Response to Submissions

Review of capital standards for general insurers and life insurers

9 December 2011

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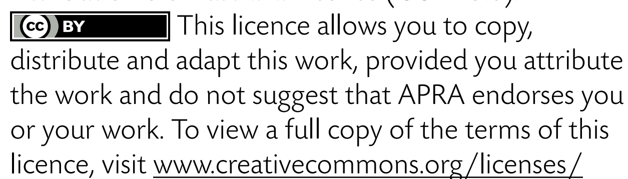
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Preamble

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

For general insurers, APRA introduced its current capital standards in 2002. Some minor modifications were made in 2006 and 2008.

The Life Insurance Actuarial Standards Board (LIASB) first introduced solvency and capital adequacy standards for life insurers in 1995. These standards were a requirement of the *Life Insurance Act 1995* (Life Act). The standards were extended to cover friendly societies in 1999 and amended in 2005 with the introduction of International Financial Reporting Standards. The Life Act was amended in 2007, transferring to APRA the responsibility for setting and administering prudential standards relating to solvency and capital adequacy.

In 2010, APRA issued a discussion paper and three technical papers outlining proposals to update the capital standards. APRA invited comments on its proposals and also invited insurers to participate in a quantitative impact study (QIS). APRA received a significant number of submissions and QIS responses.

In March 2011, APRA issued a response paper outlining the main issues raised in submissions and arising from assessment of the QIS results. In April 2011, APRA invited insurers to participate in a second quantitative impact study (QIS2). APRA received a significant number of submissions and QIS2 responses.

This paper outlines APRA's response to the main issues raised in submissions on the March 2011 response paper and arising from assessment of the QIS2 responses. APRA is inviting further comments on its proposals in light of the refinements set out in this response paper.

APRA is releasing, with this response paper, the key draft prudential standards that specify APRA's proposals in detail for general insurers and life insurers. APRA is also seeking comments on these draft standards.

Written submissions should be sent to InsuranceCapital@apra.gov.au by 24 February 2012 and addressed to:

General Manager, Policy Development
Australian Prudential Regulation Authority
GPO Box 9836
SYDNEY NSW 2001

Important

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

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

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Glossary

ADI	An authorised deposit-taking institution under the *Banking Act 1959*
APRA	Australian Prudential Regulation Authority
Additional Tier 1 capital	Capital instruments that provide loss-absorption on a going-concern basis, but which do not satisfy all of the criteria for inclusion in Common Equity Tier 1 capital.
Appointed Actuary	The actuary appointed by an insurer under the *Life Insurance Act 1995* or the *Insurance Act 1973*.
BCBS	Basel Committee on Banking Supervision
Capital base	The capital that is eligible under the relevant prudential standards for meeting the Prudential Capital Requirement.
Common Equity Tier 1 capital (CET1)	The highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date.
FCR	The Financial Condition Report prepared by the Appointed Actuary.
Friendly society	A friendly society as defined in the *Life Insurance Act 1995*[1].
General fund	The management fund for a friendly society or the shareholders' fund for other life companies.
General insurer	A general insurer authorised under the *Insurance Act 1973*.
ICAAP	Internal Capital Adequacy Assessment Process
Insurance Act	*Insurance Act 1973*
Insurer	A general insurer or a life insurer.
Lapse	Voluntary discontinuance of a life insurance policy, whether or not a surrender value is payable.
Level 1	Individual operating companies authorised to undertake activities within a single APRA-regulated industry (ADIs, general insurers, life insurers and RSE licensees).
Level 2	Consolidated groups comprise entities within a single APRA-regulated industry, headed by an ADI, general insurer or authorised non-operating holding company. Also referred to as 'groups' or 'Level 2 insurance groups'.
Level 3	Consolidated conglomerate groups containing APRA-regulated entities with material operations across more than one APRA-regulated industry and/or in unregulated entities.
Life insurer	A life company, including a friendly society, registered under the *Life Insurance Act 1995*.

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

Life Act	*Life Insurance Act 1995*
LMI	Lenders mortgage insurer
Prudential Capital Requirement (PCR)	The required level of capital for regulatory purposes. It is determined as the prescribed capital amount plus any Pillar 2 supervisory adjustment.
Policyholder	Includes a policy owner as referred to in the *Life Insurance Act 1995*.
Prescribed capital amount	Prescribed capital amount determined in accordance with the quantitative rules as set out in the prudential standards, including any Pillar 1 supervisory adjustment, but before any Pillar 2 supervisory adjustment is applied.
First QIS	The Quantitative Impact Study (completed in October 2010).
QIS2	The second Quantitative Impact Study (completed in July 2011).
RFBEL	Risk Free Best Estimate Liability, determined as per the Best Estimate Liability calculated under *Prudential Standard LPS 1.04 Valuation of Policy Liabilities* but with the gross investment yield and liability discount rate set equal to the risk-free discount rate.
Servicing expenses	Servicing expenses as defined in *Prudential Standard LPS 7.02 General Standard*.
Supervisory adjustment	An adjustment that APRA may require to the capital requirements of a life insurance fund, life company or general insurer. A Pillar 1 supervisory adjustment forms part of the prescribed capital amount. A Pillar 2 supervisory adjustment is separate from the prescribed capital amount.
Target capital	The targeted amount of capital as determined by the Board of the insurer or group.
Tier 1 capital	Capital that provides loss-absorption on a going-concern basis, comprised of Common Equity Tier 1 capital and Additional Tier 1 capital.
Tier 2 capital	Capital of lesser quality than Tier 1 capital that only provides loss-absorption in limited circumstances.
VAF	Value of the assets of a life insurance statutory or general fund.

Executive summary

APRA is reviewing and updating its capital standards for general insurers and life insurers. The aims of the review include improving the risk sensitivity of the standards and achieving better alignment across APRA-regulated industries.

APRA's initial proposals were set out in a discussion paper and three technical papers issued between May and September 2010. APRA conducted a quantitative impact study (first QIS) on these proposals in late 2010 and also invited submissions on the proposals.

Following a review of the results of the first QIS and submissions, APRA issued a response paper in March 2011. The response paper included a number of changes to the original proposals and summarised the results of the first QIS. APRA also conducted a second QIS (QIS2) in mid-2011.

APRA is publishing this response paper as a further step in the review process. The paper summarises the results of QIS2 and the submissions received on the March 2011 response paper. It also outlines further changes APRA is intending to make to its proposals in response to the QIS2 results and submissions.

Accompanying this response paper is a set of draft prudential standards for both general and life insurers that specify APRA's proposals in detail.

QIS2 results

There was a high participation rate in QIS2 from most sectors of the general insurance and life insurance industries.

The QIS2 results indicated that APRA's proposals would increase overall capital requirements across both industries, but to a much lesser extent than indicated by the results of the first QIS. APRA expects that the increase in capital requirements will be less in practice than indicated by QIS2 as insurers revise their business and capital management strategies in response to the revised capital standards.

The impact of the proposals varied widely between insurers. Some insurers reported little change or reductions in required capital whilst others reported an increase. The increase in required capital was modest for many insurers but, as expected, some insurers reported a material increase. As APRA expected, the QIS2 results for life insurers in particular indicated that further refinements to its proposals were needed. The range of outcomes remains consistent with APRA's aim of enhancing the risk sensitivity of the capital standards.

Submissions to APRA

APRA received approximately 40 submissions on the March 2011 response paper.

Submissions continued to indicate a broad level of support for APRA's aims in undertaking the review of improving the risk sensitivity of the standards and achieving better alignment across APRA-regulated industries. Some submissions noted, however, that the revised proposals were still overly conservative, pro-cyclical or unduly complex in some areas.

Many submissions raised issues regarding details of the proposals or sought clarification of aspects of the proposed method for calculating the prescribed capital amount. The key areas where issues were raised in relation to life insurers included asset risk, operational risk and the capital base calculation. The key areas where issues were raised in relation to general insurers included asset risk, operational risk and the insurance concentration risk charge.

A number of submissions requested APRA to provide more information on the Internal Capital Adequacy Assessment Process (ICAAP) and the process for determining supervisory adjustments.

Revisions to prescribed capital proposals

APRA once again welcomes the high level of interest shown by industry and interested parties in the review, and the quality of the submissions. Following consideration of the submissions and QIS2 results, APRA has revised a number of aspects of its proposals. Other proposals remain unchanged. APRA has, however, provided further clarification of its rationale and intent.

The changes simplify the proposals in some areas, address areas where the proposals were overly conservative and reduce some of the pro-cyclical effects. The changes are expected to reduce the impact of the proposals at an industry level. The details of the proposed changes are set out in Chapters 5 to 7 of this paper.

This response paper also includes additional information regarding the process proposed by APRA for determining supervisory adjustments to the capital base and required capital, APRA's expectations for the ICAAP, transitional arrangements and proposed disclosure requirements.

Capital base proposals for insurers

APRA has previously proposed that the requirements relating to the composition of the capital base for insurers will be aligned with the requirements for authorised deposit-taking institutions (ADIs) under APRA's implementation of the Basel Committee for Banking Supervision (BCBS) capital reforms (Basel III). This paper outlines the approach proposed to be adopted by APRA for achieving this alignment.

APRA intends to align the eligibility requirements for components of capital of insurers with the Basel III requirements for ADIs. This paper outlines those proposed eligibility requirements. In addition, APRA proposes to implement limits for the different components of capital, expressed as a percentage of the Prudential Capital Requirement (PCR).

APRA proposes that insurers be required to have minimum levels of Common Equity Tier 1 capital and Total Tier 1 capital (both net of regulatory adjustments) sufficient to meet a high proportion of the PCR. APRA proposes to allow insurers to meet some of the PCR with Tier 2 capital, consistent with the approach for ADIs.

APRA also proposes to introduce capital requirements for life insurers at a company level. These are in addition to the capital requirements applying separately to each of the statutory funds and the general fund of a life insurer. APRA proposes that the PCR at company level be equal to the total of the fund level PCRs. Introducing capital requirements at company level ensures that the company as a whole maintains an appropriately high quality of capital in its capital base across all funds.

Consistent with the current requirements for general insurers and ADIs, APRA is proposing that a life insurer be required to obtain APRA approval before undertaking certain actions that reduce its capital position.

Appendix 1 and 2 include a summary of the proposals relating to the capital framework for general insurers and life insurers respectively.

Transition

APRA recognises that implementation of the proposals will affect the capital requirements of all insurers. APRA expects that the revisions proposed in this paper will reduce the impact of the proposals on the overall capital position of many insurers compared to the QIS2 results. It is inevitable, however, that some insurers will have a material increase in their capital requirements or a reduction in capital coverage relative to their position under the existing capital standards. If insurers are unable to implement changes to their current operations or arrangements to mitigate these impacts before 1 January 2013, APRA will consider allowing transitional arrangements. These arrangements will be determined on a case-by-case basis. Further details of the process for requesting such arrangements are outlined in this paper.

Next steps

Submissions on this response paper and the draft standards are due by 24 February 2012. Following consideration of submissions, APRA plans to issue final capital standards in May 2012, together with drafts of other prudential standards with consequential changes. APRA will also consult in 2012 on the reporting requirements for insurers. The new capital framework will be effective from 1 January 2013.

Chapter 1 – Introduction

1.1 Background

APRA issued a discussion paper on 13 May 2010 outlining its proposals to review its capital standards for general and life insurers. The main objectives of the review are to:

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

APRA also released three technical papers providing further details on its proposals, covering the:

- asset risk capital charge (12 July 2010);
- capital base and insurance risk capital charge for life insurers (12 July 2010); and
- insurance concentration risk capital charge for general insurers (30 September 2010).[2]

APRA invited insurers to participate in a QIS during the second half of 2010.

APRA issued a response paper on 31 March 2011 that outlined the main issues raised in submissions and arising from assessment of the QIS results. The March 2011 response paper detailed refinements to the proposals in a number of areas to address some of the issues raised in submissions, and clarified other aspects of APRA's proposals. The March 2011 response paper also noted that APRA would consider further adjustments to its proposals, particularly for life insurers, after analysis of QIS2. In April 2011, APRA invited insurers to participate in QIS2.

APRA received approximately 40 submissions following the release of the March 2011 response paper. Over 110 insurers participated in QIS2. APRA has also met with a number of insurers and other stakeholders to discuss its proposals and the feedback provided in submissions.

Submissions remain supportive of APRA's objectives in undertaking the review and many of APRA's proposals. This response paper summarises the main issues raised in submissions on the March 2011 response paper and arising from assessment of the QIS2 results, and provides APRA's response. APRA proposes further refinements in some areas to address the issues raised in submissions; in other areas APRA proposes to retain the previously outlined proposals. This response paper also provides further clarification on some aspects of APRA's proposals.

1.2 Revised prudential standards for insurers

APRA's prudential standards will change when the revised capital standards are implemented. For general insurers, there will be changes to the existing capital adequacy standards. For life insurers, the existing capital standards and *Prudential Standard LPS 7.02 General Standard* (LPS 7.02) will be revoked and replaced with new standards. There will also be consequential changes to other prudential standards for both industries.

Drafts of the new life insurance standards and drafts of the general insurance standards with material changes are being released with this response paper. Those standards where only minor consequential changes are proposed will be released for consultation in mid-2012 for a short consultation period.

APRA is providing more detailed information in this response paper on its proposed requirements for the composition of the capital base for insurers. This follows the release in September 2011 of APRA's discussion paper on implementation of the Basel III capital reforms for ADIs (Basel III discussion paper).[3] The requirements relating to capital base for life insurers are included in *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112). A further draft of LPS 112 and *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge* (LPS 114) and a draft of *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112) will be released for consultation in March 2012.

2 The discussion paper and technical papers are available on APRA's website at www.apra.gov.au/GI/PrudentialFramework/Pages/review-of-capital-standards-for-general-insurers-and-life-insurers-may-2010.aspx

3 Available at www.apra.gov.au/adi/PrudentialFramework/Pages/Implementing-Basel-III-Capital-Reforms-in-Australia-September-2011.aspx

The drafts of LPS 112 and GPS 112 will include details relating to implementation of the Basel III capital reforms for ADIs. The drafts of LPS 112 and LPS 114 will include requirements relating to the illiquidity premium.[4]

For general insurers, APRA proposes to implement combined prudential standards for Level 1 general insurers and Level 2 insurance groups from 1 January 2013. The key capital adequacy concepts, including the determination of the prescribed capital amount, PCR and capital base, are similar for Level 1 insurers and Level 2 insurance groups. APRA is of the view that combined prudential standards are therefore more appropriate, and will simplify compliance with APRA's prudential requirements for Level 2 insurance groups.

APRA is also proposing that the prudential standard for general insurers dealing with audit and actuarial matters (*Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation* [GPS 310]) be divided into two separate standards, for consistency with the life insurance prudential standards. The revised standards will be released for consultation with other standards in mid-2012.

1.2.1 General insurance: Standards released for consultation

The following prudential standards are being released with this paper:

Prudential Standard GPS 001 Definitions (GPS 001)

Prudential Standard GPS 110 Capital Adequacy (GPS 110)

Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge (GPS 114)

Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge (GPS 115)

Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge (GPS 116)

Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge (GPS 117)

Prudential Standard GPS 118 Capital Adequacy: Operational Risk Charge (GPS 118)

1.2.2 Life insurance: Standards released for consultation

The following prudential standards are being released with this paper:

Prudential Standard LPS 001 Definitions (LPS 001)

Prudential Standard LPS 110 Capital Adequacy (LPS 110)

Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital (LPS 112)

Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge (LPS 114)

Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge (LPS 115)

Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge (LPS 117)

Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge (LPS 118)

The following standards will be revoked from 1 January 2013:

Prudential Standards No 3 Prudential Capital Requirement

Prudential Standard LPS 2.04 Solvency Standard (LPS 2.04)

Prudential Standard LPS 3.04 Capital Adequacy Standard

Prudential Standard LPS 6.03 Management Capital Standard

Prudential Standard LPS 7.02 General Standard

Complete lists of the draft prudential standards being released for consultation now, in mid-2012 and those being revoked are provided in Appendices 3 and 4.

4 The premium was previously called the 'liquidity premium'. However, the term 'illiquidity premium' is more appropriate as it is included in the discount rate used to value illiquid liabilities.

1.2.3 Prudential practice guides

APRA plans to release a number of draft prudential practice guides (PPGs) in September 2012. APRA proposes that these guides will cover the Internal Capital Adequacy Assessment Process, APRA's process for determining supervisory adjustments, the insurance concentration risk charge for general insurers and the asset risk charge. APRA will consider issuing PPGs on other topics if submissions from insurers indicate that further guidance relating to the new capital framework is necessary.

1.3 Timetable

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

24 February 2012	Submissions due on response paper and draft prudential standards
March 2012	Release of draft standards on measurement of capital (GPS 112 and revised draft LPS 112) and revised LPS 114 Release of methodology for calculating 'illiquidity premium'
May 2012	Release of prudential standards: • final versions of standards listed in 1.2 (except GPS 112, LPS 112 and LPS 114); and • draft versions of other prudential standards with consequential changes.
June 2012	Release of draft reporting standards
July 2012	Submissions due on draft prudential standards released for consultation in March 2012 and May 2012
August 2012	Submissions due on draft reporting standards released in June 2012
September 2012	Release of remaining final prudential standards Release of draft prudential practice guides
October 2012	Release of final reporting standards
1 January 2013	New standards effective
1 January 2013 to 31 March 2013	First reporting period under new standards for life insurers and Level 1 general insurers
1 January 2013 to 30 June 2013	First reporting period under new standards for Level 2 insurance groups

1.4 Transitional arrangements

APRA indicated in its May 2010 discussion paper and March 2011 response paper that it was inevitable that the implementation of more risk-sensitive capital requirements will lead to most insurers having different capital requirements from those under the existing capital standards. APRA also previously indicated that it will not finalise its proposals without carefully assessing their likely impact on individual insurers and the overall impact on the general insurance and life insurance industries.

APRA undertook QIS2 to enable an accurate assessment of the impact of its revised proposals on both general insurers and life insurers. The QIS2 results (which are summarised in Chapter 2) indicate that, as expected, APRA's proposals will lead to an increase in required capital and/or reduction in capital base for some insurers. The impact on the capital position of individual insurers varies widely.

APRA expects that the refinements to its proposals as set out in this response paper, together with behavioural changes by insurers, will mitigate the impact for many insurers. APRA recognises, however, that the implementation of more risk-sensitive capital standards will have a material impact on the capital position of some insurers. As previously indicated, APRA therefore proposes to consider transitional arrangements for insurers on a case-by-case basis.

Insurers will be able to submit to APRA requests for transitional arrangements; such requests should be made no later than 30 September 2012. Insurers will need to provide details of the transitional arrangements sought, including the requested transitional period and the rationale for the requested transitional arrangements. Requests for transitional arrangements should be accompanied by details of the insurer's projected capital position as at 1 January 2013 and for a further period of at least three years beyond that date.

APRA proposes to release with the draft reporting forms in June 2012, a calculation workbook to assist insurers in estimating their capital position under the revised capital standards. This workbook will be similar to the QIS workbooks and reflect the capital standards to be released in May 2012. Insurers will be able to use this workbook to support any requests for transitional relief.

APRA will assess the information submitted by insurers in the fourth quarter of 2012 and advise insurers of its decisions on requests for transitional arrangements as soon as practicable.

1.5 Structure of this paper

Chapter 2 provides an overview of the outcomes from QIS2 while Chapter 3 provides further clarification of APRA's approach to supervisory review and assessment. Chapter 4 outlines the approach proposed by APRA for aligning the composition of capital requirements of insurers with those of ADIs. Chapter 5 discusses APRA's response to submissions in areas that affect both general insurers and life insurers. Chapter 6 focuses on APRA's response to submissions in areas that are specific to Level 1 general insurers and Level 2 insurance groups while Chapter 7 discusses areas that are specific to life insurers. Chapter 8 outlines the disclosure requirements for insurers and Chapter 9 requests insurers to provide cost-benefit information.

Appendices 1 and 2 of this paper include summaries of the proposals, including the proposed changes, outlined in this paper. Appendices 3 and 4 provide a list of the final suite of prudential standards that will be effective for insurers from 1 January 2013. Details of the proposed criteria for eligibility of capital instruments for general and life insurers, and the regulatory adjustments to capital for general insurers, are included in appendices 5 to 8. Details of the regulatory adjustments for life insurers are set out in the draft of LPS 112.

Chapter 2 – QIS2 results

2.1 Scope of QIS2

Following the release of the March 2011 response paper, APRA conducted QIS2 to assess the impact of its revised proposals. The closing date for QIS2 submissions was 29 July 2011.

In total, over 110 insurers and groups from the life and general insurance industries participated in QIS2, representing a significant majority of these industries. APRA appreciates the time and effort taken by the insurers and groups that participated in QIS2. The results of QIS2 have been important in determining the revisions to APRA's proposals that are set out in this paper.

QIS2 enabled APRA to assess the impact of its revised proposals based on an assessment of the risk charges under the proposals at a past reporting date. The risk charges reported in QIS2 therefore relate to the position of insurers at that date, based on their business and capital management strategies developed under the existing capital standards.

As noted in the March 2011 response paper, APRA expects that insurers are likely to review their business and capital management strategies in light of the proposed changes to the capital standards and to address any material increase in capital requirements where practical and appropriate to do so. APRA considers such behavioural changes to be a positive consequence of capital standards that are more risk-sensitive.

Accordingly, APRA took into account reasonable behavioural changes likely to be made by the insurers in undertaking detailed analysis of the QIS2 results and their impact on the industry and individual insurers. This analysis has influenced the revised policy proposals set out in this paper.

2.2 General insurance

There was a high response rate for general insurers to QIS2 with 79 insurers, representing 94 per cent of the general insurance industry capital base, submitting QIS2 workbooks.

The response rate for Level 2 insurance groups was also high, with 13 participants representing 95 per cent of the capital base of Level 2 insurance groups.

Table 1 – Industry participation for general insurers

Industry	Participants	Industry share (by count)	Industry share (by capital base)
General insurers (Level 1)	79	60 per cent	94 per cent
General insurers (Level 2)	13	63 per cent	95 per cent

As expected, QIS2 indicated that APRA's proposals to revise the capital standards will reduce the overall level of solvency coverage of the general insurance industry. Also as expected, however, the reduction in solvency coverage based on the QIS2 results was not as substantial as indicated under the first QIS. This was due to the changes made to APRA's proposals as set out in the March 2011 response paper.

The increase in the PCR indicated in the QIS2 results for general insurers primarily reflects an increase in the asset concentration risk charge and the introduction of an operational risk charge. There were also small increases in the asset risk charge and insurance concentration risk charge relative to the current requirements. The increases in the risk charges were partially offset by the aggregation benefit.

The capital base reported by some insurers reduced, primarily due to the proposed deductions relating to the regulatory capital of investments in subsidiaries, joint ventures and associates.

As was the case for the first QIS, the results for QIS2 varied widely between insurers, reflecting the enhanced risk sensitivity of APRA's proposed capital requirements. APRA has estimated the impact of the refinements proposed in this paper on the capital position of individual general insurers and the overall industry. APRA's expectation is that the revised proposals will marginally improve the solvency coverage of insurers relative to the position indicated by QIS2.

2.3 Life insurance (other than friendly societies)

There were 24 registered life companies (excluding friendly societies) that participated in QIS2; however, three of these life companies did not submit workbooks for their general funds. The QIS2 response rate represents almost 100 per cent of the industry as measured by assets under management. The seven registered life companies (excluding friendly societies) that did not participate in QIS2 have a small asset base.

Table 2 – Life insurer participation in QIS2 (excluding friendly societies)

Industry	Participants	Industry share
Life insurance (investment linked statutory funds)	31	100 per cent of assets
Life insurers (other statutory funds)	40	100 per cent of assets
Life insurers (general funds)	21	68 per cent of funds

Investment-linked statutory funds

For investment-linked statutory funds, the required capital for QIS2 was lower than for the first QIS due to the changes proposed to the asset risk charge and operational risk charge. The total required capital for the investment-linked statutory funds that participated in QIS2 was not materially different from the capital required under the existing capital standards.

Non-investment-linked statutory funds

For non-investment-linked funds, the total required capital reported in the first QIS was substantially higher than under the existing capital standards. Only a few funds reported reduced capital requirements in the first QIS.

Overall, the total required capital for the non-investment-linked funds that participated in QIS2 was still higher than under the existing capital standards. The increase in required capital was, however, much less than under the first QIS. This reflected the revisions to APRA's proposals outlined in the March 2011 response paper.

As was the case for the first QIS, the results for QIS2 varied widely between insurers. For QIS2, 14 of the 40 non-investment-linked statutory funds reported lower required capital than under the existing capital standards.

Nevertheless, as expected, the QIS2 results indicated that further refinements to APRA's proposals were needed. The proposed refinements are set out in this paper. Most of the proposed refinements will improve the solvency coverage of insurers relative to their position in QIS2.

General funds

The March 2011 response paper extended to general funds APRA's proposals for determining the capital base and PCR of statutory funds and they were therefore included in QIS2.

The required capital for the general funds that participated in QIS2 was higher than the required capital under the existing capital standards for many of the funds. The main reason was the application of the asset risk charge to all assets (including surplus assets) of the fund. Some general funds were also affected by the asset concentration risk charge. This charge is not applied to general funds under the existing capital standards.

The proposed refinements to APRA's proposals that are set out in this paper will reduce the impact of the asset concentration risk charge.

2.4 Friendly societies

Seven of the fourteen registered friendly societies participated in QIS2. Some participants did not submit workbooks for all of their benefit funds.

The limited participation rate did not allow APRA to draw industry-wide conclusions. However, the impact of the proposals on friendly societies has been considered in framing APRA's revised proposals.

Table 3 – Friendly society participation in QIS2

Industry	Participants	Industry share
Friendly societies (investment-linked benefit funds)	15	15 per cent of assets
Friendly societies (other benefit funds)	24	50 per cent of assets
Friendly societies (general funds)	7	50 per cent of funds

Chapter 3 – Supervisory review and assessment

3.1 Internal Capital Adequacy Assessment Process

The May 2010 discussion paper and March 2011 response paper outlined APRA's proposed approach to supervisory review and assessment. APRA proposes to adopt a three pillar approach to the capital adequacy framework for insurers, including a requirement for each insurer to have a process for assessing its overall capital adequacy and a strategy for maintaining its capital levels. This process is referred to as the ICAAP. An insurer's ICAAP is expected to go beyond consideration of the need to meet regulatory capital requirements on a continuous basis and to include comprehensive assessment by the insurer of its risk profile and the capital needed to support the risks undertaken.

APRA proposed that the ICAAP address all aspects of the insurer's capital adequacy framework, including Board and management oversight, comprehensive assessment of risks, development of a target capital policy, and regular monitoring, reporting and review against the requirements established under its ICAAP.

Comments received

Submissions were supportive of APRA's ICAAP proposals but sought additional clarification on the expected content of ICAAPs and how the ICAAP may vary depending on the size, nature and complexity of insurers. Insurers also sought additional information about the reporting to be provided to APRA and how this reporting interacts with existing requirements such as the Financial Condition Report (FCR), Insurance Liability Valuation Report (ILVR), business plans and capital management plans.

APRA response

Details of the proposed ICAAP requirements are set out in the drafts of GPS 110 and LPS 110, with the main requirements set out in the section titled 'Internal Capital Adequacy Assessment Process' of both standards. APRA proposes to provide additional guidance on the ICAAP requirements in a PPG. The PPG will build on the content of this response paper and draft GPS 110 and LPS 110, and will be made available for consultation in 2012, prior to its finalisation.

The Board of an insurer has primary responsibility for the oversight of capital management of the insurer. Consistent with that overarching responsibility, the ICAAP of an insurer must be approved by its Board. APRA expects that the ICAAP will be developed by the insurer's senior management with input from relevant areas and experts (including the Appointed Actuary). The Board should, however, be actively engaged in the development of the insurer's ICAAP and its implementation on an ongoing basis.

The proposed ICAAP requirements build on APRA's current capital management requirements and guidance for insurers. Under the proposed requirements, the existing capital management plans will be subsumed into the ICAAP. Insurers will continue to be required to develop a business plan but the plan need not include specific information on capital management. However, the business plan should be consistent with the ICAAP of the insurer.

The ICAAP is distinct in its purpose and ownership from the FCR and ILVR. The ICAAP is fundamentally the responsibility of the Board; the FCR and ILVR are the responsibility of the Appointed Actuary. Accordingly, under APRA's proposals, the FCR (for life insurers and general insurers) and ILVR (for general insurers only) will continue to be required. The FCR will continue to provide the Appointed Actuary's independent opinion on the financial position of the insurer, including its approach to capital management.

The Board of an insurer is responsible for setting the insurer's risk appetite. APRA expects there to be a clear link between an insurer's risk appetite and its risk and capital management framework, including the target capital levels determined as part of the insurer's ICAAP. APRA expects that target capital levels will be set in accordance with the insurer's risk appetite and not solely by reference to APRA's minimum capital requirements. APRA expects an insurer's ICAAP to include appropriate stress and scenario testing, which will be used in developing target capital levels and as part of the insurer's ongoing capital management.

An insurer is expected to manage its capital in accordance with its ICAAP on an ongoing basis. The information provided to APRA on the insurer's ICAAP indicates the insurer's intentions as to how it expects to manage its capital. APRA will therefore expect an insurer to act in accordance with those intentions and to discuss with APRA any need to materially vary its target capital levels or other aspects of its ICAAP.

An insurer's ICAAP is expected to include trigger points for managing capital around target levels and the actions that the insurer will take when those trigger points are reached, including trigger points for reporting to APRA. APRA acknowledges that the capital position of an insurer will vary around target capital levels set in the ICAAP over time, and may fall below target capital levels from time to time. This is acceptable as long as the insurer acts in accordance with the trigger points and actions set out in its ICAAP, including reporting to APRA as appropriate.

APRA proposes to require insurers to ensure that their ICAAP is subject to a robust independent review process that is appropriate to the size, nature and complexity of the insurer's operations. The review will consider the nature and extent of any changes that have occurred, or are likely to occur, in the insurer's business profile or risk appetite. APRA proposes that an independent review be undertaken no less frequently than every three years. The review process will need to be documented to enable the Board and APRA to assess its adequacy. It will be appropriate to utilise a range of reviewers as part of the independent review process of the ICAAP to take advantage of diverse skills and functions. For example, an insurer may make use of internal audit, external audit, risk management personnel or other external consultants to undertake aspects of the review.

ICAAP documentation

APRA is proposing that the documentation of an insurer's ICAAP include the following components:

- A set of processes and systems for assessing capital requirements appropriate to the risks to which the insurer's organisation is exposed, setting target capital levels, monitoring and projecting the capital position, taking action if capital levels fall below target levels, and reporting on the process and its outcomes to the Board.

  These underlying processes will be documented in various policies and procedural documents which will be available to APRA on request.

- A document that describes and summarises the capital assessment and management processes of the insurer (ICAAP summary statement). This document will serve as a roadmap to the insurer's ICAAP process that allows the Board and APRA to understand the capital management processes of the insurer. The ICAAP summary statement will refer to other policies and procedures, but should be relatively self-contained. It will also summarise the insurer's process for independent review of its ICAAP.

It is proposed that the ICAAP summary statement be made available to APRA on request. It must be updated and approved by the Board when there are material changes to the ICAAP, or to the risk profile of the insurer.

- An annual report that sets out the outcomes of applying the ICAAP (ICAAP report). This report will describe in detail the outcomes of the ICAAP, including projected capital levels against target capital levels for at least a three-year period, and assess actual capital levels and capital management actions against the ICAAP for the previous period. The ICAAP report will provide details of any changes to the ICAAP over the previous year and areas of planned change for the coming year. It will document the outcomes of any review of the ICAAP over the past year, including any recommendations for change and the proposed response to those recommendations.

  It is proposed that the ICAAP report be submitted to APRA annually, within a period of four months from the end of an insurer's financial year. A life insurer must currently submit its FCR within three months of the end of its financial year; a general insurer must currently submit its FCR and ILVR within four months of the end of its financial year. APRA proposes to harmonise these requirements and both life insurers and general insurers will be required to submit the FCR within a period of three months after the end of an insurer's financial year.[5] This will enable insurers to use the outcomes of the FCR and ILVR as input to the ICAAP report.

  It may be appropriate in some circumstances for an insurer to incorporate the ICAAP report into the FCR prepared by the Appointed Actuary. The Board of the insurer must be satisfied that, in so doing, the independence of the Appointed Actuary is not compromised and that the Board retains clear ownership of the ICAAP. An insurer taking this approach must submit the combined document to APRA within the three-month period for completion of the FCR.

The ICAAP summary statement and ICAAP report are conceptually separate. The ICAAP summary statement is a point in time summary description of the capital management processes of the insurer. The annual ICAAP report details the outcomes of the implementation of these processes over the previous year and also looks forward for at least a three-year period to illustrate expected capital outcomes. The ICAAP report and ICAAP summary statement could be contained in a single document, provided that all the matters required to be addressed have been included.

3.2 Responsibility for calculating the capital base and prescribed capital amount

Under the existing life insurance capital standards, the Appointed Actuary has responsibility for calculation of the solvency requirement, capital adequacy requirement and management capital requirement. Under the revised capital framework, APRA is proposing that the life insurer will have responsibility for calculating the capital base and prescribed capital amount for each of its statutory funds, the general fund and the company as a whole.

5 As a result, a general insurer and Level 2 insurance group will be required to submit its ILVR within three months of the end of their financial year. A general insurer required to have a peer review of the ILVR will also be required to have the peer review by the Reviewing Actuary completed and documented by the three month deadline.

This proposal is consistent with the Board of an insurer having primary responsibility for the oversight of capital management of an insurer, including the ICAAP. It will also align the life insurance capital standards with the current capital standards for general insurers and ADIs.

Under the revised *Prudential Standard LPS 320 Actuarial and Related Matters* (LPS 320)[6], the Appointed Actuary will be required to provide advice to the insurer regarding the calculation of the capital base and prescribed capital amount. It is also proposed that, where an insurer reports a capital base or a prescribed capital amount that differs from the amount advised by the Appointed Actuary, the insurer will need to provide an explanation of all areas of difference to APRA. APRA expects this change in responsibilities to lead to a greater level of engagement between boards and the Appointed Actuary. The Appointed Actuary will continue to be responsible for preparing the FCR and monitoring the company's compliance with the capital standards as set out in LPS 320.

3.3 Application of supervisory adjustments to prescribed capital amount

The March 2011 response paper outlined APRA's proposals for determining supervisory adjustments to prescribed capital. Under the proposals, APRA may apply a supervisory adjustment to increase the total required capital amount and/or strengthen the composition of the insurer's capital base. For general insurers, similar powers are contained in paragraph 17 of the current version of GPS 110 and paragraph 32 of GPS 112, respectively.

The determination of any supervisory adjustment to prescribed capital will be part of APRA's normal supervisory review processes and is only one tool available to APRA in supervising an insurer.

Comments received

Submissions sought additional guidance on the circumstances in which a supervisory adjustment may be applied by APRA, and further information on the process that will be followed by APRA in determining any adjustments to prescribed capital. Insurers expressed concerns around the transparency and subjectivity of the process for determining supervisory adjustments; these concerns were similar to those summarised in the March 2011 response paper.

APRA's response

Types of supervisory adjustment

The proposed ability for APRA to determine a supervisory adjustment to capital is included in the draft prudential standards GPS 110 and LPS 110 released with this response paper. APRA also intends to provide additional guidance on its process for determining supervisory adjustments in a PPG that will be released for consultation in 2012. The PPG will also include information on the nature of the adjustments that may be applied and the circumstances when an adjustment may be considered. The PPG by its nature will be indicative only and should not be considered exhaustive. There will always be circumstances that cannot be readily anticipated where an adjustment may be required or where flexibility is needed on the nature of any adjustment to be applied.

A supervisory adjustment to prescribed capital may take the form of an addition to an insurer's prescribed capital amount. In these cases the insurer's PCR will be the prescribed capital amount calculated under the prudential standards plus any supervisory adjustment to the prescribed capital amount. Alternatively, APRA may apply an adjustment to the minimum requirements for the composition of the capital base used to meet the PCR. The types of supervisory adjustments are referred to as 'Pillar 2 supervisory adjustments'.

6 APRA intends to issue a draft of the revised LPS 320 for consultation in May 2012.

APRA will also have the power to adjust any aspect of the prescribed capital amount calculation where, in its view, application of the method outlined in the prudential standard does not produce an appropriate outcome. Such an adjustment could result in an increase or decrease in the prescribed capital amount depending on the circumstances and nature of the adjustment. This power will be used where interpretation of the requirements in the standard by an insurer is seen by APRA as being incorrect or inappropriate, or where unusual asset structures or lines of business are not specifically captured under the method set out in the standard for calculating the prescribed capital amount. This type of supervisory adjustment is referred to as a 'Pillar 1 supervisory adjustment'.

Processes for determining supervisory adjustments

Any supervisory adjustment will typically be determined as part of APRA's regular supervisory assessment of an insurer, and insurers are already familiar with this process. As with other supervisory decisions, consideration by APRA of the need for, and nature of, any supervisory adjustment to prescribed capital will typically involve discussions between the insurer and APRA. APRA reserves the right, however, to impose a supervisory adjustment outside of the ordinary supervisory process if it is considered necessary to do so. This may occur, for example, where APRA requires the ability to act rapidly to protect the interests of policyholders.

A decision to impose a supervisory adjustment will be based on information available to APRA from the full range of APRA's supervision activities, including:

- off-site analysis;
- on-site reviews;
- PAIRS assessment;
- review of the ICAAP;
- discussions with the insurer;
- any representations made by the insurer about the supervisory adjustment; and
- any other information held or sought by APRA.

The reasons leading to the decision to apply a supervisory adjustment will be disclosed to the insurer. Depending on the basis for the proposed adjustment, APRA may first seek to have the insurer address the areas of concern through, for example, changes to its operations, governance or risk and capital management framework or processes. If a supervisory adjustment has been imposed and the insurer has subsequently addressed the issues that led to the adjustment, APRA will review the need for continuation of the supervisory adjustment.

The process for determining any supervisory adjustment, including implementation timing, will be subject to APRA's internal governance processes, including review at appropriate levels within APRA.

Circumstances in which a supervisory adjustment may be considered

APRA may consider imposing a supervisory adjustment to prescribed capital in a range of circumstances, including:

- the prescribed capital amount calculation does not adequately address the risks specific to the insurer (e.g. strategic risk, reputation risk or other risks not adequately catered for by the standard capital calculation due to some aspect of the insurer's business or operations);
- the insurer is newly licensed or has recently materially changed, or plans to materially change, its business mix;
- APRA has identified material issues with the competence or probity of responsible persons associated with the insurer;
- APRA has identified material weaknesses in the insurer's governance, risk management strategy or realised risk management outcomes;
- the insurer has failed to comply with, or is consistently minimally compliant with, applicable prudential standards;

- the insurer is using a business model, has an organisational structure or is following a business strategy that APRA regards as highly risky, or overly difficult to assess, in a way that is not captured under the calculation of the prescribed capital amount;
- the insurer's ICAAP is not well-defined or documented, or its target capital policy is assessed as being inadequate, e.g. due to a lack of sufficiently rigorous stress and scenario testing; or
- the insurer has been unable to restore its capital position to target capital levels in accordance with its ICAAP in a timely manner.

This list is indicative only and must not be considered exhaustive. A supervisory adjustment may also be imposed by adjusting the requirements relating to composition of the capital base of an insurer. As an indication, APRA may make such an adjustment where it has concerns about the relative levels of the different components of capital held by the insurer, or where APRA is concerned about the quality of the surplus capital and its loss-absorbing ability.

Chapter 4 – Composition of capital base

The May 2010 discussion paper and March 2011 response paper included, as a fundamental reform, the concept of a capital base for life insurers, and proposed to apply to life insurers the same requirements for the composition of the capital base as apply to general insurers. The papers also noted APRA's practice to closely follow the BCBS approach as it applies to ADIs, and to maintain consistency of capital definitions for ADIs and general insurers.

The March 2011 response paper indicated that alignment of APRA's requirements for the composition of the capital base for insurers with those for ADIs will include:

- maintaining consistent capital definitions across ADIs and insurers;
- strengthening the quality of the components of capital eligible for inclusion in capital base; and
- increasing the amount of the capital base used to meet the PCR that must comprise the highest quality capital components.

APRA issued a discussion paper for ADIs on 6 September 2011 outlining its proposed implementation of the Basel III capital reforms for ADIs in Australia.

This chapter outlines the approach proposed by APRA for aligning the requirements relating to the composition of the capital base of insurers with those of ADIs. It also addresses APRA's proposals for the calculation of the capital base that are relevant to both general insurers and life insurers.

The details of the approach outlined in this response paper are included in the draft LPS 112 that is being released for consultation, given the material changes to the structure of the capital requirements for life insurers. GPS 112 is not being released for consultation at this time, as noted in Chapter 1.

4.1 Definition of components of capital for insurers

As foreshadowed in the March 2011 response paper, APRA intends to maintain consistent capital definitions for ADIs and insurers. Under the revised Basel III definition of capital, total regulatory capital (i.e. capital base) consists of the sum of the following components, net of regulatory adjustments:

- Tier 1 capital, comprising:
  - Common Equity Tier 1 (CET1);
  - Additional Tier 1; and
- Tier 2 capital.

APRA proposes that the definition of these components of capital, as determined for ADIs, will also apply for general insurers. For life insurers, some modifications are proposed in order to recognise the special features of statutory funds. Life insurers will be required to determine the capital base of the company as a whole and of each of its funds.

4.1.1 Common Equity Tier 1 capital

Under Basel III, CET1 is recognised as 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. It is the primary form of funding that helps ensure that companies remain financially sound.

Consistent with the Basel III definitions, CET1 for insurers will comprise the following components:

- paid-up ordinary shares;
- retained earnings;
- accumulated other comprehensive income;
- other disclosed reserves as specified by APRA;

- technical provisions in surplus or deficit compared to those required by the current GPS 310 (for general insurers and Level 2 insurance groups)[7];
- minority interests (for Level 2 insurance groups subject to certain criteria); and
- regulatory adjustments applied in the calculation of CET1.

APRA proposes to adopt the Basel III definition of CET 1 to replace the concept of 'Fundamental Tier 1' in the current GPS 112 paragraph 16(a). The requirements for Fundamental Tier 1 for general insurers already reflect most of the principles of the Basel III requirements for CET1. The proposed APRA definition of CET1 will reflect other additional Basel III requirements, such as more detailed criteria for the classification of paid-up ordinary shares. Appendix 5 sets out the proposed criteria for classification as paid-up ordinary shares for regulatory capital purposes.

APRA has adopted the Basel III principle that regulatory adjustments should be made to CET1.[8] The rationale for this approach is that, if an element of the balance sheet is not of sufficient quality to be included in the calculation of regulatory capital, then it is not appropriate to be included in CET1. Consistent with the ADI requirements, APRA proposes that all regulatory adjustments for insurers will be required to be made to CET1.

4.1.2 Regulatory adjustments to capital for general insurers

APRA currently applies a number of regulatory adjustments to Tier 1 capital under the current version of GPS 112. These regulatory adjustments are proposed to be amended, as set out below, and applied to CET1. A full list of the proposed regulatory adjustments to CET1 for general insurers is included in Appendix 8. These will be included in the draft of GPS 112 when it is released in March 2012.

APRA proposes that the treatment of the following regulatory adjustments be changed from the current treatment:

Regulatory capital held in subsidiaries, joint ventures and associates

The March 2011 response paper confirmed APRA's proposal that any regulatory capital requirements of the investments held in subsidiaries, joint ventures and associates be deducted from the insurer's capital base. The amount deducted for investments in APRA-regulated entities was proposed to be the PCR of the regulated entity.

Submissions noted that the requirement to deduct the PCR of an APRA-regulated subsidiary, joint venture or associate from capital may result in the PCR of these entities being publicly disclosed. It was also noted that there may be timing differences associated with the calculation of this deduction, mainly for investments in foreign subsidiaries, joint ventures or associates with different reporting requirements.

APRA proposes that the deduction for regulatory capital be revised such that the prescribed capital amount, rather than the PCR, of an APRA-regulated subsidiary, joint venture and associate will be deducted from the CET1 of an insurer. Further, for ease of calculation of this deduction for insurers with operations across different jurisdictions and multiple reporting dates, APRA proposes that the deduction of regulatory capital requirements can be based on a calculation that is at an effective date within the period of three months prior to the reporting date, or on a basis agreed with APRA.

7 Technical provisions as defined in the current GPS 112.
8 Under the current general insurance prudential standards, regulatory adjustments are referred to as deductions. APRA proposes to adopt the Basel III terminology and refer to deductions from capital as regulatory adjustments.

Deduction of deferred tax assets (net of deferred tax liabilities)

Under the current version of GPS 112, general insurers are allowed to net deferred tax liabilities against deferred tax assets when deducting deferred tax assets from the capital base. GPS 112 does not apply any restrictions to this calculation. This means that netting is permitted, even if the deferred tax assets and deferred tax liabilities could not in practice be netted when the taxes are eventually payable. APRA has reviewed this treatment and considers it appropriate to amend the netting arrangements. APRA proposes to add a requirement to GPS 112 such that netting must only be applied where the deferred tax assets and deferred tax liabilities are levied by the same authority and the authority permits netting when the taxes are payable.

Treatment of charged and encumbered assets

Under the current general insurance framework, assets subject to a fixed or floating charge, mortgage or other security are subject to an investment risk capital charge of 100 per cent.[9]

APRA proposes that instead of including these assets in the asset risk charge, any assets of a general insurer or life insurer subject to a fixed or floating charge are included as a regulatory adjustment to CET1.

Other amendments

There are a number of other amendments to regulatory adjustments under Basel III that APRA proposes to apply to general insurers:

- deficits after taking into account adjustments in the amount available in certain revaluation reserves (paragraph 25(g) of the current GPS 112) will no longer be deducted from capital;
- identified impairment of an asset where the impairment has not already been taken into account in profit or loss (paragraph 25(h) of the current GPS 112) will no longer be deducted from capital;
- any amounts included in revaluation reserves in Upper Tier 2 capital (paragraph 25(j) of the current GPS 112) will no longer be deducted from capital;
- cumulative unrealised fair value gains and losses on effective cash flow hedges reflected in retained earnings or reserves (paragraph 25(k) of the current GPS 112) will be replaced with an adjustment for cash flow hedge reserve that relates to hedging of items that are not fair valued on the balance sheet; and
- expected dividends (paragraph 25(n) of the current GPS 112) will no longer be deducted from capital.

4.1.3 Regulatory adjustments to capital for life insurers

A list of proposed regulatory adjustments to CET1 for life insurers is included in the draft LPS 112.

The proposed adjustment for the regulatory capital requirements of investments held in subsidiaries, joint ventures and associates has been modified so that it only applies to the prescribed capital amount for APRA-regulated entities (as discussed in the previous section for general insurers). There is an additional adjustment for charged and encumbered assets, which has been added for consistency with the adjustments for general insurers.

4.1.4 Additional Tier 1 capital

The Basel III principle underpinning the non-common equity components of capital (Additional Tier 1 capital) is that such instruments must be able to absorb losses on a going-concern basis. To be considered loss absorbing on a going-concern basis, these instruments will need to be subordinated, have fully discretionary non-cumulative dividends or coupons and have neither a maturity date nor an incentive to redeem.

Additional Tier 1 capital for ADIs and general insurers can include both equity instruments and capital instruments classified as liabilities for accounting purposes. The proposed criteria for these instruments are set out in Appendix 6. For life insurers, APRA proposes to restrict Additional Tier 1 to equity instruments.

APRA proposes that stapled securities may be eligible for inclusion as Additional Tier 1 capital where they meet the relevant criteria for such capital, including the loss absorption provisions described in section 4.1.6.

9 Refer to paragraphs 27 and 28 of the current version of GPS 114.

4.1.5 Tier 2 capital

APRA proposes to simplify the Tier 2 framework for general insurers to align it with the proposed requirements for ADIs. The current categories of 'Upper' and 'Lower' Tier 2 will be removed and one set of criteria for eligible Tier 2 instruments is proposed, as outlined in Appendix 7.

For life insurers, APRA proposes to restrict Tier 2 instruments to subordinated debt issued by statutory funds.

APRA proposes that Tier 2 capital instruments need to meet the minimum criteria of being subordinated to policyholders and general creditors and having an original maturity of at least five years. The amount included in an insurer's capital base is proposed to be amortised on a straight-line basis during the final five years to maturity. Tier 2 instruments will need to have the loss absorption provisions described in section 4.1.6.

4.1.6 Loss absorbency of regulatory capital

The Basel III reforms require that all instruments included in Additional Tier 1 and Tier 2 (regulatory capital instruments) must be capable of bearing loss at the point of non-viability, when the ADI is unable to support itself in the market place. The aim of these provisions is to ensure that public sector injections of capital needed to avoid the failure of an ADI do not protect investors in regulatory capital instruments from incurring the loss that they would have suffered had the public sector chosen not to intervene.

Consistent with the proposed ADI requirements, APRA proposes for insurers that all Additional Tier 1 and Tier 2 instruments must contain a provision for the instrument to be written-off upon the occurrence of a trigger event. The trigger event would be the earlier of:

- a decision that a write-off, without which the insurer will become non-viable, is necessary, as determined by APRA; and
- the decision to make a public sector injection of capital, or equivalent support, without which the insurer will become non-viable, as determined by APRA.

Consistent with the proposed requirements for ADIs, as an alternative to write-off insurers may include a provision providing for conversion of the instrument into listed ordinary shares (potentially in a listed parent) upon the occurrence of the trigger event.

A decision by APRA that it is necessary to trigger write-off or conversion in circumstances where an insurer would otherwise become non-viable is expected to be less likely for insurers than may be expected to be the case for ADIs. This reflects the different nature of the circumstances that may lead to an insurer becoming non-viable and the options available to APRA and the insurer to address such situations.

4.2 Capital base requirements for insurers

The main objective of the capital adequacy framework for insurers is similar to that for ADIs. Both frameworks are intended to ensure that APRA-regulated entities have adequate high quality capital to protect beneficiaries (i.e. depositors and policyholders).

This objective is currently achieved for ADIs and general insurers by specifying the minimum amount of total capital that needs to be held, and also stipulating limits and minima on the components of each element of capital expressed as a percentage of total capital. For life insurers, APRA currently specifies minimum amounts of total assets that need to be held in each of a life insurer's funds, and also allows a limited amount of subordinated debt to be treated as capital.

The Basel III framework has moved away from expressing the limits on components of capital as a percentage of the capital base to an approach that specifies the quantum of minimum capital requirements at three levels: CET1, Tier 1 and Total capital. There is also an increased emphasis on CET1 requirements under the Basel III framework. Under Basel III, there are no direct constraints on the composition of the capital base above the minimum capital requirements at the three specified levels.

Consistent with the approach proposed for ADIs, APRA proposes that the limits for the composition of the capital base of insurers be expressed relative to the PCR rather than the capital base. This approach will ensure that insurers with lower target capital levels relative to their PCR will be obliged to hold a higher percentage of their capital base in the highest quality forms of capital.

Minimum requirements for ADIs

Under its proposed implementation of the Basel III framework for ADIs, APRA is proposing to adopt the Basel III minimum percentages of risk-weighted assets that must be held in CET1, Tier 1 and Total capital of 4.5 per cent, six per cent and eight per cent, respectively. In addition, APRA is proposing to introduce for ADIs a capital conservation buffer (CCB) requirement. This buffer is intended to promote the conservation of capital and the build-up of adequate buffers above the minimum that can be used to absorb losses during periods of financial and economic stress. The proposed CCB requirement for ADIs comprises Common Equity Tier 1 of up to 2.5 per cent of risk-weighted assets. This buffer will apply in addition to the minimum CET1, Tier 1 and Total capital requirements. Capital distribution constraints will be imposed on an ADI when its CET1 capital level falls within the CCB range.

Minimum requirements for insurers

APRA proposes that insurers at all times satisfy the following requirements:

- CET1 must exceed 70 per cent of the PCR;
- Tier 1 capital must exceed 80 per cent of the PCR; and
- Capital base must exceed the PCR.

These proposals broadly align the minimum requirements for insurers with the overall requirements for ADIs. APRA does not propose that an explicit capital conservation buffer be required for insurers.

APRA expects the minimum regulatory capital requirement to be one of the aspects considered by insurers in developing their ICAAP, including establishing appropriate target levels for CET1, Tier 1 and the capital base. As noted in Chapter 3, however, APRA expects an insurer's ICAAP to go beyond consideration of the need to meet regulatory capital requirements on a continuous basis and include comprehensive assessment by the insurer of its risk profile and the capital needed to support the risks to which it is exposed.

Consideration of the need for conservation of capital and the build-up of adequate buffers above the minimum that can be used to absorb losses during periods of financial and economic stress would be factors that APRA expects insurers to consider in establishing appropriate capital targets.

Specific requirements for life insurance

For life insurers, it is proposed that the minimum requirements for CET1, Tier 1 and capital base outlined above will apply at a company level. For this purpose, the PCR of the company will be the sum of the PCRs for the general fund and the statutory funds, subject to a minimum prescribed capital amount of $10 million.

At statutory fund level, the separate limits for CET1 and Tier 1 capital are proposed to be replaced with a single requirement that the capital base of the fund, excluding Tier 2 instruments, must exceed 80 per cent of the fund's PCR. This avoids the need for a statutory fund to separately account for CET1 and Additional Tier 1 capital.

In summary, at all times:

- the capital base of each statutory fund, excluding Tier 2 capital, must exceed 80 per cent of the PCR of the fund;
- the capital base of each statutory fund, including Tier 2 capital, must exceed the PCR of the fund; and
- the capital base of the general fund must exceed the PCR of the fund.

APRA proposes that capital instruments treated as liabilities for accounting purposes not be eligible for inclusion in the Tier 1 capital of a life insurer. These instruments are liabilities of a specific fund, which is inconsistent with other Tier 1 share capital instruments that are issued at company level.

APRA proposes to restrict Tier 2 capital for life insurers to subordinated debt of statutory funds. To keep the capital framework simple at statutory fund level, APRA is proposing that any Tier 2 capital instruments that are classified as equity for accounting purposes not be eligible for inclusion in Tier 2 capital. APRA does not consider it appropriate for subordinated debt of the general fund to be treated as capital.

The proposed requirements for subordinated debt to be eligible for inclusion in Tier 2 capital are set out in Appendix 7. These differ from the current requirements for approved subordinated debt set out in Circular E.1 Investment Issues – Subordinated Debt. A key difference is the requirement to amortise the amount of subordinated debt included in the capital base over the final five years to maturity. It is proposed that there not be a requirement for interest or capital repayments to be suspended if a statutory fund would fail to meet the capital standards following any of these payments. APRA could, however, activate the conversion or write-down mechanism for these instruments if the statutory fund would otherwise become non-viable.

4.3 Transitional arrangements

4.3.1 Transitional arrangements for capital instruments of general insurers

A number of general insurers have issued non-common equity instruments that qualify as Tier 1 or Tier 2 capital under the existing version of GPS 112.

Few, if any, of these instruments will satisfy all of the criteria for inclusion in regulatory capital that are set out in Appendices 6 and 7 of this paper. This is because these instruments may include incentives to redeem, such as step-ups combined with call options, that create an expectation that the instrument will be redeemed. All such instruments will lack the required non-viability conversion trigger.

APRA has previously confirmed to general insurers that capital instruments issued prior to 9 April 2010 will be eligible for transitional treatment when the revised eligibility requirements are implemented.[10]

Consistent with the letter sent to general insurers on 8 April 2011 and the GPS 112 Frequently Asked Questions, APRA confirms that it will allow transitional treatment for capital instruments issued from 9 April 2010, providing there are no features of the instrument, apart from the absence of the conversion trigger, that are clearly inconsistent with the eligibility criteria.[11]

The arrangements for non-complying instruments that are allowed transition will be consistent for general insurers and ADIs:

- instruments will only be eligible for transition until their first available call date after 1 January 2013. The loss of eligibility for transition at the call date will give insurers a strong incentive to call non-complying instruments;
- there will be a cap on the amount of non-complying instruments included in the capital base. The cap will be calculated as a proportion of the dollar value of the outstanding instruments eligible for transition at 1 January 2013. The proportion will be 90 per cent at 1 January 2013, reducing by 10 per cent in each subsequent year (i.e. transition ends by 1 January 2022 at the latest);
- the caps and amortisation schedules will be determined separately for Tier 1 and Tier 2 instruments; and

10 Refer to letter to general insurers dated 9 April 2010 found at Pages - Other Information for General Insurance

11 Refer to letter to general insurers dated 8 April 2011 found at Pages - Other Information for General Insurance and GPS 112 Frequently Asked Questions found at General Insurance Prudential Standards and Guidance Notes

- non-qualifying instruments that are eligible for transition and are currently included in Tier 1 capital will be classified as Additional Tier 1 capital.

APRA expects general insurers to plan for the replacement of non-complying instruments with fully complying instruments.

4.3.2 Transitional arrangements for capital instruments of life insurers

For life insurers, the eligibility for transition of non-common equity instruments that fail to meet the proposed criteria set out in Appendices 6 and 7 will be determined by APRA on a case-by-case basis.

4.4 Reductions in capital base

Under the current capital standards, a general insurer must obtain APRA's written consent before reducing its capital. A reduction in capital includes:

- a share buy-back;
- redemption, repurchase or early repayment of capital instruments;
- trading in the insurer's own shares or other capital instruments;
- payment of dividends on paid-up ordinary shares that exceeds an insurer's after-tax earnings (as reported to APRA in the statutory accounts), including any payments on more senior capital instruments, in the financial year to which they relate; and
- dividend or interest payments on other capital instruments that exceed an insurer's after-tax earnings (as reported to APRA in the statutory accounts), including any payments made on more senior capital instruments, calculated before any such payments are applied in the financial year to which they relate.

This requirement is consistent with the capital framework for ADIs. APRA proposes to extend this requirement to life companies (in prudential standard LPS 110) so that it will be harmonised across the insurance and banking industries.[12]

In APRA's view, it is important that APRA have an opportunity to consider and approve capital management actions that weaken the capital position of an insurer, before they occur. This enables APRA to ensure that the capital strength of the insurer remains adequate, or to prevent the capital reduction should this not be the case.

4.5 Release of GPS 112 and LPS 112 Capital Adequacy: Measurement of Capital

The proposed requirements relating to the determination of the capital base for insurers, together with the detailed criteria for eligible capital instruments, included in this paper are based on the Basel III discussion paper.

Submissions on the Basel III discussion paper closed on 2 December 2011. APRA is reviewing the submissions made by ADIs and proposes to issue draft prudential standards for consultation in March 2012.

A draft of LPS 112 is being released for consultation now and specifies the calculation of the capital base for life insurers at both company and fund level. The attachments to LPS 112 listing the criteria that instruments must satisfy to be included in an insurer's capital base are high-level principles as set out in the Basel III discussion paper.

APRA will also issue drafts of LPS 112 and GPS 112 for consultation in March 2012. The revised draft standards will include full details of the proposed requirements relating to the determination of capital base and the detailed eligibility criteria of capital instruments for insurers.

12 For an Eligible Foreign Life Insurance Company, APRA proposes that the requirements relating to reductions in the capital base will be applied at the level of each statutory fund of the Australian operations.

Chapter 5 – Prescribed capital amount calculations: general insurers and life insurers

This chapter addresses submissions on APRA's proposals for the calculation of the prescribed capital amount that are relevant to both general insurers and life insurers. The areas covered are:

- asset risk;
- aggregation benefit;
- operational risk;
- discount rates; and
- determinations made under previous standards.

Other components of the prescribed capital amount calculations that are relevant to general insurers or life insurers are addressed in Chapters 6 and 7, respectively.

5.1 Asset risk charge

APRA proposes that the asset risk charge be determined by subjecting the balance sheet to a series of seven stress tests, with parameters specified by APRA for:

- real interest rates;
- expected inflation;
- currency (exchange rates);
- equity assets;
- property assets;
- credit spreads (for interest-bearing assets); and
- default risk (for non-interest-bearing assets subject to the risk of counterparty default, including reinsurance recoverables).

APRA proposes that the risk charges for each of the stress tests be aggregated using a correlation matrix. This method of aggregation recognises that the probability of all seven stresses occurring simultaneously is very remote.

In response to issues raised in submissions, APRA is proposing some further changes to the real interest rates, equity and credit spreads stress tests. The comments received and APRA's response are described in this section.

This section also clarifies APRA's position in relation to certain technical issues that were raised by insurers that completed QIS2.

5.1.1 Real interest rates stress

The real interest rates stresses proposed in the March 2011 response paper were an increase of 30 per cent or a reduction of 25 per cent to the nominal risk-free interest rate. The maximum movement in either direction was proposed to be 200 basis points.

Comments received

Some submissions expressed the view that the proposed real interest rate stresses were too high relative to actual stresses observed in the past and were inconsistent with the target of a 99.5 per cent probability of sufficiency over a one-year period.

APRA's response

APRA has conducted a further review of the real interest rate stresses. Historical data from both Australia and overseas are an important reference for determining an appropriate level of stress, but a significant amount of judgement is also necessary. APRA considers that it is appropriate to reduce the proposed real interest rate stresses. The reduced stresses will, in APRA's judgement, still meet the objective of providing a capital requirement that has a target of 99.5 per cent probability of sufficiency over a one-year horizon.

APRA therefore proposes that the upward stress be reduced to 25 per cent of the nominal yield and the downward stress be reduced to 20 per cent of the nominal yield. It is proposed that the maximum movement in either direction remain at 200 basis points.

5.1.2 Equity stress

The equity stress proposed by APRA was:

- a 2.5 percentage point increase to the ASX 200 dividend yield for listed equities;
- a 45 per cent fall in the value of unlisted equities, hedge funds and any other assets not considered in the other stress tests; and
- a 15 per cent addition to the forward-looking equity volatility parameter.

Comments received

The submissions received on the equity stress suggested that there should be explicit allowance for diversification benefits between unlisted and listed equities. Submissions also indicated that the fixed 45 per cent stress for unlisted equities and other assets is strongly pro-cyclical. It was suggested that applying a stress to dividend yields would reduce the pro-cyclicality of this risk charge.

APRA's response

APRA expects the correlation between the movements in values of unlisted and listed equities to be close to one in severely stressed circumstances. APRA's view, therefore, is that it is not appropriate to recognise any diversification benefits between unlisted and listed equities.

APRA has reviewed the stress for unlisted equities with the aim of reducing the pro-cyclical nature of this charge. APRA now proposes that the stress be a fall in value equivalent to a three per cent increase in the ASX 200 dividend yield. This is slightly higher than the stress applied to listed equities, which is considered appropriate as unlisted equities tend to have higher risk and less liquidity than listed equities. In extreme circumstances, the realisable value of unlisted equities may fall further than listed equities.

5.1.3 Hedge funds

APRA proposed that the risk charge for hedge funds would be the same as for unlisted equities.

Comments received

Submissions noted that hedge funds vary widely in their strategies and risk characteristics. Some hedge funds are demonstrably less risky than listed equities and their returns can have a low correlation with other asset classes. Submissions also indicated that APRA's blanket approach to hedge funds may result in insurers being penalised (through higher risk charges) for adopting an optimal investment strategy.

APRA's response

APRA aims to balance the benefits of greater risk sensitivity of its capital standards with the desirability of maintaining simplicity and clarity. APRA does not believe it is necessary or appropriate to have different risk charges for different types of hedge funds. Distinguishing between different types of hedge funds will add greater complexity to the standards with limited impact on their risk sensitivity. It is also difficult to distinguish between different types of hedge fund in a sufficiently objective manner.

5.1.4 Credit spreads stress

APRA substantially revised its original proposals for credit spread stress in the March 2011 response paper to improve the sensitivity of the risk charge to asset duration by introducing separate default and spread factors. The revised spread factors for low-quality assets were also substantially reduced from the original proposals in order to make the proposals less pro-cyclical for longer-duration assets that are downgraded during severe market stresses. The risk sensitivity of the factors was further enhanced by introducing separate factors for re-securitisation exposures. The spread factors for primary securitisations were also substantially reduced.

Comments received

A number of subsequent submissions indicated that the revised stresses were still too high.

APRA's response

APRA has undertaken further review of the credit spread stresses and is of the view that it is appropriate to reduce some of the credit spread stresses. The reduced stresses will still, in APRA's judgment, be consistent with the target of 99.5 per cent probability of sufficiency over a one-year horizon.

APRA proposes further small reductions to the default factors for counterparty grades 6 and 7 and the spread factors for most grades of structured/securitised and re-securitised assets. The revised table of factors is shown below. For those factors that have been changed, the previously proposed factor is shown in brackets.

5.1.5 Credit spread stress for short duration assets

APRA proposed that the default factor be applied to all interest-bearing assets, including cash deposits and floating-rate assets.

Comments received

Some submissions asserted that it was not appropriate to apply the default factor in full to assets that would mature or could be redeemed without penalty within the one-year timeframe.

APRA's response

APRA considers it appropriate to apply a full year's default factor to short duration assets. Required capital should be sufficient to provide protection against adverse experience over the following 12 months. Assets that mature within the 12 months will need to be reinvested. Therefore, APRA proposes that assets be assumed to be at risk of default for a full 12 month period.

Counterparty grade	S&P rating	Default (%)	Bonds* spread (%)	Structured/ securitised spread (%)	Re-securitised spread (%)
1 (government)	AAA	0.0	0.0	0.0	0.0
1 (other)	AAA	0.2	0.6	1.0	1.8 (2.0)
2	AA	0.6	0.8	1.4 (1.6)	2.4 (2.8)
3	A	1.2	1.2	2.0 (2.4)	3.2 (3.6)
4	BBB	3.0	1.6	2.5 (3.0)	4.0 (4.5)
5	BB	6.0	2.0	3.0 (3.5)	5.0 (5.5)
6	B	10.0 (11.0)	2.5	3.5 (4.0)	6.0 (6.5)
7	CCC	16.0 (17.0)	3.0	4.5	7.5

*and other non-securitised assets.

5.1.6 Treatment of term deposits

Comments received

Some submissions expressed concerns about the proposed treatment of term deposits. In particular, it was indicated that APRA's proposals were unclear about whether guaranteed early redemption values could be recognised when applying the stresses.

APRA's response

For the purposes of the asset risk charge, APRA proposes that term deposits be valued using a discounted cash flow method in the same manner as a corporate bond with the same contractual cash flows. If the insurer has a contractual right to early redemption of the term deposit, APRA proposes that the stressed value of the term deposit will have a minimum of the guaranteed redemption value applied in the real interest rates and expected inflation stresses. In the credit spreads stress, APRA proposes that the minimum value for the term deposit be the guaranteed redemption value multiplied by (1 – default factor).

5.1.7 Materiality

Comments received

Some submissions requested that short duration assets be excluded from the real interest rates, expected inflation and credit spreads stresses as the calculations for these stresses were complex and the impact on capital requirements of these assets would be immaterial.

APRA's response

APRA proposes that the capital standards will allow insurers to consider materiality when calculating the capital base and prescribed capital amount. Insurers will not, however, be permitted to omit or simplify calculations if this would produce results likely to be misleading to users of the information. It would be misleading to materially overstate the capital base or understate the prescribed capital amount.

5.1.8 Relationships between funds (life insurance)

For each stress test where both upward and downward stresses have to be considered, APRA proposed that the risk charge could be reduced where the same stress would result in an increase in the capital base in one fund and a reduction in another. This offset might be used, for example, by an insurer that had one statutory fund that required capital against the risk of rising interest rates and another fund that required capital against the risk of falling interest rates.

Comments received

Some submissions noted an inconsistency in APRA's proposals in that they allow offsets between funds for some risks (e.g. rising and falling interest rates) but not others (e.g. mortality and longevity). It was also felt to be inconsistent that diversification benefits are only recognised within funds and not between funds.

APRA's response

APRA has reviewed the consistency of its proposals for recognising offsets and diversification benefits between funds. APRA's view is that each fund must be treated as a stand-alone entity as life insurers cannot guarantee that it will be possible to transfer capital between funds in severely stressed circumstances. Hence, it is not appropriate to recognise offsets or diversification benefits between funds. APRA therefore proposes to remove the allowance for risk charges to be reduced where the same stress would result in an increase in the capital base in one fund and a reduction in another fund.

5.1.9 Disaggregation of assets (life insurance)

Disaggregation refers to a method of splitting certain types of assets (e.g. property) into separate sub-assets (e.g. a sub-asset consisting of a rental stream and a sub-asset consisting of a vacant property). Disaggregation could reduce the risk charges for the real interest rates and expected inflation stresses by allowing the asset cash flows (e.g. the rental stream) to be matched to the liability cash flows.

In the March 2011 response paper, APRA stated its intention of finalising its proposals for allowing disaggregation after analysing the QIS2 results. The QIS2 results showed limited use of disaggregation by insurers. Those insurers that did disaggregate some of their assets reported only a marginal reduction in their required capital as a result.

APRA is therefore proposing to remove the allowance for disaggregation as it complicates the proposed capital standards whilst having little benefit in terms of increased risk sensitivity.

5.1.10 Application to surplus assets (life insurance)

APRA proposed in the May 2010 discussion paper that, consistent with the current approach for general insurers, the asset risk stresses would be applied to all of a life insurer's assets, including those backing surplus capital above that needed to meet the PCR.[13] A number of the submissions APRA received from the life insurance industry in 2010 were opposed to this proposal. In the March 2011 response paper, APRA set out its reasons for retaining this proposal.

Comments received

APRA again received submissions from the life insurance industry arguing against this proposed change. The submissions largely repeated the points made in the submissions on the May 2010 discussion paper.

APRA's response

APRA's response to the comments raised in previous submissions on this issue was set out in the March 2011 response paper. APRA remains of the view that it is appropriate that the asset risk stresses be applied to all of an insurer's assets, as originally proposed. As indicated in the March 2011 response paper, surplus assets over and above the PCR are important to overall policyholder security. Where surplus assets are invested in risky assets, APRA considers it appropriate that the additional risk is captured in the PCR. Further, because the minimum quality of capital is based on the PCR, the additional risk will be supported by capital of appropriate quality. The proposal is also consistent with the existing capital standards for general insurers and ADIs.

5.2 Aggregation benefit

The aggregation benefit is an explicit allowance for diversification between asset and insurance risks. It reduces the prescribed capital amount for insurers that have both an asset risk charge and an insurance risk charge. The proposed formula for the aggregation benefit includes a correlation factor between asset and insurance risks. For the purposes of QIS2, the proposed correlation factor was 0.3 for all insurers except lenders mortgage insurers (LMIs); the proposed factor for LMIs was 0.5.

Comments received

Few submissions commented on the choice of correlation factor.

APRA's response

APRA intended to conduct a further review of the correlation factors before finalising its proposals. After further review of available information on such correlations, APRA is proposing to adopt a correlation factor of 0.2 for all insurers except for LMIs, for which the factor is proposed to remain at 0.5.

13 An exception would be made for assets that have been deducted from the capital base and any part of an asset that was in excess of the asset concentration limits.

The proposed factor of 0.2 for non-LMIs reflects APRA's view that, in stressed circumstances, there can be a weak positive correlation between some types of insurance risk and some asset risks.

5.3 Operational risk charge

Operational risk is a key risk for insurers and APRA is of the view that it is important to explicitly address operational risk in the determination of the prescribed capital amount. In the March 2011 response paper APRA noted that, given the relative immaturity of operational risk modelling for insurers, limited indicators exist from which to estimate the level of operational risk for an insurer. APRA therefore proposed a simplified formula that used an insurer's size as a proxy for its exposure to operational risks. The formula set out in the March 2011 response paper included a number of modifications to the original formula used for the first QIS. These modifications were made to address issues raised in submissions following the first QIS.

Comments received

Submissions on the March 2011 response paper again raised concerns about the proposed approach to operational risk. Submissions argued that the revised operational risk charge formula was not a good indicator of operational risk as it was not sensitive to the quality of management and internal risk controls, and improvements in operational risk management would not be reflected in a lower operational risk charge.

Submissions also suggested that APRA should set the operational risk charge based on PAIRS and SOARS ratings, with the operational risk charge included as part of the supervisory adjustment to the PCR rather than as part of the prescribed capital amount. Finally, some submissions also reiterated the views that insurers should be able to use a partial internal model to determine the operational risk charge and that the operational risk charge should be included in the aggregation benefit. APRA was also requested to set a date for future review of the formula.

APRA's response

APRA's view remains that an explicit charge for operational risk needs to be included in the prescribed capital amount, for the reasons outlined in the March 2011 response paper.

The formula proposed for the calculation of the operational risk charge reflects the scale of an insurer's operations and provides a base level for the operational risk charge. If an insurer has a higher operational risk profile or an inadequate approach to operational risk management, APRA could increase the PCR of the insurer by applying a supervisory adjustment.

APRA recognises that the argument made in submissions for including operational risk in the aggregation benefit has some merit. However, APRA continues to propose the exclusion of the operational risk charge from the aggregation benefit because the correlation between operational risks and other risks becomes stronger in times of extreme stress.

APRA's capital standards for ADIs and general insurers allow an ADI or a general insurer to seek APRA's approval to use an internal model to determine the prescribed capital amount and this is also being proposed for life insurers. An internal model allows an insurer to calculate a prescribed capital amount that better reflects the nature and risks of the insurer. APRA's longstanding policy has been to require internal models to be used for determining the total prescribed capital amount of a general insurer and only allow partial internal models in exceptional circumstances. It is not APRA's intention to allow insurers to use an internal model-based method to calculate specific components of the prescribed capital amount.

APRA recognises that modelling and measurement of operational risk are receiving a great deal of attention across all industries, both locally and internationally. APRA is cognisant of these developments and encourages insurers to follow these developments and enhance their own approaches to modelling and measurement of operational risk. APRA will monitor industry progress, including approaches taken in insurers' ICAAPs. APRA will review the formula for the operational risk charge when the modelling and measurement of operational risk by the insurance industry achieves a level where APRA is comfortable that the approaches adopted may be appropriately reflected in the formula for the operational risk charge. APRA's view is that it is not appropriate to set a specific timeframe for this review.

5.3.1 Specific suggestions about the formula

Comments received

Insurers made some suggestions to revise the parameters of the operational risk charge formula. These included revising the 'change' thresholds to reduce the impact of acquisitions, disposals, foreign exchange fluctuations and premium rate increases; basing the 'change' item on the difference between the premium for the current year and the budgeted premium for the next year; and excluding commissions from the definition of premiums.

Some insurers suggested that the operational risk charge should be capped at a specified percentage of the total prescribed capital amount. It was also suggested that the formula encourages the use of reinsurance as the change factor is based on net insurance liabilities. Some submissions were concerned that the operational risk charge could be unnecessarily volatile for those insurers that have liabilities (rather than premiums) as the driver of the charge.

Life insurance submissions suggested that the change item for non-risk business should exclude benefit payments that are reinvested in another policy issued by the same insurer, and the charge for non-risk business that is not investment-linked (e.g. annuities) should be reduced.

APRA's response

The formula proposed in the March 2011 response paper incorporated a number of modifications in response to submissions made to APRA following the first QIS. APRA's view is that it has already made appropriate allowance for premium rate increases and the impact of foreign currency fluctuations by changing the threshold for the change factor from 10 per cent to 20 per cent, and no further change is proposed. APRA considers it appropriate that large acquisitions and disposals should lead to a higher operational risk charge as these activities create additional operational risks. APRA also considers it appropriate for the measure of premium to include commissions.

The proposed operational risk charge calculation approach is relatively simple. The parameters used in the calculation are readily and objectively available at each reporting period. An approach that uses budgeted premium would be less objective, could produce inconsistent results and may require insurers to undertake additional calculations at each reporting period.

The method set out in the prudential standards for calculating the prescribed capital amount for an insurer does not cap any component of the risk charge calculations. Consistent with this approach, APRA does not propose to apply a cap to the operational risk charge calculated using the proposed formula.

The use of reinsurance is a key business decision made by insurers and is influenced by many factors, including their risk appetite and capital management plans. APRA does not expect that insurers will change their reinsurance programs with the sole aim of reducing the operational risk charge.

For life insurers, APRA recognises that reinvestments can make a marginal contribution to operational risk but are not a primary indicator of operational risk levels. APRA is therefore proposing to remove reinvestments from the change factor for non-risk business (both for premiums and claims).

Non-risk life insurance business is subject to many different types of operational risk. APRA does not believe there is sufficient justification for applying a lower operational risk charge to annuities and other types of non-investment-linked business.

5.4 Discount rates

The capital standards for both general insurers and life insurers require the value of liabilities to be determined by discounting future cash flows using risk-free discount rates. APRA proposed that the risk-free discount rates for liabilities denominated in Australian dollars must be derived from the yields of Commonwealth Government Securities (CGS). APRA may allow an illiquidity premium to be added to the risk-free discount rate for some types of life insurance liabilities. The submissions from the life insurance industry regarding the illiquidity premium are discussed in Chapter 7.

5.4.1 Extrapolation and interpolation of the yield curve

APRA proposed to allow insurers to determine the risk-free rate for durations beyond the maximum available duration of CGS by reference to other instruments (e.g. swap rates), providing appropriate adjustments are made for credit and liquidity risk.

Comments received

Some submissions asked that APRA provide guidance or a prescribed method for extrapolation and interpolation in order to minimise divergence of practice amongst insurers.

APRA's response

APRA considers that sufficient guidance has already been provided. There is some scope for divergent practices between insurers; however, this is not expected to lead to material differences in capital requirements. APRA will monitor the methods insurers use for calculating their capital base and prescribed capital amounts and may take supervisory action where it believes an insurer is using an inappropriate method that is leading to a material overstatement of its capital base or understatement of its prescribed capital amount.

5.5 Determinations made under prudential standards

Under paragraph 32(3D) of the *Insurance Act 1973* (Insurance Act) and paragraph 230A(4) of the *Life Insurance Act 1995* (Life Act), respectively, a prudential standard 'may provide for APRA to exercise powers and discretions under the standard, including (but not limited to) discretions to approve, impose, adjust or exclude specific prudential requirements in relation to one or more specified regulated entities'. The exercise of this power by APRA is referred to as a 'determination'.

5.5.1 General insurers

Most of the existing general insurance prudential standards provide for determinations through a generic provision in the prudential standard. In addition, when a prudential standard is revoked and re-made, APRA usually includes a paragraph in the relevant prudential standard that preserves the operation of previous determinations. As the current capital review proposes major revisions to the capital adequacy framework, many of these determinations are likely to have limited relevance and applicability after the implementation of APRA's proposed capital standards. APRA proposes, therefore, that determinations made under the current capital standards (i.e. GPS 110 through to GPS 116) will not be preserved. Any determinations made under other prudential standards will continue as these prudential standards will include a paragraph that preserves the operation of any of these determinations.

General insurers requiring the continuation of capital-related determinations will need to submit new requests for assessment by APRA under the adjustment provisions of each capital standard.

5.5.2 Life insurers

The existing life insurance capital standards do not include any provisions allowing APRA to make adjustments to specific requirements. To align the life insurance standards with the general insurance prudential standards, it is proposed that the prudential standards include the power for APRA to make determinations for life insurers.

Chapter 6 – Response to APRA's proposals: general insurers only

This chapter addresses submissions on APRA's proposals for the calculation of the prescribed capital amount that are only relevant for general insurers. The areas covered are:

- asset concentration risk;
- insurance risk; and
- insurance concentration risk.

Other components of the prescribed capital amount relevant to general insurers, including asset risk, operational risk, discount rates and the aggregation benefit, are addressed in Chapter 5.

6.1 Asset concentration risk charge

In the March 2011 response paper, APRA proposed some modifications to the asset concentration risk charge.

6.1.1 Non-reinsurance exposures

For non-reinsurance exposures, APRA proposed an increase in the limit for exposures to unrelated APRA-regulated ADIs and insurers from 50 per cent to 100 per cent of the capital base, subject to a maximum of 50 per cent for longer-term exposures.

Comments received

Submissions welcomed APRA's increase in the limit for non-reinsurance exposures to unrelated APRA-regulated ADIs and insurers; however, some questioned the sub-limit for longer-term exposures. Other submissions argued that any limit on exposures to APRA-regulated entities would effectively require insurers to invest in riskier assets. Responses also sought clarification as to whether the limit should apply to all exposures, such as large, transient levels of premiums receivables.

APRA's response

As outlined in the March 2011 response paper, APRA intends to introduce tighter asset concentration limits to discourage excessive and avoidable concentrations of exposure to a single counterparty or group of related counterparties. Exposures to a single counterparty or group of counterparties that exceed the entire capital base of the general insurer are not prudent. Based on the submissions in both the first QIS and QIS2, APRA is satisfied that insurers have access to investments of a similar credit standing to their current investments and therefore will not necessarily have to invest in riskier assets.

APRA accepts that there may be a small number of transient exposures (such as a large premium receivable) that generate an asset concentration risk charge that may be inappropriate. APRA proposes that, in limited circumstances, an insurer can apply to APRA to vary the risk charge for these types of exposures.

6.1.2 Reinsurance exposures

For reinsurance exposures, APRA proposed maintaining the existing asset concentration thresholds. APRA also proposed that an insurer could make a one-off election to treat reinsurance recoverables from non-APRA-authorised reinsurers that are supported by collateral, guarantee or letter of credit as either:

- a reinsurance exposure;
- an exposure to the entity providing the guarantee or letter of credit; or
- an exposure to the underlying collateral.

Comments received

Submissions queried APRA's approach to reinsurance recoverables after the second balance date that are supported by collateral, guarantee or letter of credit. Submissions argued that APRA should not require a one-off election regarding the treatment of these exposures as it may have unintended consequences, such as encouraging an insurer to cancel an otherwise effective guarantee or letter of credit from an ADI to avoid an asset concentration risk charge.

Submissions also sought clarification as to whether the step-down of grades for non-APRA-authorised reinsurers that applies for asset risk also applies to exposures within the asset concentration risk charge. One submission queried the appropriateness of the reinsurance limits now that unrated counterparties have a lower percentage threshold.

APRA's response

APRA accepts that requiring a one-off election by the insurer may have unintended consequences and that, in most circumstances, the insurer will have access to the reinsurer and to the guarantee, letter of credit or underlying collateral. APRA proposes that the insurer can elect the treatment of reinsurance recoverables from non-APRA-authorised reinsurers at each reporting date. In conjunction with this change, APRA proposes that it be able to adjust the treatment applied by an insurer should it consider the treatment by the insurer to be inappropriate.

APRA confirms that the step-down of grades for non-APRA-authorised reinsurers does not apply to the asset concentration risk charge. This treatment will remain for the asset risk charge due to the greater risk associated with settlement of reinsurance recoverables from non-APRA-authorised reinsurers.

APRA's view is that the concentration limits that apply to grade 5 and below are appropriate given the credit rating of those counterparties. APRA notes that the prudential standards will include provision for transitional relief, as outlined in Chapter 1.

6.1.3 Corporate captive insurers

APRA proposed to allow corporate captive insurers that meet certain criteria, including that the parent is not APRA-regulated, to request an exemption from the asset concentration limits.

Comments received

Some submissions supported APRA's approach to providing exemptions for corporate captives; however, a small number of submissions requested that APRA reconsider the exemption for captives with APRA-regulated parents.

APRA's response

As outlined in the March 2011 response paper, APRA's primary goal as a prudential supervisor of general insurers is to protect the interests of policyholders. APRA proposed that certain captive insurers have the ability to request exemption from the proposed limits where the insured parties are restricted to the corporate parent and its subsidiaries. This exemption will be granted where the insurer's parent is not APRA-regulated, it does not have exposures to third parties and it does not write compulsory insurance. APRA maintains its position that this exemption is not appropriate for a captive insurer with an APRA-regulated parent, as the parent may receive a reduction in its required capital as a result of the existence of the captive insurer. APRA notes that a captive insurer may have incidental exposure to third parties and will take this into account when determining any exemption from the asset concentration limits.

6.1.4 Other

Comments received

Submissions sought clarification of some aspects of the asset concentration risk charge and its limits, including how to apply the limits to groups where only part of the group is APRA-regulated.

APRA's response

The draft GPS 117 provides further details on the operation of the various limits and the asset concentration risk charge. This includes the treatment of exposures where only part of the group is APRA-regulated. APRA has clarified that, for the purposes of the higher limits in this prudential standard, part of an APRA-regulated group refers to an exposure where the ultimate parent is an APRA-regulated entity (including an ADI, general insurer, life insurer or APRA-authorised non-operating holding company).

6.2 Insurance risk charge

In the March 2011 response paper, APRA proposed to modify the insurance risk charge. The proposals were to:

- reduce the insurance risk charge factors for the highest grouping of APRA classes of business by one percentage point for outstanding claims liabilities and by 1.5 percentage points for premiums liabilities to offset the potential for double-counting of inflation risk in the asset risk charge;
- address gross uncertainty through the inclusion of a principles-based requirement in draft *Prudential Standard GPS 320 Actuarial and Related Matters* (draft GPS 320) rather than requiring the determination of a gross risk margin; and
- monitor the level of diversification benefit allowed in the risk margins through the collection of both stand-alone and diversified risk margins for each APRA class of business in the APRA annual returns, and requiring supporting rationale to be documented in the Appointed Actuary's ILVR, rather than potentially limiting the allowance for diversification.

In addition to the above three proposals, APRA confirmed its proposal to increase the insurance risk charge factors for travel and mortgage insurance.

Comments received

Submissions again indicated that the change of the mortgage class of business to the highest risk category was inappropriate as LMIs do not have the same levels of volatility in claims experience or the frequent large claims attributable to other classes in the category. Submissions also noted that such characteristics are captured within the Probable Maximum Loss (PML) calculation for LMIs.

Submissions also indicated that, when compared to other classes in the medium risk category, travel featured lower claim volatility, and lower catastrophe and large loss allowances. One submission also suggested that foreign currency risk was a large driver of any volatility within the travel class and that this would already be captured under the asset risk charge.

Submissions welcomed the reduction of the insurance risk charge factors for the highest grouping of APRA classes of business. However, submissions noted that the reduction did not entirely offset the inflation component of the asset risk charge.

Submissions also supported the proposed approach for addressing gross uncertainty and diversification.

APRA's response

As outlined in the March 2011 response paper, APRA has reviewed the calibration of the insurance risk charges in the context of the proposed changes along with the target level for the capital standards of a 99.5 per cent probability of sufficiency over a one-year period. APRA considers that the structure and the groupings of classes of business for the insurance risk charge, including the proposed change for travel and mortgage insurance, are appropriate in this context.

APRA has undertaken further analysis of the inflation risk aspects of the asset and insurance risk charges and considers that the reduction in the insurance risk charge factors for the highest grouping of APRA classes of business sufficiently addresses the potential double-counting of inflation risk in the asset risk charge.

No further changes to the insurance risk charge factors are therefore proposed.

6.3 Insurance concentration risk charge

APRA proposed an approach for determining the insurance concentration risk charge (ICRC) for general insurers that calculates both a vertical requirement and a horizontal requirement.

In the March 2011 response paper, the ICRC formula was revised to:

ICRC = Maximum (VR_{prop}, $VR_{non\text{-}prop}$, $ICRC_{LMI}$, H3, H4), where:

- VR_{prop} = whole-of-portfolio vertical requirement for property risks, including the cost of one full reinstatement of cover used to reduce an insurer's exposure to concentration of risks.
- $VR_{non\text{-}prop}$ = whole-of-portfolio vertical requirement for non-property risks, assessed on a class-by-class basis.
- $ICRC_{LMI}$ = ICRC for LMIs (discussed further in section 6.3.7).
- H3 = whole-of-portfolio net retained loss and cost of reinstatements for three 1 in 10 year loss events, less C.
- H4 = whole-of-portfolio net retained loss and cost of reinstatements for four 1 in 6 year loss events, less C.
- C = annualised portion of premiums liabilities relating to events that lead to a substantial number of claims.

Submissions

The majority of general insurance submissions provided commentary on the proposed approach to the ICRC. The comments focused on the inclusion of, and specific detail on, the horizontal requirement. Submissions also commented on the inability to reduce the vertical requirement for certain types of reinsurance and expected claims costs, the level of reinstatements required, the timing of the calculation of the ICRC and the impact of the proposals on the reinsurance market.

Further detail on each of these areas, together with APRA's response, is set out below. The draft of GPS 116 also provides further detail on the proposed implementation of the ICRC.

6.3.1 Framework for the ICRC

Comments received

Most submissions supported the proposed approach for determining the vertical requirement and its inclusion in the ICRC; many submissions, however, raised concerns regarding the inclusion, and method of calculation, of the horizontal requirement in the ICRC. Submissions requested that further information be provided by APRA on the rationale for, and calibration of, the horizontal requirement.

APRA's response

APRA considers it appropriate that the capital framework consider catastrophic risks, specifically the net impact to an insurer of a loss or series of losses of varying size and frequency over a one-year time horizon. This 'aggregate net catastrophic loss' is driven by the nature of the risks in the insurer's portfolio and its reinsurance program, including the retention and vertical limit on the reinsurance program and any aggregate reinsurance covers.

The ICRC estimates the aggregate net catastrophic loss through a simple scenario-based approach comprising a vertical requirement and a horizontal requirement. The vertical requirement is the net cost to the insurer of a single event loss with a probability of occurrence of 0.5 per cent over a one-year period. The vertical requirement includes an allowance for reinsurance cover and the cost of reinstating any catastrophe reinsurance cover. It is noted, however, that the vertical requirement does not consider the net impact of multiple events over the year on the aggregate net catastrophic loss.

An insurer's capital position can be adversely affected over a year by the occurrence of a succession of smaller-sized loss events, including the cost of purchasing additional reinstatements of reinsurance cover. The horizontal requirement is intended to address this weakness in the current capital framework.

The horizontal requirement is structured in the form of simple one-year scenarios with a fixed number of events of a given severity. The proposed scenarios are calibrated such that the ICRC broadly replicates the aggregate net catastrophic loss with a probability of occurrence of 0.5 per cent over a one-year period for a range of insurers. It cannot replicate this target level exactly for every insurer, as this is not possible under a simplified scenario-based approach. At a high level, the calibration approach involved undertaking simulation analyses for different proxy insurers with various risk profiles and reinsurance programs and comparing the model output against the ICRC for these proxy insurers. Where appropriate, adjustments were made for dependencies between weather-related events, limitations in the simulation models used and assumptions for the minimum size of loss used in the modelling. The last item relating to the threshold for a catastrophe loss also affects the calibration and design of the expected claims offset (as discussed in section 6.3.2).

In light of industry feedback on its proposals, APRA has undertaken further analysis including reviewing the calibration approach and considering additional data from QIS2 and insurers' internal models. A number of external parties have also provided technical input that has been used to test the reasonableness of the calibrations and inform the judgments made for both the horizontal requirement scenarios and the expected claims offset. Based on this analysis, APRA's view is that the calibration of the horizontal requirement scenarios is appropriate and no changes are proposed. APRA has, however, more clearly defined the loss threshold to be used for the calculation of the expected claims offset.

6.3.2 Calculation of the horizontal requirement

Comments received

Submissions sought further clarity on the calculation of the expected claims offset, 'C'. Submissions argued that the approach should enable insurers to determine an offset that is objective, consistent, unambiguous and simple to calculate. Submissions requested that insurers be given the ability to deduct expected profits, in addition to the expected claims offset, in determining the horizontal requirement.

In addition, some submissions expressed concern that estimating the gross loss at lower return periods, including consideration of non-modelled perils, would be difficult. Some insurers sought further clarity on the modelling approach for the horizontal scenarios, such as consideration of single policy exposures.

Finally, submissions requested that insurers be given the ability to use an internal model to determine the horizontal requirement.

APRA's response

<u>Expected claims offset</u>

As outlined in the September 2010 technical paper and March 2011 response paper, the purpose of the expected claims offset is to remove the potential double-counting between an insurer's premiums liability and the horizontal requirement. Responses in both QIS2 and its questionnaire showed that insurers took a variety of approaches to determining the expected claims offset and, in particular, the threshold loss level above which events were included in the offset. Some insurers incorrectly interpreted the expected claims offset as being the budgeted allowance in premiums for catastrophe events. The expected claims offset is not intended to remove provisions for very small events as these events were not considered by APRA in the calibration of the horizontal requirement.

There are a number of methods that could be used to remove the potential double-counting in this component of the capital framework, including recalibrating the horizontal scenarios, using a prescribed formula and/or requiring the offset to be determined by the Appointed Actuary. APRA's objective is to ensure that the removal of the potential double-counting is appropriate to the circumstances of the insurer, whilst also ensuring that there is broad consistency of approach across the industry. A standard adjustment to the prescribed scenarios or a prescribed formula will ensure a consistent approach but will not achieve the objective of being appropriate to the circumstances of each insurer. APRA remains of the view that requiring the Appointed Actuary to determine the level of potential double-counting in the insurer's provisions is the most appropriate method for determining the expected claims offset, as it sets a broad framework for the Appointed Actuary to follow as well as catering to an insurer's individual situation. The events that contribute to the horizontal requirement occur with a relatively high frequency. An insurer considers these catastrophe events as part of its business, such as setting prices and determining reinsurance needs. Hence, the information required to assist the Appointed Actuary should be readily available from the insurer.

APRA proposes that Appointed Actuaries determine the magnitude of the appropriate offset, named 'PL offset' in the draft GPS 116, as follows:

1. Determine the amount, by class of business, of the central estimate premiums liability that accounts for 'catastrophic losses' (see below for further detail on the determination of 'catastrophic losses').
2. Annualise the amount from step 1, usually by doubling; the Appointed Actuary should consider, however, whether adjustments for changes (growth/decline) in exposures and seasonality are required.
3. Apply the 'diversified risk margin' (determined as outlined below) and then the insurance risk charge, as a percentage by class of business, to the annualised amount from step 2.
4. Sum the outcomes by class of business in step 3 to determine the PL offset.

The threshold level at which 'catastrophic losses' is set will have a material impact on the outcome of the calculation. APRA therefore proposes to provide clear guidance on the level above which these losses are expected to be included by the Appointed Actuary in the above process. APRA notes that this threshold level and the calibration of the frequency and severity in the scenarios are interlinked. This means that a balance needs to be struck between the number of events, the return period of the two scenarios for the horizontal requirement and the return period of catastrophes included in the premiums liability. It is therefore not appropriate for all weather-related attritional losses to be included by the Appointed Actuary when undertaking the calculation of the PL offset. The Appointed Actuary should consider natural perils that give rise to a relatively significant number of claims for the particular insurer. Based on the return period of the horizontal scenarios, APRA proposes that the threshold for loss events that the Appointed Actuary includes for the purpose of determining the PL offset be determined as those losses that occur approximately once every three months. This means that the Appointed Actuary will need to consider historical data over an appropriate period of time, as well as other information from the insurer, rather than relying on output from catastrophe or internal models.

The 'diversified risk margin percentage' used in Step 3 will be that used at the class of business level for premiums liabilities, which will already be estimated as part of the liability valuation. For pragmatic reasons, APRA proposes that the Appointed Actuary not be required to undertake further analysis to split the risk margin for affected classes of business into separate components for catastrophic losses and attritional losses.

As an example, assume an insurer has a central estimate premiums liability for householders business of $100 million. The Appointed Actuary determines that $40 million relates to 'catastrophic losses' determined as proposed above, and that the annualised amount is $80 million. The diversified risk margin for the householders class of business is 8 per cent and the premiums liability risk charge percentage for this class is 13.5 per cent. Therefore, the PL offset for the insurer's householders class of business is $80m x (1.08) x (1.135) = $98.064 million.

Profit offset

APRA is not proposing to allow the horizontal requirement to include an offset for expected profits. A significant portion of the expected profits for business already written is already captured by the adjustment to the capital base for the difference between unearned premium and premiums liability.

Modelling at lower return periods

APRA is confident that, given the availability of data, market models and individual insurer's approaches to pricing and reinsurance, insurers will be able to model at lower return periods the gross and net cost of the smaller-sized events proposed to be captured in the determination of the horizontal requirement. These events should include both single policy exposures as well as multiple claims from policyholders due to the occurrence of a natural peril event.

Internal model-based approach

Consistent with the approach proposed for the operational risk charge, as indicated in section 5.3, it is not APRA's intention to allow a partial internal model to be used to determine a specific component of the prescribed capital amount. Therefore, APRA proposes that an insurer not be permitted to use an internal model to determine the ICRC, or a component of it such as the horizontal requirement.

Timing of calculation

APRA confirms that the horizontal requirement is proposed to be calculated once a year, at the reporting date on or prior to the inception date of the catastrophe reinsurance program, and then held constant for the duration of the catastrophe reinsurance program. APRA proposes that an insurer be required to approach APRA to determine whether the horizontal requirement should be re-calculated during the year if there is a material change to the reinsurance program during the treaty year. If an insurer has multiple inception dates for its reinsurance program, APRA proposes that the insurer will need to agree with APRA the timing of the calculation of the horizontal requirement.

APRA also confirms that it is proposing that an insurer can take into account recoverables from aggregate and stop-loss reinsurance covers, provided these covers are in place for the current and next full reporting period. The methodology for determining the credit for these types of cover must be agreed with APRA.

Further guidance

APRA intends to review the approach insurers take to determine the outcomes of the two horizontal scenarios and the PL offset as part of normal supervision activities. APRA will consider whether there is a need for further guidance in the PPG on specific aspects of the determination of the ICRC, such as approaches to non-modelled perils or the PL offset.

6.3.3 Vertical requirement

The vertical requirement is similar to the existing Maximum Event Retention, except that it targets a loss equal to the whole-of-portfolio loss with a 0.5 per cent probability of occurrence over a one-year period.[14]

14 Maximum Event Retention is defined in the current version of GPS 116 as 'the largest loss to which an insurer will be exposed (taking into account the probability of that loss) due to a concentration of risk exposures, after netting out any potential reinsurance recoverables'.

APRA proposed that insurers not be able to take into account any recoverables under aggregate or stop-loss reinsurance covers in the determination of the vertical requirement.

Comments received

Submissions queried the inability to count aggregate or stop-loss reinsurance cover in the vertical requirement. Submissions argued that the vertical requirement is biased: after an event, the cost of reinstatements had to be included and increases the vertical requirement; however, any covers that respond to the event are not allowed to decrease the vertical requirement.

Submissions also queried the inability of insurers to include a deduction for the expected cost of claims in the vertical requirement. Finally, submissions sought clarification of when the vertical requirement needs to be calculated and whether it should be recalculated after an event.

APRA's response

Aggregate and stop-loss covers

The intent of the vertical requirement is to ensure sufficient purchase of vertical reinsurance cover, on a whole-of-portfolio basis. The vertical requirement represents the cost to the insurer of the next very large event. APRA acknowledges that aggregate or stop-loss reinsurance cover as part of the insurer's wider reinsurance program may reduce the immediate and short-term cost to an insurer of a large event during a treaty year. APRA therefore proposes that an insurer be able to apply to APRA to reduce the vertical requirement for aggregate and stop-loss covers that have reached their attachment point during the treaty year, if these covers are in place for the next full reporting quarter. The methodology for determining the credit for these types of reinsurance cover must be agreed with APRA.

Expected claims offset

APRA notes that an insurer may have provisions on its balance sheet that relate to a single whole-of-portfolio loss event with a probability of occurrence of 0.5 per cent over one year. APRA expects, however, that this amount will typically only represent a very small portion of premiums liabilities. The inclusion of an expected claims offset will add complexity to the determination of the vertical requirement, for little benefit. APRA is therefore proposing as a practical measure to not allow insurers to reduce the vertical requirement for the expected cost of claims.

Timing of calculation

The vertical requirement needs to be regularly monitored by the insurer. This includes being able to determine the level of the vertical requirement at all times, including the change in the vertical requirement after the occurrence of a catastrophic event. Each insurer must report its vertical requirement to APRA at the end of each quarter. The amount reported should represent the maximum net cost to the insurer of the single loss event for the current reporting quarter and the next reporting quarter. As a result, the vertical requirement must take into account reinsurance in place for the next reporting period, including any increase in reinsurance retentions. An insurer cannot decrease the vertical requirement in the current reporting period for reinsurance that does not incept until the next reporting quarter.

6.3.4 Catastrophe reinsurance reinstatements

APRA proposed that an insurer must have in place at the start of the reinsurance treaty period a contractually agreed reinstatement of the entire catastrophe program that is included in determining reinsurance recoveries for the vertical requirement.

Comments received

Submissions requested that APRA provide further clarity on the minimum number of reinstatements that need to be in place for the purposes of the vertical requirement. Submissions also sought clarification on the allowance for reinstatements in the horizontal requirement, including the number and cost that must be allowed for in the calculation.

APRA's response

Contractually agreed reinstatement

APRA proposed to introduce a requirement that an insurer must have in place a contractually agreed reinstatement with the reinsurer(s) for the catastrophe reinsurance cover that reduces the impact of the PML event in determining the vertical requirement component of the ICRC. This requirement is only applicable at the start of each treaty year. During a treaty year, should the insurer claim on the reinsurance program, APRA does not expect an insurer to necessarily contractually agree or place additional reinstatements of the program with the reinsurer(s). However, the placement of second and subsequent reinstatements, including the capital implications, must be considered in the insurer's Reinsurance Management Strategy (ReMS) and ICAAP. If APRA is not satisfied with the insurer's approach to reinstatements, it may apply a supervisory adjustment to the insurer's prescribed capital amount.

Vertical requirement reinstatements

When calculating the vertical requirement, an insurer must include the cost of reinstating catastrophe reinsurance cover used to reduce the impact of the PML event. The inclusion of the cost of this reinstatement is important as it is intended to ensure that, immediately following the occurrence of an extreme event, cover against another extreme event can be put in place.

At the start of the treaty year, the price or rate for the cost of reinstatement is known as the insurer has a contractually-agreed reinstatement. This cost may be zero if the insurer has a pre-paid reinstatement. During the treaty year, after the occurrence of an event that impacts on the reinsurance cover, the insurer will need to revise the vertical requirement to include an estimate of the cost of reinstating part or all of the reinsurance cover. If there are no further reinstatements at agreed rates, the estimate should be based on prevailing market conditions. The amount used in calculating the vertical requirement cannot be less than the full original cost of the cover. The amount can be reduced if only part of the layer is being reinstated; however, there cannot be a downwards adjustment to the estimated cost solely because there is less than a year remaining in the treaty program.

For example, consider an insurer that has a reinsurance layer covering it for losses between $100 million to $200 million, for a cost of $20 million. It incurs a loss of $175 million half-way through the treaty year and claims $75 million on the reinsurance layer. The estimated cost of reinstating this layer would be 75 per cent of $20 million, or $15 million. The $15 million cannot be reduced solely because the layer will, in theory, only be in place for six months.

Horizontal requirement reinstatements

With respect to the horizontal requirement, the purpose of including the cost of reinstatements is to ensure that the insurer has set aside enough capital for a succession of smaller-sized events where the insurer may need to purchase multiple reinstatements of cover. The horizontal requirement represents the cost of two different scenarios over a one-year period. This means for H3 the insurer needs to estimate and include the cost of reinsurance cover for three events i.e. two reinstatements. For H4, the insurer needs to estimate and include the cost of reinsurance cover for four events i.e. three reinstatements. This results in a difference between the determination of the vertical and horizontal requirements in terms of the number of reinstatements included in the calculation.

6.3.5 Level 2 insurance groups

Comments received

APRA received a small number of submissions on the ICRC proposals for Level 2 insurance groups. These related to the determination of the expected claims offset and the regional approach to the ICRC calculation.

APRA's response

The detail provided in section 6.3.2 on the horizontal requirement should provide Level 2 insurance groups with sufficient clarification of the calculation of the proposed expected claims offset.

The regional calculation of the ICRC for Level 2 insurance groups is intended to be based on the location of the exposures, and not necessarily where the risks were written. It is APRA's expectation that the regions used by Level 2 insurance groups will closely align with those used for APRA reporting purposes. The regions used by the Level 2 insurance group for determining the ICRC must be agreed with APRA.

6.3.6 Other proposals (excluding lenders mortgage insurance)

Comments received

Submissions noted as a concern the potential impact of the proposed changes to the ICRC on the reinsurance market, including the cost and availability of cover such as aggregate and stop-loss reinsurance. Submissions argued that APRA is encouraging the purchase of covers that may be unavailable or expensive.

Submissions also sought clarification as to whether other reinsurance types available in the market can be used to reduce the impact of the vertical or horizontal requirements.

APRA also received a small amount of feedback on the proposals for other accumulations of exposure, mainly seeking confirmation about the release of guidance from APRA.

APRA's response

APRA notes that the proposed approach to the ICRC will have an impact on the decision-making process of Boards and management, including the types and levels of reinsurance cover purchased. APRA is of the view that insurers should already be considering the impact of a series of smaller events on the capital position of the insurer, along with a range of other factors, when determining their reinsurance management strategy and designing their reinsurance program.

APRA notes that other products in the reinsurance and capital markets may reduce the impact of the vertical or horizontal requirement, such as catastrophe bonds and reinsurance premium protection policies. APRA proposes that an insurer be able to apply to APRA to assess the extent to which (if any) these covers may be included to reduce the ICRC. APRA will make an assessment on whether or not to permit any offset for these products, and the amount of offset that may be appropriate, on a case-by-case basis. The assessment will depend on a range of factors, including the type and details of the product, contract certainty requirements, the credit standing of the product provider, existence and location of any collateral and recovery processes.

APRA intends to implement the proposals relating to other accumulations of exposure as previously outlined in the September 2010 technical paper. The release of guidance on scenarios that may be appropriate for insurers to consider in determining the ICRC for these exposures will be considered by APRA as part of the development of the PPG on the determination of the ICRC.

6.3.7 Lenders mortgage insurance

In the March 2011 response paper, APRA proposed to maintain the current principles for the determination of the ICRC for LMIs. APRA proposed, however, to introduce two changes to the capital requirement for lenders mortgage insurance:

- the ability to deduct net premiums liabilities from the PML where these represent claims due to an economic downturn; and
- the removal of the explicit claims-handling expense.

APRA also proposed to place a floor on the value of the ICRC for LMIs to ensure that it is not less than 10 per cent of PML.

The implementation of the changes required the lenders mortgage ICRC model to be recalibrated and APRA proposed changes to the probability-of-default factors.

The proposed ICRC formula for LMIs was:

$ICRC_{LMI}$ = PML – ALR – NPL (ED), subject to a minimum of 10 per cent of PML

where:

- PML = the probable maximum loss, derived based on the sum insured, loan-to-valuation ratio, type of loan and age of each underlying LMI policy.
- ALR = allowable reinsurance, the lesser of 60 per cent of PML and available reinsurance. Available reinsurance is the value of all contractually agreed reinsurance available to the LMI during the prescribed three-year downturn.
- NPL (ED) = the value (at a 75 per cent level of sufficiency) of net premiums liabilities at the valuation date that represents potential losses due to an economic downturn.

The deduction for NPL was proposed to be limited to the portion of the premiums liabilities that represents losses due to a severe economic downturn. APRA proposed to require that the Appointed Actuary determine this amount as part of the annual insurance liability valuation.

Comments received

Submissions focussed on the deduction for premiums liabilities. Submissions noted the deduction added complexity to the calculation and would lead to inconsistencies across LMIs in the level of deduction and therefore the ICRC.

Submissions also sought further information on the approach APRA had undertaken to recalibrate the probability-of-default factors, requesting further detail on the process and the change in relativities between standard and non-standard factors. Submissions suggested that the change in relativities was not consistent with claims data for LMIs.

Submissions also raised a small number of technical questions on the current wording of the prudential standard in relation to available reinsurance and additional loans.

APRA's response

Premiums liability offset

APRA proposes to implement the proposals set out in the March 2011 response paper, including the deduction from the ICRC formula for premiums liability provisions and the removal of the claims-handling expense. The premiums liability offset adds additional complexity to the ICRC; however, APRA's view is that it is important to ensure that there is no double-counting between an LMI's ICRC and insurance liabilities. Having the Appointed Actuary determine the offset will allow it to be considered in conjunction with the overall reserving of the LMI. APRA notes that while QIS2 participants used differing percentages for this offset, the range used was reasonable. APRA does not propose to prescribe a particular percentage of net premiums liabilities for this offset or to allow the deduction of all net premiums liabilities. APRA will monitor the methodology and level of offset used by LMIs as part of its normal supervision activities.

Recalibration

As outlined in the March 2011 response paper, the recalibration of the ICRC model for LMIs took into account the change to the ICRC formula as well as the change to the return period. As part of the recalibration, APRA also considered empirical evidence with respect to claims data for different loan-to-valuation ratios and the relativities between standard and non-standard loans. APRA is satisfied that the recalibration has taken account of all available claims data, including relativities.

APRA has provided further clarity on the technical questions raised in submissions in Attachment A of draft GPS 116.

Chapter 7 – Response to APRA's proposals: life insurers only

This chapter addresses submissions on APRA's proposals for the calculation of the prescribed capital amount that are relevant only to life insurers (including friendly societies). It also includes some new proposals. The areas covered are:

- capital base calculation;
- insurance risk;
- adjustment to tax and management actions;
- asset concentration risk;
- operational risk;
- the minimum $10 million prescribed capital amount; and
- the use of internal models.

Other components of the prescribed capital amount calculation relevant to life insurers, including asset risk, operational risk, discount rates and the aggregation benefit, are addressed in Chapter 5.

7.1 Capital base calculation

7.1.1 Deferred tax assets associated with termination values

The March 2011 response paper did not specify whether the tax benefits that would arise following the adjustment of policy liabilities would be eligible for inclusion in the capital base when the adjusted liability is a termination value. APRA collected data in QIS2 to enable it to assess the size of the potential tax benefits and the extent to which they could be absorbed by existing tax liabilities.

Comments received

Those submissions that commented on this issue were in favour of recognition of these tax benefits.

APRA's response

APRA considers that recognising the tax benefits arising from application of the termination value minimum will allow the tax consequences of all adjustments to policy liabilities to be treated in a consistent manner.

APRA therefore proposes to permit recognition of these tax benefits, subject to the over-riding requirement that tax benefits can only be recognised to the extent that tax legislation allows them to be absorbed by the existing deferred tax liabilities of the insurer.

QIS2 showed that allowing the recognition of tax benefits from this source will have little impact on insurers' surplus assets. The capital base will increase for many funds, but there will be an offsetting increase in the PCR as there were no remaining tax liabilities that could absorb the tax benefits after the insurance risk and asset risk stresses were applied.

7.1.2 Admissibility of deferred tax assets

APRA proposed that deferred tax assets may only be recognised to the extent they can be offset against existing deferred tax liabilities.

Comments received

Submissions noted that the proposed recoverability test for deferred tax assets is more restrictive than the tests in the accounting standards and in APRA's existing solvency and capital adequacy standards. These standards currently allow longer timeframes for assessing the recoverability of deferred tax assets.

Some submissions also noted that the proposals are pro-cyclical. Deferred tax liabilities reduce in response to adverse experience and increase in response to good experience. Therefore deferred tax assets are more likely to be required to be deducted from the capital base after adverse experience has occurred.

Some submissions indicated that it was not clear whether deferred tax liabilities would include amounts accruing after the reporting date.

APRA's response

APRA's proposals are more restrictive than the existing capital standards for life insurers. However, APRA proposes to retain this restrictive approach. The proposals are consistent with the existing capital standards for ADIs and general insurers under which deferred tax assets that can only be realised if an insurer continues to operate must be deducted from the capital base.

APRA acknowledges the pro-cyclical nature of the proposed deduction of deferred tax assets from the capital base. This reflects the pro-cyclical nature of tax legislation, which only allows tax assets to be realised when they can be offset against tax liabilities.

APRA clarifies that, for the purpose of determining the recoverability of deferred tax assets, any tax liabilities that depend on the continuance of the business beyond the reporting date must be ignored. However, the tax effects of the adjustments to policy liabilities at the reporting date may be recognised.

In order to make the treatment of tax clearer, APRA proposes that the allowance for tax on future profits be removed from the Risk Free Best Estimate Liability and an adjustment to the deferred tax assets or deferred tax liabilities will need to be made as a consequence of any adjustments to policy liabilities.

7.1.3 Illiquidity premium

In the March 2011 response paper, APRA indicated that it was continuing to consider potential methods for determining an illiquidity premium. The illiquidity premium would be added to the risk-free rate for certain types of liabilities.

APRA expects to issue a proposed method for calculating the illiquidity premium for consultation in early 2012.

7.1.4 Illiquid liabilities

In the March 2011 response paper, APRA proposed that an illiquidity premium could be used for the purpose of discounting the liabilities for immediate life annuities, term certain annuities, fixed term/rate products and funeral bonds, providing the contract allows the surrender value (if any) to be reduced to the APRA minimum.

Comments received

A number of submissions claimed that the proposed definition of illiquid liabilities was too restrictive. In particular, submissions indicated that:

- the range of illiquid liabilities should be extended to include reserves for disability claims in payment as these reserves are similar in nature to annuity liabilities;
- any product that allowed the insurer to impose material withdrawal penalties on policy owners who terminate their contract should be considered illiquid; and
- the proposed requirement that the contractual minimum surrender value should not exceed the APRA minimum surrender value is too harsh. The use of an illiquidity premium should be permitted, providing the adjusted policy liability is not less than the greater of the contractual minimum surrender value and the APRA minimum surrender value.

APRA's response

APRA acknowledges that the level of illiquidity varies between different types of liabilities but is of the view that the application of the capital standards must be clear and unambiguous. APRA still proposes, therefore, to limit the use of the illiquidity premium to immediate life annuities, term certain annuities, fixed term/rate products and funeral bonds.

APRA proposes, however, to remove the requirement that the contract must allow the surrender value to be reduced to the APRA minimum. Instead, the adjusted policy liability (discounted using the risk-free discount rate plus illiquidity premium) will be subject to a floor of the minimum termination value (greater of contractual minimum surrender value and APRA minimum surrender value). This minimum will be applied at policy level.

7.2 Insurance risk charge

7.2.1 Short-term losses test

Comments received

Some submissions suggested that the short-term losses test should be restricted to a one-year horizon in order to make it consistent with the objective of the capital standards of providing for the adjusted liabilities in one year's time.

APRA's response

APRA proposes to restrict the short-term losses test to a one-year horizon, consistent with the objective of the capital standards. This change will also simplify the calculation of the insurance risk charge.

The QIS2 results showed that only a small number of insurers had post-stress insurance losses extending beyond the one-year horizon.

7.2.2 Minimum event stress

The March 2011 response paper proposed a minimum event stress for insured lives of a pandemic scenario with excess mortality and morbidity rates specified by APRA.

Comments received

Some submissions noted that it would be unrealistic to assume there would be no increase in mortality rates for annuitants in the event of a pandemic occurring.

APRA's response

APRA accepts that annuitants would be affected in a pandemic scenario. Accordingly, APRA proposes to allow the same increase in mortality (0.5 per thousand for two years) to be applied to annuitants in this scenario. This will reduce the overall impact of the pandemic scenario for statutory funds that have exposure to both mortality and longevity risk.

7.2.3 Longevity stress

In the July 2010 technical paper on the capital base and insurance risk charge, APRA proposed that the longevity stress would be a permanent 25 per cent decrease in mortality rates for each age. This stress would be applied to lifetime annuities. The longevity stress would be prescribed, instead of being determined by actuaries, as APRA does not believe there is sufficient data on Australian annuitant experience to enable actuaries to derive consistent stress margins.

Comments received

Few comments were received on the longevity stress. However, one submission asserted the proposed stress provided a level of sufficiency considerably greater than the required 99.5 per cent over one year.

APRA's response

Following further review, APRA proposes to reduce the longevity stress to a permanent 20 per cent decrease in mortality rates for each age.

7.2.4 Servicing expense reserve for friendly societies

The March 2011 response paper proposed that the insurance risk charge for the general fund include a servicing expense reserve for friendly societies.

Comments received

Submissions noted that the proposed charge did not make any allowance for tax relief on the increased expenses and would be inconsistent with the proposals for recognising tax assets elsewhere within the insurance risk charge.

APRA's response

APRA accepts that the proposed treatment of tax is inconsistent with other proposals. Accordingly, APRA now proposes to allow recognition of tax relief within the servicing expense reserve. The recoverability of these tax assets will, however, need to be tested and an adjustment made to the prescribed capital amount to reflect the extent to which the tax assets cannot be offset against deferred tax liabilities.

7.3 Adjustment for tax assets and management actions

APRA proposed in the March 2011 response paper that tax benefits and management actions (such as reductions to bonus rates) would be recognised within each of the stressed insurance and asset risk scenarios. It was proposed, however, that the recoverability of tax benefits would not be tested within these scenarios. Rather, the limits to the recoverability of tax assets and the limits to management actions would be recognised through an adjustment to the prescribed capital amount after the insurance risk and asset risk charges were aggregated.

In the March 2011 response paper, APRA proposed that a combined diversified scenario could be used to test the recoverability of tax assets and the limits to management actions. The combined diversified scenario would apply all stresses simultaneously and each of the stresses would be mitigated through application of diversification factors.

Comments received

Some submissions noted an inconsistency between the specifications for the insurance risk charge (which requires post-insurance stress termination values to be met at the end of the year) and the asset risk charge (which requires post-asset stress termination values to be met at the start of the year). This made it unclear how, in a combined scenario, to determine the amount of tax assets that can be recognised and whether the limits to management actions (e.g. future bonus rates cannot fall below zero) would be exceeded.

APRA's response

APRA proposes that a combined diversified scenario must be used to calculate the adjustment for tax assets and management actions. The adjustment will be calculated as follows:

- the risk charge for the scenario will be the reduction in capital base;
- the asset stresses will be applied at the reporting date;
- the post-stress liabilities will be subject to a minimum of an amount sufficient to fund stressed termination values in one year's time; and
- if the risk charge for the scenario exceeds the insurance risk charge plus the asset risk charge less the aggregation benefit, the excess will be added to the prescribed capital amount.

This method will allow insurers to recognise tax assets if they could be netted against tax liabilities at the end of the year following the reporting date in the post-stress environment. It will effectively allow a more concessional treatment of asset risk than allowed for in the calculation of the asset risk charge. Post-stress termination values in this scenario will only need to be funded after one year, rather than immediately. This will allow any positive net cash flows during the year to offset the asset risk stresses. The single scenario can therefore give a lower aggregate risk charge than the asset risk charge by itself. In this circumstance, APRA proposes that a reduction in the prescribed capital amount will not be permitted. APRA is of the view that the prescribed capital amount needs to be sufficient to meet the asset risk stresses if they are applied immediately at the reporting date.

7.4 Asset concentration risk charge

7.4.1 Asset concentration risk – five per cent and one per cent limits

In the May 2010 discussion paper, APRA proposed to retain the asset concentration limits specified in the existing capital standards for statutory funds (e.g. paragraph 10.5.1 of LPS 2.04), but with the removal of category (k) which specified a limit of five per cent of the assets of the fund for certain types of mortgages. In the March 2011 response paper, APRA proposed that the asset concentration limits would be applied to the general fund as well as to the statutory funds of each life company.

Comments received

Submissions indicated that the removal of category (k) would reduce the limit for some mortgage assets from five per cent to one per cent, which would adversely affect a small number of statutory funds.

Some submissions suggested that the asset concentration limits for general funds should be higher than for statutory funds. Some general funds have small amounts of liabilities relative to their capital base. For these general funds it would be more appropriate to apply the limits for general insurers, which are expressed as a percentage of the insurer's capital base.

APRA's response

APRA has revised its proposals with the aim of improving the alignment between the life insurance and general insurance standards and providing greater consistency between the limits for different types of assets.

APRA proposes that the limit for asset exposures of category (l) be replaced with a limit of the greater of five per cent of the value of the assets of the fund, or 25 per cent of the capital base.[15] This limit better aligns with the asset concentration limit of 25 per cent of capital base which applies to most similar types of assets held by general insurers.

APRA also proposes that the limit for asset exposures of type (m) be replaced with a limit of the greater of 2.5 per cent of the value of the assets of the fund, or 12.5 per cent of the capital base.[16] APRA acknowledges that the existing one per cent limit is unduly restrictive in comparison with the five per cent limit for other types of assets.

7.5 Operational risk charge

In the March 2011 response paper, APRA proposed that the 'change' item in the operational risk charge for non-risk business would be calculated as the sum of:

- the gross premium revenue for the latest 12 months in excess, if any, of 20 per cent of gross adjusted policy liabilities at the start of the 12 months; and
- the gross claim payments for the latest 12 months in excess, if any, of 20 per cent of gross adjusted policy liabilities at the start of the 12 months.

Comments received

Some submissions noted that the change item for non-risk business includes all claim payments that are reinvested as premiums in another policy issued by the insurer. These reinvestments are counted twice (as claim and premium) but are not necessarily an indicator of increased operational risk.

APRA's response

Reinvestments can make a marginal contribution to operational risk but are not a primary indicator of operational risk levels. APRA therefore proposes to remove reinvestments from the change factor for non-risk business (for both premiums and claims).

7.6 Minimum $10 million prescribed capital amount

In the March 2011 response paper, APRA proposed that a minimum PCR of $10 million would apply to the general fund of all life insurers. Existing friendly societies would be able to apply to APRA for an exemption from this requirement.

15 Other actively traded securities; non-traded securities or loans with a grade of 1, 2 or 3; real estate; and other income producing real property assets.

16 Non-reinsurance assets not covered by the other categories.

APRA proposed that an offset for the PCRs of statutory funds would be allowed, so that the minimum of $10 million effectively applied at company level. The offsets would allow the PCR of a statutory fund to be reduced, provided the PCR of the general fund was increased by the same amount. The maximum offset allowed would be the amount required to increase the PCR of the general fund to the $10 million minimum.

Comments received

Some submissions expressed concern that existing friendly societies might have to fund a $10 million PCR and that the March 2011 response paper did not specify any criteria for determining whether friendly societies would be granted exemption from this requirement.

APRA's response

APRA now proposes to specify capital requirements at both company and fund level (refer to section 4.2). The minimum $10 million prescribed capital amount will apply at company level. There will, therefore, no longer be a need for the $10 million minimum to be applied to the prescribed capital amount of the general fund.

APRA does not intend that existing friendly societies will have to raise additional capital or reduce distributions to policyholders in order to meet the minimum prescribed capital amount. APRA will apply a minimum prescribed capital amount of less than $10 million to smaller friendly societies that do not currently meet the $10 million minimum requirement. The minimum amount may be varied from time to time depending on changes to the individual circumstances of each friendly society.

7.7 Internal models

In the May 2010 discussion paper, APRA indicated that it would consider the use of an internal model-based method for life insurers to determine required capital if a number of life insurers indicate a strong desire to use such a method.

The draft of LPS 110 includes a section that permits the use of internal models subject to APRA approval. For APRA to grant approval, it would first need to develop a prudential standard setting out comprehensive requirements regarding model governance, model use and technical sufficiency (similar to existing standards for ADIs and general insurers). The development of a prudential standard for internal models for life insurers is not part of this review of capital standards and would only occur if there were sufficient demand from life insurers for the use of internal models.

Chapter 8 – Disclosure

APRA's supervisory approach aims to ensure adequate market disclosure by insurers to assist market observers to assess capital adequacy. APRA's proposed disclosure requirements are intended to provide market observers with ready access to basic information on the capital adequacy position of insurers on a regular basis.

APRA has previously indicated that it intends to align the disclosure requirements for life insurers with those of general insurers. APRA also proposed in the May 2010 discussion paper that insurers be required to disclose annually the individual components and the total of the prescribed capital amount and capital base. It was also proposed that if APRA determines that the PCR of an insurer includes a supervisory adjustment, the insurer will not be permitted to disclose this adjustment.

APRA is not proposing any material changes to these disclosure requirements. APRA is, however, proposing that in addition to the items listed above, insurers be required to disclose any agreed transitional amount (i.e. any regulatory adjustments to the prescribed capital amount) as a separate item in the components of the prescribed capital amount. APRA proposes that an insurer will be allowed, but not required, to disclose further details of the agreed transitional arrangements as part of its annual disclosure.

For life insurers, it is proposed that disclosure of the capital base and the prescribed capital amount will be required for the company as a whole and for each of its statutory funds and the general fund.

The draft standards being released with this response paper reflect these proposals and also clarify that the required information must be published so that it is readily accessible to both policyholders and other market participants.

Chapter 9 – Cost-benefit analysis information

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

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

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

Appendix 1 – Summary of proposed capital requirements for general insurers

General insurers	March 2011 proposals	Revised proposals
Capital base	• Intent to align with BCBS proposals (Basel III) was noted.	• Definition of components of capital is aligned with Basel III. • Regulatory adjustments to capital base need to be made to CET1. • CET1 must exceed 70 per cent of PCR at all times. • Tier 1 capital must exceed 80 per cent of PCR at all times. • Capital base must exceed PCR at all times.
Regulatory adjustments to capital base	• Regulatory capital and value in excess of net tangible assets will only need to be deducted from the capital base for subsidiaries (etc) that are subject to prudential capital requirements, or that are operationally dependent or undertake insurance-related business, including brokers, agents, servicing or management companies.	• The regulatory capital deduction would be based on the prescribed capital amount of the subsidiary (etc). • Assets subject to a charge, mortgage or other security will be deducted from CET1. • A number of other adjustments will apply to CET1 to align with Basel III treatment of these components.
Prescribed capital amount	• The existing Minimum Capital Requirement (MCR) would be replaced by the Prudential Capital Requirement (PCR). The part of the PCR that is calculated by insurers and must be publicly disclosed would be called the prescribed capital amount.	• No change.
Supervisory adjustment	• APRA could increase an insurer's total required capital if it believed the prescribed capital amount did not adequately account for all of an insurer's risks. This adjustment would not be permitted to be publicly disclosed.	• In addition, APRA will also be able to adjust the prescribed capital amount if the insurer has unusual assets or liabilities that are not appropriately dealt with by the standards. • The supervisory adjustment may be applied to strengthen the composition of an insurer's capital base.
Prudential capital requirement (PCR)	• The PCR would be the total of the prescribed capital amount and any supervisory adjustment. • An insurer would be required to have a capital base that exceeds the PCR at all times.	• In addition to the requirement of the capital base exceeding the PCR at all times, the Tier 1 capital of an insurer must exceed 80 per cent of the PCR and CET1 must exceed 70 per cent of the PCR.
Components of the prescribed capital amount	• The prescribed capital amount would comprise separate charges for insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk. An aggregation benefit would be deducted.	• No change.

General insurers	March 2011 proposals	Revised proposals
Insurance liabilities	• Insurers will not need to adjust their approach to setting gross insurance liabilities although the Appointed Actuary will be required to provide comment on the gross uncertainty in the insurance liabilities. • Limits on the overall level of diversification benefit allowed in risk margins will not be applied although general insurers will be required to report stand-alone risk margins in APRA returns.	• No change.
Insurance risk charge	• The insurance risk charge is described in GPS 115. It will continue to be calculated by applying APRA-specified factors to the outstanding claims provisions and premiums liability provisions. • Minor changes would be made to the outstanding claims liability and premiums liability risk charge factors. The classes affected will be travel, mortgage insurance and 'other'. • Changes were proposed to the insurance risk charge groupings for inwards reinsurance business. The separate charges for facultative versus treaty business would be removed, and the groupings by class would be aligned with groupings for the direct classes. • Insurance risk charges have been reduced for longer tail classes of business to offset the double-counting on inflation risk in the asset risk charge.	• No change.

General insurers	March 2011 proposals	Revised proposals
Insurance concentration risk charge	• The proposed formula for calculating the insurance concentration risk charge has been amended. • The definition of 'C' in the formula has been modified to provide greater clarity and a more consistent approach across industry. • A general insurer must have in place at the start of the reinsurance treaty period a contractually agreed reinstatement of the entire catastrophe program that is included in determining the vertical requirement. Second and subsequent reinstatements of reinsurance cover are not required to be contractually agreed but provision for the cost of the next reinstatement must still be included in the insurance concentration risk charge. • The formula and probability-of-default factors for calculating the insurance concentration risk charge for an LMI has been revised.	• Further clarity on the inclusion of a horizontal requirement and the 'expected claims offset' within has been included in Chapter 6 and the draft GPS 116. • General insurers can apply to APRA to reduce the vertical requirement for aggregate and stop-loss covers that have reached their attachment point during the treaty year.
Asset risk charge	• The investment risk charge (which would be renamed the asset risk charge) is described in GPS 114. • APRA proposed to improve the risk sensitivity of the asset risk charge by requiring the insurer to apply a series of stress tests to the balance sheet. • The stress tests would include changes to a range of factors affecting the assets and, in some cases, the liabilities. • The risk charge for asset risk would be determined as the change in capital base from specified adverse movements in a range of seven asset risk stresses including: – real interest rates; – expected inflation; – currency; – equity (including volatility); – property; – credit spreads; and – default.	• The stresses for real interest rates and some of the stresses for credit spreads have been reduced. • The stress for unlisted equity has been changed to a three per cent increase in the ASX 200 dividend yield.

General insurers	March 2011 proposals	Revised proposals
Asset risk charge (continued)	• The capital required for each stress would be combined using a correlation matrix prescribed by APRA. Correlations adopted between each pair of risk modules would be set at conservative levels allowing for the relative likelihood of two scenarios occurring at the same time.	
Asset concentration risk charge	• The asset concentration limits have been increased for short-term exposures (less than 12 months) to unrelated APRA-regulated entities. • General insurers can choose to treat letters of credit and guarantees provided by ADIs or collateral within a trust either as a reinsurance exposure to the originating reinsurer, or as an exposure to the entity providing the guarantee or letter of credit or entity holding collateral. • A general insurer that is licensed only to write the risks of its parent may apply for an exemption from the asset concentration limits.	• General insurers can elect the treatment of reinsurance recoverables from non-APRA-authorised-reinsurers at each reporting date. However, APRA proposes to be able to adjust the treatment applied by an insurer if needed.
Operational risk charge	• The operational risk charge formula has been modified. • Separate factors are applied for direct business and reinsurance business. • The formula is applied to gross written premiums and net insurance liabilities rather than gross written premiums and gross insurance liabilities. • The 'change' item will only apply to gross written premiums, not to liabilities. The change threshold has been increased from 10 per cent to 20 per cent and only that part of the increase or decrease in excess of the threshold will incur a risk charge.	• No change.
Aggregation benefit	• Asset risk and the combined sum of insurance risk and insurance concentration risk will be included in the aggregation formula. • The correlation factor to be used for QIS2 will be 0.5 for lenders' mortgage insurers (LMIs) and 0.3 for all other general insurers.	• The correlation factor between asset risk and the combined sum of insurance risk and insurance concentration risk is 0.2 for all general insurers other than LMIs, for whom it remains at 0.5.

Appendix 2 – Summary of proposed capital requirements for life insurers

Life insurers	March 2011 proposals	Revised proposals
Replacement of solvency, capital adequacy, and management capital requirements	• The solvency and capital adequacy requirements for statutory funds and the management capital requirement for general funds would be replaced by a single measure called the Prudential Capital Requirement (PCR). The PCR would be compared with the capital base of each statutory fund or general fund.	• No change.
Responsibility for calculations	• The capital base and prescribed capital amount would be calculated by the Appointed Actuary.	• The capital base and prescribed capital amount would be calculated by the insurer with advice from the Appointed Actuary.
Capital base	• Intent to align with BCBS proposals (Basel III) was noted.	• Definition of components of capital is aligned with Basel III. • Regulatory adjustments to capital base need to be made to CET1. • CET1 must exceed 70 per cent of PCR at all times. • Tier 1 capital must exceed 80 per cent of PCR at all times. • Capital base must exceed PCR at all times.
Capital base for funds	• The capital base for statutory and general funds would include shareholders' net assets and approved subordinated debt (and seed capital in the case of friendly societies). • Deductions would be made for inadmissible assets. • Adjustments would be made to policy and other liabilities for the purpose of determining the capital base. The adjusted policy liability for non-participating business without discretionary benefits would be the greater of the Risk Free Best Estimate Liability and the Best Estimate Termination Value. The 'greater of' would be determined for all business in a statutory fund, except for participating and discretionary investment business, which must be treated separately.	• The capital base for a general fund cannot include subordinated debt. Otherwise, no change.

Life insurers	March 2011 proposals	Revised proposals
Regulatory adjustments to capital base	• Intangible assets would be deducted from the capital base. • Deferred tax assets (DTA) net of deferred tax liabilities (DTL) would be deducted from the capital base. • The regulatory capital requirements and any excess of the value of the entity over net tangible assets would be deducted for subsidiaries, associates and joint ventures that are subject to prudential capital requirements, or that are operationally dependent or undertake insurance-related business, brokers, agents, servicing or management companies.	• DTA and DTL would include any tax consequences of adjustments to policy liabilities. • DTL would not include any tax liabilities that would depend on continuance of the business beyond the reporting date. • The deduction for the regulatory capital requirement for subsidiaries (etc) that are regulated by APRA is the prescribed capital amount.
Prescribed capital amount	• The prescribed capital amount would be required to be publicly disclosed.	• No change.
Supervisory adjustment	• APRA could increase an insurer's total required capital if it believed the prescribed capital amount did not adequately account for all of an insurer's risks. This adjustment would not be permitted to be publicly disclosed.	• APRA will also be able to adjust the prescribed capital amount if the insurer misinterprets the standards, or if the insurer has unusual assets or liabilities that are not appropriately dealt with by the standards. • The supervisory adjustment may be applied to strengthen the composition of an insurer's capital base.
Prudential capital requirement (PCR) for statutory and general funds	• The PCR would be the total of the prescribed capital amount and any supervisory adjustment. • The capital base must exceed the PCR at all times. • The minimum PCR for the general fund would be $10 million. Existing friendly societies may be granted an exemption from this requirement. Any excess of the minimum PCR over the calculated PCR (before applying the minimum) can be used as an offset to statutory fund PCRs.	• The capital base, excluding subordinated debt, must exceed 80 per cent of the PCR at all times. The capital base, including subordinated debt, must exceed the PCR at all times. • The minimum PCR for the general fund of $10 million no longer applies.

Life insurers	March 2011 proposals	Revised proposals
Company level requirements	• The standards for the quality of eligible capital instruments would be aligned with those that apply to ADIs, including the BCBS proposals (Basel III). These standards would be applied at company level.	• The PCR and capital base would be calculated at company level as well as for each statutory fund and the general fund. • The prescribed capital amount for the company would be the sum of the prescribed capital amounts for the funds, with a minimum of $10 million. Existing friendly societies may be granted an exemption from the minimum requirement. • CET1 capital must exceed 70 per cent of PCR at all times. • Tier 1 capital must exceed 80 per cent of PCR at all times. • Capital base must exceed 100 per cent of PCR.
Components of the prescribed capital amount	• The prescribed capital amount would comprise separate charges for insurance risk, asset risk, asset concentration risk and operational risk. An aggregation benefit would be deducted. An adjustment for tax benefits and management actions would be added.	• No change.
Insurance risk charge	• The insurance risk charge would be the amount of capital required to cover the risks that mortality, morbidity, lapses and servicing expenses are worse than best estimate. • The insurance risks considered would include extreme events. The minimum event stress would be a flu pandemic scenario, with a 0.5 per thousand increase in mortality for two years plus a specified increase in short duration morbidity. • The margins for servicing expenses, longevity and the minimum event stress would be determined by APRA. Others margins would be determined by the appointed actuary. • The insurance risk charge would be the difference between the stressed policy liabilities and the adjusted policy liabilities.	• The pandemic scenario includes a reduction in longevity of 0.5 per thousand for two years. • For the short-term losses test, the stressed policy liabilities must allow for stressed termination values to be funded 12 months after the reporting date. Subsequent losses do not need to be funded if they can be offset against long-term profits. • Any tax benefits associated with the servicing expense reserve for friendly societies may be recognised if they can be netted against tax liabilities.

Life insurers	March 2011 proposals	Revised proposals
Insurance risk charge (continued)	• The stressed policy liabilities must allow for stressed termination values to be funded at all times from 12 months after the reporting date (short-term losses test). • The insurer can assume it will exercise discretions to mitigate the effects of insurance risks. However, APRA would specify limits to the discretions that can be assumed for future repricing. • Repricing in response to the stresses would not be allowed to be assumed within one year of the reporting date. • The capital required for the insurance risk stresses would be aggregated using a correlation matrix specified by APRA. • For friendly societies the capital charge for servicing expense risk would be held in the general (management) fund. The tax benefits associated with this risk would not be recognised.	
Asset risk charge	• The range of asset risks considered in the asset risk charge would include those in LPS 2.04 and LPS 3.04 as well as inflation and equity volatility (affecting the value of derivative-type investments and any financial options and guarantees embedded in the liabilities). • The stress tests used for the asset risk charge would include changes to a range of factors affecting the assets and, in some cases, the liabilities. • Hypothecation of specific assets to specific liabilities would be allowed. • The risk charge required for asset risk would be determined as the change in capital base from specified adverse movements in a range of seven asset risk stresses including: – real interest rates; – expected inflation; – currency; – equity (including volatility); – property; – credit spreads; and – default.	• The stresses for real interest rates and some of the stresses for credit spreads have been reduced. • The stress for unlisted equity has been changed to a three per cent increase in the ASX 200 dividend yield. • Offsets between funds that require capital for stresses in opposite directions (e.g. real interest rates, expected inflation and currency) would not be allowed. • Disaggregation of assets would not be allowed.

Life insurers	March 2011 proposals	Revised proposals
Asset risk charge (continued)	• The capital required for each stress would be combined using a correlation matrix prescribed by APRA. Correlations adopted between each pair of risk modules would be set at conservative levels allowing for the relative likelihood of two scenarios occurring at the same time.	
Asset concentration risk charge	• The asset concentration risk charge would be calculated in a similar way to the asset concentration risk reserve required under LPS 2.04 and LPS 3.04. • The special treatment of mortgages would be removed. • Allowance for collateralisation and other forms of security would be permitted. • Exposures of a specialist reinsurer to its overseas parent would no longer be unlimited; rather they would be subject to a limit of 50 per cent of VAF. • The relief provided to specialist reinsurers with regard to exposures to offshore parents would not be available to statutory funds that include directly written business.	• The five per cent of VAF limit has been changed to the greater of five per cent of VAF or 25 per cent of capital base. • The one per cent of VAF limit has been increased to 2.5 per cent of VAF or 12.5 per cent of capital base.
Operational risk charge	• There would be an explicit charge for operational risk, to apply to all types of life insurance business. • Different formulae would apply to risk business and non-risk business. • A 'change' item would apply to premiums for risk business and both premiums and claims for non-risk business. The change threshold would be 20 per cent. If the 'change' exceeds 20 per cent only the excess amount would incur a risk charge. • A reduced charge applies to specialist reinsurers. • The existing investment-linked margins in LPS 2.04 and LPS 3.04 would be removed. • Operational risk profile and management would be a consideration in determining any supervisory adjustment. • For friendly societies the operational risk charge would be held in the general (management) fund.	• Reinvestments are excluded from premiums and claims for the 'change' item.

Life insurers	March 2011 proposals	Revised proposals
Aggregation benefit	• The aggregation of the insurance risk charge and the asset risk charge would include explicit allowance for diversification between risks. • The correlation factor between asset and insurance risk would be 0.3 for QIS2. • The operational risk charge and asset concentration risk charge would be added unadjusted to the other charges.	• The correlation factor between asset and insurance risk is 0.2.
Adjustment for tax benefits and management actions	• An adjustment to the prescribed capital amount must be made if the tax benefits or management actions assumed in each of the risk charges would not be realisable when all of the charges are aggregated.	• The methods for recognising the limits to management actions and realisable tax benefits have been clarified. • Tax assets arising from the insurance risk and asset risk stresses may be recognised if they could be netted against tax liabilities 12 months after the reporting date.
New business reserve	• The new business reserve (required under LPS 3.04) would be removed. However, APRA would expect insurers to consider the capital requirements of future new business in their ICAAP.	• No change.
Expense reserve	• The expense reserve (required under LPS 2.04) would be removed.	• No change.
Risk-free discount rates	• The risk-free rates used for valuing Australian liabilities would be the yields on Commonwealth Government Securities. • For foreign liabilities government bond yields may be adjusted in some circumstances. • Extrapolation of risk-free rates beyond the maximum available duration of CGS can be done by reference to other instruments providing there is appropriate adjustment for credit and liquidity risk. • APRA is considering potential methods for determining an illiquidity premium. If an illiquidity premium is included in the capital standards, it may be used for annuities, fixed term/rate products and funeral bonds.*	• No change.

* Fixed term/rate products and funeral bonds are defined in the draft of *Prudential Standard LPS 001 Definitions*.

Appendix 3 – Prudential standards for general insurers

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

Proposed framework of prudential standards	Incorporating the requirements from the following standards in the current framework	Released for consultation
GPS 001 Definitions	GPS 001 Definitions	December 2011
GPS 110 Capital Adequacy	GPS 110 Capital Adequacy GPS 111 Capital Adequacy: Level 2 Insurance Groups	December 2011
GPS 112 Capital Adequacy: Measurement of Capital	GPS 112 Capital Adequacy: Measurement of Capital	March 2012
GPS 113 Capital Adequacy: Internal Model-Based Method	GPS 113 Capital Adequacy: Internal Model-Based Method	May 2012
GPS 114 Capital Adequacy: Asset Risk Charge	GPS 114 Capital Adequacy: Investment Risk Capital Charge	December 2011
GPS 115 Capital Adequacy: Insurance Risk Charge	GPS 115 Capital Adequacy: Insurance Risk Capital Charge	December 2011
GPS 116 Capital Adequacy: Insurance Concentration Risk Charge	GPS 116 Capital Adequacy: Insurance Concentration Risk Capital Charge	December 2011
GPS 117 Capital Adequacy: Asset Concentration Risk Charge	GPS 114 Capital Adequacy: Investment Risk Capital Charge	December 2011
GPS 118 Capital Adequacy: Operational Risk Charge	New standard	December 2011
GPS 120 Assets in Australia	GPS 120 Assets in Australia	May 2012
GPS 220 Risk Management	GPS 220 Risk Management GPS 221 Risk Management: Level 2 Insurance Groups	May 2012
GPS 230 Reinsurance Management	GPS 230 Reinsurance Management	May 2012
CPS 231 Outsourcing	GPS 231 Outsourcing (effective until 30 June 2012)	No change
CPS 232 Business Continuity Management	GPS 222 Business Continuity Management (effective until 30 June 2012)	No change

Proposed framework of prudential standards	Incorporating the requirements from the following standards in the current framework	Released for consultation
GPS 310 Audit and Related matters	GPS 310 Audit and Actuarial Reporting and Valuation GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups	May 2012
GPS 320 Actuarial and Related matters	GPS 310 Audit and Actuarial Reporting and Valuation GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups	May 2012
GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers	GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers	No change
CPS 510 Governance	GPS 510 Governance (effective until 30 June 2012)	No change
CPS 520 Fit and Proper	GPS 520 Fit and Proper (effective until 30 June 2012)	No change

Appendix 4 – Prudential standards for life insurers

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

New prudential standards	**Released for consultation**
LPS 001 Definitions	December 2011
LPS 110 Capital Adequacy	December 2011
LPS 112 Capital Adequacy: Measurement of Capital	December 2011*
LPS 114 Capital Adequacy: Asset Risk Charge	December 2011
LPS 115 Capital Adequacy: Insurance Risk Charge	December 2011
LPS 117 Capital Adequacy: Asset Concentration Risk Charge	December 2011
LPS 118 Capital Adequacy: Operational Risk Charge	December 2011
Other prudential standards	**Released for consultation**
LPS 1.04 Valuation of Policy Liabilities	May 2012
LPS 4.02 Minimum Surrender Values and Paid-up Values	May 2012
LPS 5.02 Cost of Investment Performance Guarantees	May 2012
LPS 220 Risk Management	May 2012
LPS 230 Reinsurance	May 2012
CPS 231 Outsourcing	No change
CPS 232 Business Continuity Management	No change
LPS 310 Audit and Related Matters	May 2012
LPS 320 Actuarial and Related Matters	May 2012
LPS 350 Contract Classification for the Purpose of Regulatory Reporting	May 2012
CPS 510 Governance	No change
CPS 520 Fit and Proper	No change
LPS 600 Statutory Funds	May 2012
LPS 700 Friendly Society Benefit Funds	May 2012
Prudential standards to be revoked from 1 January 2013	
PS 3 Prudential Capital Requirement	
LPS 2.04: Solvency Standard	
LPS 3.04: Capital Adequacy Standard	
LPS 6.03: Management Capital Standard	
LPS 7.02: General Standard	

* There will be a second round of consultation on this standard in March 2012 when the detailed criteria for eligible capital instruments are released.

Appendix 5 – Criteria for classification as paid-up ordinary shares for regulatory capital purposes

1. Represents the most subordinated claim in liquidation of the insurer.
2. Entitled to a claim on the residual assets that is proportional with its share of issued capital, after all senior claims have been repaid in liquidation (i.e. has an unlimited and variable claim, not a fixed or capped claim).
3. Principal is perpetual and never repaid outside of liquidation (setting aside discretionary repurchases or other means of effectively reducing capital in a discretionary manner that is allowable under relevant law).
4. The insurer does nothing to create an expectation at issuance that the instrument will be bought back, redeemed or cancelled and the statutory or contractual terms do not provide any feature which might give rise to such an expectation.
5. Distributions are paid out of distributable items (retained earnings included). The level of distributions is not in any way tied or linked to the amount paid in at issuance and is not subject to a contractual cap (except to the extent that an insurer is unable to pay distributions that exceed the level of distributable items).
6. There are no circumstances under which the distributions are obligatory. Non-payment is therefore not an event of default.
7. Distributions are paid only after all legal and contractual obligations have been met and payments on more senior capital instruments have been made. This means that there are no preferential distributions, including in respect of other elements classified as the highest quality issued capital.
8. It is the issued capital that takes the first and proportionately greatest share of any losses as they occur.[17] Within the highest quality capital, each instrument absorbs losses on a going concern basis proportionately and pari passu with all the others.
9. The paid-in amount is recognised as equity capital (i.e. not recognised as a liability) for determining balance sheet insolvency.
10. The paid-in amount is classified as equity under the relevant accounting standards.
11. It is directly issued and paid-in and the insurer cannot directly or indirectly have funded the purchase of the instrument.
12. The paid-in amount is neither secured nor covered by a guarantee of the issuer or related entity or subject to any other arrangement that legally or economically enhances the seniority of the claim.[18]
13. It is only issued with the approval of the owners of the issuing insurer, either given directly by the owners or, if permitted by applicable law, given by the Board of Directors or by other persons duly authorised by the owners.
14. It is clearly and separately disclosed on the insurer's balance sheet.

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

18 A related entity can include a parent company, a sister company, a subsidiary or any other affiliate.

Appendix 6 – Criteria for inclusion in Additional Tier 1 capital for regulatory capital purposes

1. Issued and paid-in.
2. Subordinated to policy owners, creditors and subordinated debt of the insurer.
3. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis the insurer's creditors.
4. Is perpetual (i.e. there is no maturity date and there are no step-ups or other incentives to redeem).
5. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option an insurer must receive prior supervisory approval; and
   (b) an insurer must not do anything which creates an expectation that the call will be exercised; and
   (c) an insurer must not exercise a call unless:
      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the insurer; or
      (ii) the insurer demonstrates that its capital position is well above its PCR after the call option is exercised.
6. Any repayment of principal (e.g. through repurchase or redemption) must be with prior supervisory approval and insurers should not assume or create market expectations that supervisory approval will be given. Replacement issues can be concurrent with but not after the instrument is called.
7. Dividend/coupon discretion:
   (a) the insurer must have full discretion at all times to cancel distributions/payments[19];
   (b) cancellation of discretionary payments must not be an event of default;
   (c) insurers must have full access to cancelled payments to meet obligations as they fall due; and
   (d) cancellation of distributions/payments must not impose restrictions on the insurer except in relation to distributions to ordinary shareholders.
8. Dividends/coupons must be paid out of distributable items.
9. The instrument cannot have a credit sensitive dividend feature (i.e. a dividend/coupon that is reset periodically based in whole or in part on the insurer's credit standing).
10. The instrument cannot contribute to liabilities exceeding assets if such a balance sheet test forms part of national insolvency law.
11. For life insurers, the instrument must be classified as equity for accounting purposes.
12. The instrument must contain a provision for the instrument to be written-off upon the occurrence of a trigger event. The trigger event is the earlier of:
    (a) a decision that a write-off, without which the insurer will become non-viable, is necessary, as determined by APRA; and
    (b) the decision to make a public sector injection of capital, or equivalent support, without which the insurer will become non-viable, as determined by APRA.

19 A consequence of full discretion at all times to cancel distributions/payments is that 'dividend pushers' are prohibited. An instrument with a dividend pusher obliges the issuing insurer to make a dividend/coupon payment on the instrument if it has made a payment on another (typically more junior) capital instrument or share. This obligation is inconsistent with the requirement for full discretion at all times. Furthermore, the term 'cancel distributions/payments' means extinguish these payments. It does not permit features that require the insurer to make distributions/payments in kind.

As an alternative to write-off, insurers may elect to include a provision providing for conversion of the instrument into listed ordinary shares upon the occurrence of the trigger event.

13. Neither the insurer nor a related party over which the insurer exercises control or significant influence can have purchased the instrument, and the insurer cannot have funded (directly or indirectly) the purchase of the instrument.
14. The instrument cannot have any features that hinder recapitalisation, such as provisions that require the issuer to compensate investors if a new instrument is issued at a lower price during a specified time frame.
15. If the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a special purpose vehicle [SPV]), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Additional Tier 1 capital.[20]

20 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Appendix 7 – Criteria for inclusion in Tier 2 capital for regulatory capital purposes

1. Issued and paid-in.
2. For general insurers, is subordinated to policy owners and creditors.
3. For life insurers, is a debt instrument subordinated to policy owners and creditors of a particular statutory fund.
4. Is neither secured nor covered by a guarantee of the issuer or related entity or other arrangement that legally or economically enhances the seniority of the claim vis-à-vis policy owners and creditors.
5. Maturity:
   (a) minimum original maturity of at least five years;
   (b) recognition in regulatory capital in the remaining five years before maturity will be amortised on a straight line basis; and
   (c) there are no step-ups or other incentives to redeem.
6. May be callable at the initiative of the issuer only after a minimum of five years:
   (a) to exercise a call option an insurer must receive prior supervisory approval;
   (b) an insurer must not do anything that creates an expectation that the call will be exercised[21]; and
   (c) an insurer must not exercise a call unless:
      (i) it replaces the called instrument with capital of the same or better quality and the replacement of this capital is done at conditions which are sustainable for the income capacity of the insurer[22]; or
      (ii) the insurer demonstrates that its capital position is well above its PCR after the call option is exercised.
7. The investor must have no rights to accelerate the repayment of future scheduled payments (coupon or principal), except in bankruptcy and liquidation.
8. The instrument cannot have a credit sensitive dividend feature (i.e. a dividend/coupon that is reset periodically based in whole or in part on the insurer's credit standing).
9. The instrument must contain a provision for the instrument to be written-off upon the occurrence of a trigger event. The trigger event is the earlier of:
   (a) a decision that a write-off, without which the insurer will become non-viable, is necessary, as determined by APRA; and
   (b) the decision to make a public sector injection of capital, or equivalent support, without which the insurer will become non-viable, as determined by APRA.

   As an alternative to write-off, insurers may elect to include a provision providing for conversion of the instrument into listed ordinary shares upon the occurrence of the trigger event.
10. Neither the insurer nor a related party over which the insurer exercises control or significant influence can have purchased the instrument, and the insurer cannot have funded (directly or indirectly) the purchase of the instrument.
11. For general insurers, if the instrument is not issued out of an operating entity or the holding company in the consolidated group (e.g. a SPV), proceeds must be immediately available without limitation to an operating entity or the holding company in the consolidated group in a form which meets or exceeds all of the other criteria for inclusion in Tier 2 capital.[23]

21 An option to call the instrument after five years but prior to the start of the amortisation period will not be viewed as an incentive to redeem as long as the insurer does not do anything that creates an expectation that the call will be exercised at this point.

22 Replacement issues can be concurrent with but not after the instrument is called.

23 An operating entity is an entity set up to conduct business with clients with the intention of earning a profit in its own right.

Appendix 8 – Regulatory adjustments to Common Equity Tier 1 capital for general insurers*

8.1 Level 1 general insurers

1. The following regulatory adjustments are proposed to be made to CET1 for Level 1 general insurers:

   (a) goodwill and any other intangible assets, net of adjustments to profit or loss, reflecting any changes arising from impairment of goodwill[24];

   (b) deferred tax assets net of deferred tax liabilities (subject to netting requirements specified in paragraph 2 below)[25];

   (c) any portion of current year earnings or retained earnings that represents any amount deriving from the insurer's share of undistributed profit or loss in an associate, under equity accounting;

   (d) any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which the insurer is an employer-sponsor, unless otherwise approved, in writing, by APRA (refer to paragraph 3 below). Any excluded surplus must reverse any associated deferred tax liability from Tier 1 capital;

   (e) any deficit in a defined benefit superannuation fund of which the insurer is an employer-sponsor and that is not already reflected in CET1;

   (f) all holdings of own CET1 instruments;

   (g) unrealised fair value gains (or, where applicable, adding back unrealised fair value losses) arising from changes in an insurer's own creditworthiness;

   (h) cash flow hedge reserve that relates to the hedging of items that are not fair valued on the balance sheet;

   (i) all reinsurance assets reported in relation to each reinsurance arrangement that do not meet the reinsurance documentation test in paragraph 33 of GPS 112[26];

   (j) all reinsurance assets reported in relation to each reinsurance contract entered into by the insurer incepting on or after 31 December 2008 that do not meet the requirements of paragraph 31 of *Prudential Standard GPS 230 Reinsurance Management*;

   (k) relevant portion of regulatory capital of investments in subsidiaries, joint ventures and associates[27]; and

   (l) assets of an insurer that are under a fixed or floating charge, mortgage or other security to the extent of the indebtedness secured on those assets.[28]

2. For the purposes of paragraph 1(b) of this Appendix, netting of deferred tax assets and deferred tax liabilities must only be applied where an insurer has a legally enforceable right to set-off current tax assets against current tax liabilities where they relate to income taxes levied by the same taxation authority and the taxation authority permits the insurer to make or receive a single net payment.

3. For the purposes of paragraph 1(d) of this Appendix, an insurer may make representations to APRA to include a surplus as an asset (and hence include the surplus in Tier 1 capital) where the insurer that is the employer-sponsor is able to demonstrate unequivocal and unrestricted access to a fund surplus in a timely manner. Where APRA is satisfied regarding such access, an insurer may include the surplus in its assets subject to the appropriate risk charge calculated in accordance with GPS 114. This surplus will no longer be required to be deducted from Tier 1 capital.

24 This includes that component of investments in controlled entities which represents goodwill and any other intangible assets (i.e. current value less value of identifiable net tangible assets).

25 Where the amount of deferred tax liabilities exceeds the amount of deferred tax assets, the excess cannot be added to CET1 (i.e. the net deduction is zero). This item also excludes any amounts associated with surpluses in any insurer employer-sponsored superannuation funds.

26 For the purposes of this Appendix, 'reinsurance assets' refers to reinsurance assets as defined in GPS 001 net of doubtful debts.

27 Regulatory capital requirements exclude any supervisory adjustment applied by APRA in accordance with paragraph 33 of the draft GPS 110.

28 Where the security supports an insurer's insurance liabilities, the deduction is applicable only to the amount by which the fair value of the charged assets exceeds the insurer's supported insurance liabilities.

* For life insurers, refer to the draft of *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*

4. For the purposes of paragraph 1(k) of this Appendix, only include entities that are subject to prudential capital requirements, or that are operationally dependent or undertake insurance-related business, including brokers, agents, servicing or management companies.

8.2 Level 2 insurance groups

The following regulatory adjustments are proposed to be made to CET1 for Level 2 insurance groups:

(a) any items specified as regulatory adjustments for Level 1 general insurers (as outlined in section 8.1 above); and

(b) the items specified as capital deductions under the current version of *Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups*.

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