup> Financial institution' is defined in the draft 3PS 111.



Exposures to Level 3 institutions in the group are not deducted as these institutions are within the scope of consolidation, and holdings on behalf of third parties such as FM clients, investment-linked policyholders and RSE fund members are also not deducted as these holdings do not constitute a direct financial risk to the group.

### Corresponding deduction approach

APS 111 includes the corresponding deduction approach, which requires an ADI to deduct holdings of other financial institutions' Additional Tier 1 Capital or Tier 2 Capital instruments from the corresponding category of capital issued by the ADI itself. As Level 3 is a CET1 framework, all deductions would have to be made from Level 3 EC. APRA proposes, however, to acknowledge the ADI corresponding deduction approach by excluding from the deduction at Level 3 any holdings by the ADI of Additional Tier 1 Capital or Tier 2 Capital instruments that are deducted by the ADI from the corresponding category of capital at Level 1 or Level 2. This ensures that the Level 3 framework is consistent with the ADI framework in its application of deductions to CET1 quality capital.

Institutions in the FM and OA blocks cannot issue Additional Tier 1 Capital or Tier 2 Capital so there is no possibility of applying a corresponding deduction approach. APRA considers that there are two possible approaches to holdings by these institutions of Additional Tier 1 Capital or Tier 2 Capital instruments: either deduct them from Level 3 EC or not deduct them at all. APRA notes that the recipient ADI or insurer would be able to recognise the capital at Level 1 and Level 2. If the investment were not deducted from the Level 3 group's capital position, this could lead to a double-counting of capital in the financial system. To avoid this risk, APRA proposes to deduct holdings of Additional Tier 1 Capital or Tier 2 Capital instruments by institutions in the FM and OA blocks from Level 3 EC. APRA is interested in industry feedback on this proposed treatment and, in particular, is seeking proposals for alternative treatments that do not lead to a double-counting of capital in the financial system.

## 5.5 Operational risk reserves

SPS 114 recognises two types of financial resources for RSE licensees to meet their ORFR target amount:

- an operational risk reserve held within each RSE; or
- operational risk trustee capital, which must be of CET1 quality, held by the RSE licensee.

Financial resources to meet the ORFR target amount may be held as a combination of these two types of resources.

Operational risk trustee capital is within the scope of accounting consolidation and will therefore automatically be reflected in Level 3 EC. As operational risk trustee capital in excess of the ORFR target amount may potentially be transferred elsewhere in the group to address other risks, in principle there is no explicit limit on the inclusion in Level 3 EC of operational risk trustee capital.

Operational risk reserves are held by RSEs and are not within the scope of accounting consolidation. APRA notes that these reserves cannot be moved elsewhere in the group and are only available to meet the ORFR target amount. In light of this limitation on the loss absorbency of operational risk reserves, APRA proposes to limit their recognition to the level of the ORFR target amount that is included in the determination of RC for the Super block.

## Chapter 6 – Public disclosure

As noted in the December 2012 response paper, APRA proposes to publish a register of Level 3 Heads on its website, similar to the current registers in place for other APRA-regulated institutions. Throughout the Level 3 framework policy development process, APRA has held regular discussions with those groups to which it intends to apply the framework.

This chapter addresses public disclosure of Level 3 capital adequacy results.

### Comments received

Several submissions raised concerns that any proposed disclosure of a Level 3 PCR would allow market participants to deduce the underlying Level 1 and Level 2 PCRs.

### APRA's response

APRA considers that disclosure of a Level 3 PCR would have the potential for confusion with publicly disclosed Level 1 and Level 2 capital adequacy data, as:

- the Level 3 PCR includes material risks of non-APRA-regulated institutions, whereas the Level 1 and Level 2 data are limited to the APRA-regulated institutions in the group;
- Level 3 capital adequacy is based on an equity-equivalent approach, whereas the Level 1 and Level 2 data are based on Total Capital;
- the Level 3 EC and Level 3 PCR are dollar amounts, whereas the ADI Level 1 and Level 2 capital adequacy disclosures are presented as percentages; and
- the adequacy of any reported Level 3 EC in excess of the Level 3 PCR cannot be assessed without also assessing any capital shortfall in non-APRA regulated institutions.

APRA notes that the Level 3 PCR reflects only a minimum figure and groups also need to consider the capital shortfall assessment, which reflects restrictions on capital transfers within the group due to factors such as capital triggers in Level 1 and Level 2 ICAAPs and the ADI capital conservation buffer. Furthermore, the Level 3 ICAAP requires the Level 3 Head to set specific capital targets above the Level 3 PCR.

The difference between Level 3 EC and the Level 3 PCR therefore does not provide a measure of freely distributable capital.

APRA considers market discipline to be the primary benefit of the public disclosure of capital adequacy figures. However, as the factors set out above limit the benefits of public disclosure, APRA does not propose to prescribe any public disclosure at this time.

APRA will not prohibit Level 3 groups from publishing information relating to their Level 3 capital adequacy. APRA proposes, however, that it must review a Level 3 group's approach to such disclosures prior to their first release and whenever there are material changes to the group's disclosure approach. Importantly, the existing rules prohibiting disclosure of Level 1 and Level 2 PCRs and APRA supervisory adjustments (including at Level 3) remain in place. It is therefore necessary to ensure that any published Level 3 PCR amount does not disclose PCRs and APRA supervisory adjustments at Levels 1, 2 and 3. This can be achieved by:

- recalculating the ADI block's RC figure using the 4.5, 6.0 and 8.0 per cent minimum PCRs rather than the ADI's actual PCRs as determined by APRA;
- recalculating the GI and LI blocks' RC figures using the prescribed capital amounts rather than the insurer's PCRs; and
- deducting any Level 3 supervisory adjustment from the Level 3 PCR.

APRA will review its position on prescribing public disclosure at Level 3 once it believes that financial markets are able to interpret Level 3 capital information and understand how this differs from Level 1 and Level 2 capital information.

## 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 requirements 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](http://www.finance.gov.au/obpr/bcc/index.html).



Telephone  
1300 55 88 49

Email  
[info@apra.gov.au](mailto:info@apra.gov.au)

Website  
[www.apra.gov.au](http://www.apra.gov.au)

Mail  
GPO Box 9836  
in all capital cities  
(except Hobart and Darwin)