



Response to Submissions

Supervision of conglomerate groups

3. Prudential standards and draft guidance


August 2014

Disclaimer and copyright

While APRA endeavours to ensure the quality of this publication, it does not accept any responsibility for the accuracy, completeness or currency of the material included in this publication and will not be liable for any loss or damage arising out of any use of, or reliance on, this publication.

© Australian Prudential Regulation Authority (APRA)

This work is licensed under the Creative Commons Attribution 3.0 Australia Licence (CCBY 3.0).

 This licence allows you to copy, distribute and adapt this work, provided you attribute the work and do not suggest that APRA endorses you or your work. To view a full copy of the terms of this licence, visit www.creativecommons.org/licenses/by/3.0/au/.

Preamble

In March 2010, APRA released a discussion paper that outlined proposals for a framework for the supervision of conglomerate groups (Level 3 groups). In December 2012 and May 2013, APRA released consultation packages that included draft prudential standards covering the four components of the Level 3 framework: group governance, risk exposures, risk management and capital adequacy. APRA is now releasing Level 3 prudential standards, accompanied by a response to submissions on the proposals. APRA is also releasing draft prudential practice guides to provide guidance on the Level 3 requirements.

On 31 January 2014, APRA released prudential standards on risk management requirements. Those cross-industry standards will apply to Level 3 groups as well as Level 1 institutions and Level 2 groups, other than in the superannuation industry.

APRA has identified eight APRA-regulated institutions that it intends to determine to be a Level 3 Head. APRA will update this list as circumstances require.

However, given the Financial System Inquiry is looking actively at the regulatory regime more broadly, APRA believes it appropriate to await the views of the Inquiry, and the Government's response to its recommendations, before settling on the final form of the Level 3 Framework. Nevertheless, the release of the framework today provides an opportunity for relevant stakeholders to understand how APRA's thinking has evolved in response to the most recent round of consultation.

Contents

Glossary	6
Executive summary	8
Chapter 1 – Introduction	11
1.1 Background	11
1.2 The principles of the Level 3 framework	11
1.3 Prudential standards	12
1.4 Draft guidance	12
1.5 Timetable	12
1.6 Definitions prudential standard	13
1.7 Structure of this paper	13
Chapter 2 – Group governance	14
2.1 Governance (CPS 510)	14
2.2 Fit and proper (CPS 520)	15
2.3 Outsourcing (CPS 231)	15
2.4 Business continuity management (CPS 232)	16
2.5 Audit and related matters (3PS 310)	17
Chapter 3 – Risk exposures	18
3.1 Aggregate risk exposures (3PS 221)	18
3.2 Intra-group transactions and exposures (ITEs) (3PS 222)	18
Chapter 4 – Risk management	19
4.1 Level 3 risk management requirements (CPS 220)	19
Chapter 5 – Group capital adequacy	21
5.1 Equity-equivalent capital	21
5.2 Test 1: Capital adequacy	21
5.3 Test 2: Capital shortfall assessment	22
5.4 Internal Capital Adequacy Assessment Process	23

Chapter 6 – Level 3 Prudential Capital Requirement	24
6.1 Building block approach	24
6.2 ADI, GI and LI blocks	24
6.3 Intra-group transactions and exposures	25
6.4 Operational separation or separability	27
6.5 Funds management activities	28
6.6 Internal capital allocation	30
6.7 Cross-block diversification benefits	31
6.8 Level 3 supervisory adjustment	31
Chapter 7 – Level 3 Eligible Capital	32
7.1 Minority interests	32
7.2 Regulatory adjustments	33
7.3 Fair valuation	35
7.4 Genuine contribution to financial strength	36
Chapter 8 – Public disclosure	37

Glossary

ADI	An authorised deposit-taking institution under the <i>Banking Act 1959</i> (Banking Act)
Additional Tier 1 Capital	Capital instruments that provide loss-absorption but do not satisfy all of the criteria for inclusion in Common Equity Tier 1 Capital
Authorised NOHC	A non-operating holding company authorised under the Banking Act or the <i>Insurance Act 1973</i> (Insurance Act) or registered under the <i>Life Insurance Act 1995</i> (Life Insurance Act)
APRA	Australian Prudential Regulation Authority
APRA beneficiary	A depositor of an ADI, a policyholder (including policy owner) of an general insurer or life company, or a beneficiary of an RSE licensee
APRA-regulated institution	An ADI, Extended Licensed Entity, general insurer, life company, RSE licensee or authorised NOHC
Common Equity Tier 1 (CET1) Capital	The highest quality component of capital. It is subordinated to all other elements of funding, absorbs losses as and when they occur, has full flexibility of dividend payments and has no maturity date
December 2012 response paper	Response to Submissions, <i>Supervision of conglomerate groups. 1. Group governance and risk exposures</i> , December 2012
FM	Funds management
General insurer	A general insurer authorised under the Insurance Act
ICA	Internal capital allocation
ICAAP	Internal Capital Adequacy Assessment Process
Insurer	A general insurer or a life company
ITEs	Intra-group transactions and exposures
January 2014 risk management response paper	Response to Submissions, <i>Harmonising cross-industry risk management requirements</i> , January 2014
Level 1 institution	An individual operating company authorised to undertake activities within a single APRA-regulated industry (ADIs, general insurers, life companies and RSE licensees)
Level 2 group	A consolidated group within a single APRA-regulated industry, headed by an ADI, general insurer or authorised NOHC
Level 3 EC	Eligible capital (EC) held by a Level 3 group that APRA recognises for capital adequacy purposes
Level 3 group	A conglomerate group, containing an APRA-regulated institution, with operations across more than one APRA-regulated industry and/or including material non-APRA-regulated activities
Level 3 Head	An APRA-regulated institution heading a Level 3 group
Level 3 institution	An institution within the Level 3 group

Level 3 PCR	Level 3 Prudential Capital Requirement (PCR), determined as the Level 3 prescribed capital amount plus any Level 3 supervisory adjustment
Level 3 prescribed capital amount	Prescribed capital amount determined in accordance with the quantitative rules as set out in the capital standards, before any Level 3 supervisory adjustment is applied
Level 3 supervisory adjustment	An adjustment that APRA may require to be included in the Level 3 PCR
Life company	A life company, including a friendly society, registered under the Life Insurance Act
March 2010 discussion paper	Discussion Paper, <i>Supervision of conglomerate groups</i> , March 2010
May 2013 response paper	Response Paper, <i>Supervision of conglomerate groups. 2. Risk management and capital adequacy</i> , May 2013
May 2013 risk management discussion paper	Discussion Paper, <i>Harmonising cross-industry risk management requirements</i> , May 2013
NOHC	Non-operating holding company
Non-APRA-regulated institution	An institution other than an APRA-regulated institution
OA	Other activities
ORFR target amount	The operational risk financial requirement (ORFR) target amount determined for RSE licensees in accordance with <i>Prudential Standard SPS 114 Operational Risk Financial Requirement</i>
PPG	Prudential Practice Guide
RC	Required capital
RSE	A registrable superannuation entity as defined in the <i>Superannuation Industry (Supervision) Act 1993</i> (SIS Act)
RSE licensee	A registrable superannuation entity licensee as defined in the SIS Act
September 2013 reporting discussion paper	Discussion Paper, <i>Supervision of conglomerate groups. Proposed Level 3 reporting requirements</i> , September 2013
Tier 1 Capital	Capital that provides loss-absorption, comprised of Common Equity Tier 1 Capital and Additional Tier 1 Capital
Tier 2 Capital	Capital instruments that provide loss-absorption but do not satisfy the criteria for Common Equity Tier 1 Capital or Additional Tier 1 Capital

Executive summary

Background

In March 2010, APRA released a discussion paper, *Supervision of conglomerate groups*, outlining its proposed prudential framework for the supervision of such groups (Level 3 framework).¹ The Level 3 framework consists of four components: group governance, risk exposures, risk management and capital adequacy. In December 2012 and May 2013, APRA released draft prudential standards to give effect to these four components.² APRA is now releasing updated versions of the prudential standards, taking into account submissions received on the two consultation packages. It is also releasing draft prudential practice guides.

On 31 January 2014, APRA released a separate consultation package on harmonising cross-industry risk management requirements. That consultation package included prudential standards and draft guidance relating to risk management. These cross-industry requirements and proposals will affect Level 3 groups as well as Level 1 institutions and Level 2 groups. Aspects that are specific to Level 3 groups are addressed in this response paper. APRA will respond separately to submissions on the broader aspects of that consultation later in 2014.

The need for a Level 3 framework

APRA has for some time been cognisant of the complexity of business and financial structures of conglomerate groups and the contagion risks faced by APRA-regulated institutions within such groups. Recent international experience has shown that these complexities and risks could contribute to the failure of APRA-regulated financial institutions, highlighting the need for conglomerate supervision.

Membership of a conglomerate group may provide benefits to APRA-regulated institutions, but may also increase and change the risks they face. The more material a group's activities outside its primary industry, the greater the risk that an industry-focused supervisory regime will not appropriately detect or respond to risks associated with these activities, and the greater the

danger of a supervisory 'blind spot' that may result in risks building up without adequate remediation.

APRA's primary objective in developing the Level 3 framework has been to ensure that APRA's supervision adequately captures the risks to which APRA-regulated institutions within a Level 3 group are exposed and which, because of the operations or structures of the group, are not adequately captured by the existing prudential arrangements at Level 1 or Level 2. The Level 3 framework is intended to give APRA formal oversight of the material risks faced by Level 3 groups, supported by the implementation of Level 3-specific prudential standards. These prudential standards establish the following overarching requirements:

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

Broadly, submissions and feedback were supportive of the Level 3 framework, with a number of submissions suggesting that the group governance and risk management requirements are already largely met through existing group policies. Further, quantitative impact analyses suggest that no potential Level 3 group would be required to raise additional capital as a result of the implementation of the proposed Level 3 framework.

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

2 <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/Supervision-of-conglomerate-groups-2012.aspx> and <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/Supervision-of-conglomerate-groups-May-2013.aspx>.

Key governance requirements

Level 3 groups must develop and maintain group-wide policies that establish consistent business practices for governance, fitness and propriety of key staff, business continuity management and outsourcing. The Level 3 behavioural prudential standards for these aspects of corporate governance set out the minimum standards required by APRA and must be applied appropriately across a Level 3 group. The Level 3 Head must appoint an auditor for assurance on the appropriateness and effectiveness of group-wide policies.

Key risk exposures requirements

Level 3 groups must develop and maintain risk exposures policies to ensure that a concentration of risk in one part of, or across, a Level 3 group does not pose a threat to the APRA-regulated institutions in the group. In order to adequately manage this risk, Level 3 groups must have systems and processes to monitor aggregate risk exposures across the group as well as intra-group transactions and exposures. The governance, data capabilities and risk reporting must be meaningful and support decision-making.

Key risk management requirements

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

Key capital adequacy requirements

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

The Level 3 capital adequacy framework consists of two tests:

- a Level 3 group must at all times have eligible capital (Level 3 EC) in excess of its Prudential Capital Requirement (Level 3 PCR); and
- a Level 3 group must have sufficient unrestricted surplus capital to cover any shortfall in eligible capital held by non-APRA-regulated institutions within the group.

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

Disclosure

APRA has identified eight APRA-regulated institutions that it intends to determine to be a Level 3 Head. These institutions have been informed of APRA's intention. APRA will in due course publish a register of Level 3 Heads on its website, similar to the current registers in place for other APRA-regulated institutions.

While APRA does not intend to prescribe at this time any public disclosure on Level 3 capital adequacy, it will not prohibit a Level 3 group from publishing such information. APRA intends to review each group's approach to such disclosures and whenever there are material changes to the group's disclosure policy, to ensure that the disclosures do not inadvertently reveal confidential prudential information. Draft *Prudential Practice Guide 3PG 110 Capital Adequacy* includes guidance on how to recalculate the Level 3 prescribed capital amount so that it excludes Level 1 and Level 2 PCRs and supervisory adjustments. APRA will review its position on Level 3 disclosure after the framework has been implemented.

Timetable

Given the Financial System Inquiry is looking actively at the regulatory regime more broadly, APRA believes it to be appropriate to await the views of the Inquiry, and the Government's response to its recommendations, before settling on the final form on the Level 3 Framework. Therefore, no decisions will be taken on the implementation of the framework until such time as APRA has had the opportunity to consider the Government's response to the Inquiry's recommendations. This will also provide an opportunity to make further adjustments to the framework, if needed.

APRA will ensure that, once an implementation date is established, affected institutions are given a transition period to enable them to comply with the new requirements. This transition period will be a minimum of 12 months.

Chapter 1 – Introduction

1.1 Background

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

Subsequent to that release, APRA gathered feedback through a quantitative impact study (QIS) conducted in late 2010 and an information request in mid 2012. As the proposed Level 3 framework evolved, APRA undertook numerous discussions with potential Level 3 groups to communicate the key areas of change, which culminated in the release of further consultation packages in December 2012 and May 2013.

APRA received nine formal submissions on the December 2012 response paper and a further ten submissions on the May 2013 response paper. These two consultation packages included draft prudential standards for the four components of the Level 3 framework: group governance, risk exposures, risk management and capital adequacy. APRA received five submissions on the policy proposals contained in the September 2013 reporting discussion paper.

This package responds to submissions on the draft prudential standards and the various discussion and response papers, and includes the Level 3 prudential standards. APRA is also releasing draft PPGs that provide additional guidance on the Level 3 requirements.

On 31 January 2014, APRA released a separate consultation package on harmonising cross-industry risk management requirements. That consultation package included cross-industry prudential standards and draft guidance relating to risk management. These requirements and proposals will affect Level 3 groups as well as Level 1 institutions and Level 2 groups. Aspects that are specific to Level 3 groups are addressed in this response paper. APRA will respond separately to submissions on the broader aspects of that consultation later in 2014.

1.2 The principles of the Level 3 framework

The high-level principles underpinning the four components of the Level 3 framework are:

- *Group governance.* Business practices such as governance, fitness and propriety of key staff, business continuity management and outsourcing should be broadly consistent across institutions of a Level 3 group. APRA's cross-industry behavioural prudential standards on these aspects of corporate governance are required to be applied across Level 3 groups, including to non-APRA-regulated institutions engaging in business activities that may have a material financial or operational impact on the group.
- *Risk exposures.* A concentration of risk in one part of, or across, a Level 3 group must not have an adverse impact on the ability to meet beneficiary entitlements of the APRA-regulated institutions in the group. In order to adequately manage this risk, Level 3 groups must have systems and processes in place to monitor aggregate exposures across the group as well as intra-group transactions and exposures.
- *Risk management.* A Level 3 group must understand and prudently manage the risks arising from its business, including its non-APRA-regulated activities. It must have a risk management framework and strategy that is appropriate to the nature and scale of its operations. There must be adequate systems, processes, structures, policies and people to identify, assess, manage and monitor risks.
- *Capital adequacy.* A Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group. Capital management must be an integral part of a Level 3 group's risk management, requiring the alignment of the group's risk appetite and risk profile with its capacity to absorb losses. A Level 3 group must, at all times, have eligible capital in excess of its PCR.

1.3 Prudential standards

When fully implemented, the following prudential standards will set out the Level 3 framework's requirements.

Level 3-specific prudential standards

Prudential Standard 3PS 001 Definitions (3PS 001)

Prudential Standard 3PS 110 Capital Adequacy (3PS 110)

Prudential Standard 3PS 111 Capital Adequacy: Measurement of Capital (3PS 111)

Prudential Standard 3PS 221 Aggregate Risk Exposures (3PS 221)

Prudential Standard 3PS 222 Intra-group Transactions and Exposures (3PS 222)

Prudential Standard 3PS 310 Audit and Related Matters (3PS 310)

Cross-industry prudential standards that also apply to Level 3 groups

Prudential Standard CPS 220 Risk Management (CPS 220)

Prudential Standard CPS 231 Outsourcing (CPS 231)

Prudential Standard CPS 232 Business Continuity Management (CPS 232)

Prudential Standard CPS 510 Governance (CPS 510)

Prudential Standard CPS 520 Fit and Proper (CPS 520)

Cross-industry prudential standards apply not only to Level 3 groups but also to all ADIs, general insurers, life companies and Level 2 groups. Hence, a separate package was released on 31 January 2014, which included a Response Paper, *Harmonising cross-industry risk management requirements*, and versions of CPS 220, CPS 510 and draft guidance. The aspects that are specific to Level 3 groups are addressed in this response paper. APRA will respond separately to submissions on the broader aspects of that consultation later in 2014.

1.4 Draft guidance

The following is a list of the draft PPGs included in this consultation package and the 31 January 2014 risk management package.

Level 3-specific draft guidance

Prudential Practice Guide 3PG 110 Capital Adequacy (3PG 110)

Prudential Practice Guide 3PG 221 Aggregate Risk Exposures (3PG 221)

Prudential Practice Guide 3PG 222 Intra-group Transactions and Exposures (3PG 222)

Cross-industry draft guidance that also applies to Level 3 groups³

Prudential Practice Guide CPG 110 Internal Capital Adequacy Assessment Process and Supervisory Review (CPG 110)

Prudential Practice Guide CPG 220 Risk Management (CPG 220)

1.5 Timetable

A number of submissions expressed concern with the proposed implementation date of the Level 3 framework of 1 January 2014. In an August 2013 letter to potential Level 3 groups, APRA responded to these concerns by delaying the implementation date of the Level 3 framework.

APRA now proposes to defer a decision on the start date of the new framework until after the Government's response to the recommendations of the Financial System Inquiry has been announced.

APRA will ensure that, once an implementation date is established, affected institutions are given a transition period to enable them to comply with the new requirements. This transition period will be a minimum of 12 months.

³ CPG 220 was released with the January 2014 'Harmonising cross-industry risk management requirements' response paper.

1.6 Definitions prudential standard

The May 2013 response paper included an updated version of draft 3PS 001 incorporating capital adequacy definitions, and amended definitions of 'APRA-regulated institution' and 'Level 3 group'.

Comments received

A proposal was made to amend the definition of a Level 3 group to exclude commercial (non-financial) subsidiaries. Any investment risk relating to such deconsolidated commercial subsidiaries would then be included in the Level 3 PCR. It was proposed that criteria similar to those used for operational separation or separability could be applied to determine which commercial subsidiaries would be excluded.

APRA's response

APRA considers that a core objective of the Level 3 framework is to assess the risk to APRA beneficiaries from material non-APRA-regulated activities. This includes material activities performed by commercial subsidiaries. This would not be possible if the Level 3 group excludes commercial subsidiaries.

Within the standards, APRA has moved the definition of a Level 3 group to 3PS 110 to more explicitly link it with the definition of a Level 3 Head. It has also updated the definition of a Level 3 group to increase certainty about the scope of the Level 3 group.

APRA has incorporated three minor changes into 3PS 001: 'dual licensed entity' has been replaced with 'dual regulated entity' to align with existing superannuation terminology; a definition of the 'Board' is added so that this no longer needs to be defined in the individual Level 3 prudential standards; and the definition of extended licence entity has been expanded to also include general insurers and life companies, where applicable.

1.7 Structure of this paper

Chapter 2 discusses the group governance requirements, Chapter 3 the risk exposures requirements and Chapter 4 the elements of the cross-industry risk management standard relating to Level 3 groups. Chapters 5 through 7 discuss submissions on various aspects of capital adequacy. Finally, Chapter 8 discusses public disclosure.

Chapter 2 – Group governance

This chapter addresses APRA's response to issues raised in submissions in relation to group governance.

The December 2012 package proposed to extend the requirements for governance, fitness and propriety, outsourcing and business continuity management to the Level 3 Head and, in some instances, to the Level 3 group more generally. Where prudential standards indicated that requirements are to apply across the group, the responsibility for compliance with these requirements would rest with the Level 3 Head. APRA proposed that the Level 3 Head establish group governance policies that apply to all business activities that pose a material risk to the group. These group governance policies would have to comply with the requirements in the respective prudential standards. The draft prudential standards also included a number of consequential changes to align with the proposed superannuation standards on governance, fitness and propriety, outsourcing and business continuity management (BCM). In addition to these refinements, APRA proposed a new prudential standard on audit and related matters applicable to Level 3 Heads.

In May 2013, APRA released for consultation enhanced governance requirements in CPS 510. These included an extension of responsibilities for the Board Audit Committee and proposed new requirements for a separate Board Risk Committee. These proposed changes were intended to apply to all ADIs and insurers on a Level 1 basis, as well as to Level 2 groups and Level 3 groups. This response paper focuses on the comments received on the application of these proposals to Level 3 groups. A separate response paper, *Harmonising cross-industry risk management requirements*, which was released on 31 January 2014, discussed comments relevant to the application of the proposals to ADIs and to insurers at Level 1 and to Level 2 groups.

Submissions and feedback received were supportive of the proposals for behavioural standards at Level 3. A number of submissions suggested that the proposed requirements were already largely met through existing group policies and practices.

2.1 Governance (CPS 510)

APRA proposed that Level 3 Heads maintain appropriate group-wide governance arrangements that are consistent with the requirements of CPS 510. The May 2013 enhancements to CPS 510 added a requirement for the establishment of a Board Risk Committee for the Level 3 group that is separate from the Board Audit Committee.

Comments received

Submissions sought clarification on the circumstances where it would be appropriate for a Level 3 Head to apply CPS 510 to non-APRA-regulated institutions in the group. Submissions also identified potential difficulties in applying governance requirements to overseas institutions that are subject to overseas regulatory requirements.

APRA's response

A Level 3 Head is required to establish a comprehensive and consistent governance framework across the group that supports sound governance practices for all institutions within the group. This requirement reflects the responsibility of the Board of the Level 3 Head for the sound and prudent management of the group, balancing the needs of individual institutions and the group as a whole.

APRA's intention is for group governance arrangements to apply to non-APRA-regulated institutions engaging in business activities that may pose a material risk to the group. The Level 3 Head would establish criteria to determine whether a risk is considered material based on the size, business mix and complexity of the Level 3 group.

APRA has clarified in CPS 510 that the board composition and board representation requirements in that standard do not apply to non-APRA-regulated institutions in a Level 3 group.

As stated in the May 2013 response paper, where a Level 3 institution is subject to non-APRA regulatory requirements, the Board of the Level 3 Head would have the option of demonstrating to APRA that the institution is meeting the higher of the APRA or non-APRA regulatory requirements. APRA believes it is appropriate for all Level 3 institutions to be captured by the group-wide risk management framework and, where relevant, the Level 3 Head should require a non-APRA-regulated institution to meet the higher risk management standards.

Where a Level 3 Head is unable to require a Level 3 institution to implement group-wide policies due to legal or local regulatory constraints, APRA expects the Level 3 Head would consider alternative controls to mitigate the risk of contagion from the operations of that institution. For example, APRA would expect the Level 3 Head to implement additional controls locally to reflect the higher risk profile of the institution arising from its inability to adhere to the group's risk management framework.

2.2 Fit and proper (CPS 520)

APRA proposed that the Level 3 Head develop and maintain a 'Fit and Proper Policy' for the group. This Policy is to ensure that persons who are responsible for decisions and actions that pose a material risk to the group possess the integrity, competence, experience and qualifications to fulfil their role and exercise sound objective judgement.

Comments received

A potential impediment to the assessment of the fitness and propriety of directors appointed by minority interest shareholders and joint venture partners was raised.

APRA's response

In the December 2012 response paper, APRA responded to a similar query regarding overseas executives. Fundamental to the Level 3 framework is the principle that activities that are material to the group must be managed taking into consideration the financial and operational impact they could have on the group. Requiring all persons responsible for material group activities to be assessed as fit and proper reflects this principle.

Where a non-APRA-regulated subsidiary has a minority interest shareholder that appoints representatives for which no fit and proper assessment has been undertaken, APRA expects the Level 3 Head to implement additional controls to mitigate the additional risk to the group. The suitability of controls may vary depending on the person's degree of influence on, or their respective responsibilities for, the Level 3 group. For instance, a Level 3 Head may limit intra-group transactions and exposures (ITEs) to that institution.

2.3 Outsourcing (CPS 231)

The December 2012 response paper proposed to require a Level 3 Head to maintain a group-wide outsourcing policy and ensure that, if non-APRA-regulated institutions engage in outsourcing arrangements that pose a material risk to the group, these arrangements adhere to the requirements of CPS 231.

A sound group outsourcing policy would clearly outline the group's approach to addressing the risks related to outsourcing and offshoring and identify the scope of arrangements in which the group is willing to engage. The policy would also outline processes for assessing the group's outsourcing risk profile, monitoring the group's outsourced arrangements and managing the relationship with each service provider.

Comments received

Submissions identified that the extension of CPS 231 to outsourcing arrangements of non-APRA-regulated institutions would take time, given that clauses in existing arrangements will need to be updated. Submissions suggested that APRA allow Level 3 groups to transition existing outsourcing arrangements until their respective end dates.

Submissions also sought clarification on changes to the application of offshoring requirements to the international business of a group.

APRA's response

There may be legal constraints and costs associated with renegotiating the terms and conditions of existing outsourcing arrangements. Where a Level 3 group has existing outsourcing arrangements that do not meet the requirements in CPS 231, the group will need to make the necessary changes at the next available opportunity, such as the next renewal date.

APRA has also updated CPS 231 to clarify that offshoring only occurs when a Level 3 institution engages with a service provider that is overseas to that Level 3 institution. For example, offshoring requirements would apply where a Level 3 institution in the United Kingdom outsources to India. Where the Level 3 institution in the United Kingdom outsources to a United Kingdom service provider, this would not constitute offshoring.

2.4 Business continuity management (CPS 232)

The December 2012 response paper outlined requirements for a Level 3 Head to maintain a group-wide BCM Policy, so that, where non-APRA-regulated institutions engage in activities that are material to the group, these activities are subject to the requirements of CPS 232.

The group BCM Policy would clearly outline a strategy for coordinating the recovery of critical business operations to the Level 3 group in the event that an individual operation is disrupted or a number of operations are disrupted at the same time. APRA expects the group BCM Policy and group outsourcing policy would support one another in identifying exposures to service providers that are responsible for critical business operations across the group.

Comments received

It was requested that APRA clarify how a Level 3 Head was to consistently apply BCM for each part of the Level 3 group.

APRA's response

It is the responsibility of a Level 3 Head to oversee the appropriateness of the group's BCM Policy, and its consistent application across the Level 3 group. Consistent application may not result in every institution having the same business continuity plan; rather, the policies and processes for developing business continuity plans should be consistent. APRA expects the Level 3 Head to ensure that the group has a commonality of approach for maintaining or recovering critical Level 3 business operations in the event of a disruption. This coordination role would include consideration of the impact of contagion from a disruption affecting one institution to the rest of the group.

2.5 Audit and related matters (3PS 310)

The December 2012 response paper outlined APRA's proposal to develop a specific audit standard for Level 3 Heads. APRA has updated the wording in 3PS 310 to identify the Level 3 capital adequacy reporting forms and to clarify that the level of assurance for capital adequacy purposes at Level 3 does not override any Level 1 requirements. For example, *Prudential Standard LPS 310 Audit and Related Matters* requires auditors to prepare a report that provides reasonable assurance on a Level 1 life company's capital adequacy returns. This obligation is not overridden or replaced by the limited assurance required in 3PS 310 regarding a Level 3 group's capital adequacy returns.

Comments received

Submissions sought clarification on the applicability of 3PS 310 to non-APRA-regulated institutions in the group.

APRA's response

3PS 310 applies to the Level 3 Head and is intended to provide assurance that the Level 3 Head is meeting its prudential requirements. APRA expects that the auditor's involvement with subsidiaries would be based on obtaining this assurance, and would include the use of existing audit reports. For example, the auditor of the Level 3 Head may use audits of the financial accounts of Level 3 institutions in reporting on APRA's Level 3 data collections.

Chapter 3 – Risk exposures

The December 2012 response paper outlined APRA's proposals for Level 3 Heads to establish and maintain policies, procedures and systems for managing internal and external risk exposures of the Level 3 group.

APRA has not changed its proposals requiring Level 3 Heads to manage aggregate risk exposures and ITEs. Following consultation, however, APRA has made a number of changes to 3PS 221 and 3PS 222 to clarify its intent. The majority of changes are to the structure of the prudential standards rather than to the substance of the requirements. This chapter outlines APRA's response to specific issues raised in submissions.

3.1 Aggregate risk exposures (3PS 221)

Comments received

Submissions queried the proposal for the Board to engage in 'active' oversight of the management and review of aggregate risk exposures. The term 'active' was seen as a potential blurring of the roles and responsibilities of the Board and senior management.

Submissions also raised concerns that requirements for a Level 3 Head to articulate limits across a number of parameters, such as counterparties, industry sectors and geographical locations, was too prescriptive. Submissions suggested that aggregate exposure limits should be set by the Board and depend on the size, business mix and complexity of the Level 3 group.

APRA's response

APRA's intent was not to have the Board undertake the roles and responsibilities of management but to ensure that the Board proactively monitors and oversees the management of aggregate risk exposures across the group. APRA has removed the term 'active' from the prudential standard to reduce the scope for confusion about its expectations.

The appropriateness of aggregate exposure limits depends on the size, business mix and complexity of the Level 3 group. Further, the aggregate risk exposures policy would be expected to reflect the way that Level 3 groups manage their aggregate risk exposures. 3PS 221 has been amended to clarify that Level 3 groups are not required to put in place limits

on all of the parameters listed in the standard but rather, must consider them in formulating appropriate limits that are consistent with the Level 3 group's risk appetite, risk profile and capital strength.

3.2 Intra-group transactions and exposures (ITEs) (3PS 222)

Comments received

As for 3PS 221, submissions queried the proposal for the Board to engage in 'active' oversight of the management and review of ITEs.

Submissions identified that arm's-length arrangements are currently governed by the *Corporations Act 2001*, while also suggesting that non-arm's-length arrangements with group members may be less risky than arrangements with third parties.

APRA's response

Consistent with the change made to 3PS 221, APRA has removed the term 'active' from the prudential standard.

APRA requires the Board to consider and approve ITEs that are not conducted on an arm's-length basis to ensure ITEs do not expose one or more group institutions to undue risk. Where there is appropriate justification and documentation, APRA does not expect their approval by the Board of the Level 3 Head to be onerous.

Chapter 4 – Risk management

This chapter provides APRA's response to submissions on risk management requirements in relation to Level 3 groups. The January 2014 risk management response paper details APRA's response to general submissions on risk management.

APRA proposed to require a Level 3 Head to ensure that the Level 3 group's material risks were captured by an overarching group-wide risk management framework. The purpose of this group-wide framework was to ensure that the Board of the Level 3 Head had clear and effective oversight of the material risks of the group, whether they emerge from APRA-regulated or non-APRA-regulated institutions.

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

4.1 Level 3 risk management requirements (CPS 220)

CPS 220 requires a Level 3 Head to establish and maintain a group-wide risk management framework to coordinate the management of all material risks in the group. The group risk management framework needs to be consistently implemented across the group, with evidence of appropriate oversight.

The Level 3 Head is required to implement a risk management framework that appropriately applies CPS 220 across the group. This includes the Board fulfilling its responsibilities both to the APRA-regulated institution/s and, as the Board of the Head of a group, to the group. For example, the Board must develop a group-wide risk appetite, risk management strategy and business plan. APRA expects these documents to provide sufficient high-level guidance for subsidiaries to develop appropriate policies and procedures that meet the needs of each business.

A group framework can be flexible in the way that subsidiaries manage different risks. However, any deviation from the group framework would be documented with an explanation as to why differences are appropriate and how any additional risks from these differences are being managed.

Group Chief Risk Officer

Comments received

Submissions focused on the ability of Level 3 institutions to meet APRA's requirements on a group basis. In particular, submissions sought clarification on whether APRA-regulated institutions could use a group Chief Risk Officer (CRO).

APRA's response

CPS 220 allows Level 3 institutions to meet APRA's requirements on a group basis, subject to a number of requirements. The intent of these requirements is to ensure that the risk management framework of the group is appropriate for risk management in that Level 3 institution.

A Level 3 group may have a CRO in each of its APRA-regulated institutions who directly report to a group CRO, while maintaining a 'dotted' reporting line to their respective institution's Chief Executive Officer (CEO). However, the group CRO must report to the group CEO.

Risk management declaration

Comments received

Submissions raised concerns about the potential overlap of risk management declaration requirements between CPS 220 and existing industry-specific prudential standards.

APRA's response

The May 2013 discussion paper highlighted that CPS 220 was intended to replace the existing requirements for ADIs and insurers at Level 1, and extend these requirements to Level 2 and Level 3 groups. The finalisation of CPS 220 will allow APRA to assess the degree of overlap of risk management declarations and, where appropriate, remove any duplication or conflicting requirements over the course of 2014.

APRA-regulated institutions would continue to meet the existing risk management declaration requirements until CPS 220 commences 1 January 2015.

Notification requirement

Comments received

Clarity was sought on when the 10 business day notification requirement commences on becoming aware of prospective changes to the size, business mix and complexity of a Level 3 group.

APRA's response

APRA expects to be informed of prospective material changes to the group's risk profile as part of the ongoing engagement between supervisors and the Level 3 Head. However, APRA expects to be notified within 10 business days of the Board becoming aware of such changes.

Group liquidity management policy

Comments received

Submissions questioned whether the liquidity policy of an ADI within the group can be expanded to become a group liquidity management policy.

APRA's response

The group liquidity management policy is required to ensure the Level 3 group has sufficient liquidity to meet its obligations as they fall due, including in stressed conditions, and to identify constraints on the transfer of funds to meet these obligations.

APRA expects the liquidity issues faced by ADIs would be different from the liquidity risks faced by the rest of the Level 3 group, including insurers and non-APRA-regulated institutions. In addition, a Level 3 Head would consider the risk of contagion from liquidity issues in one Level 3 institution on other institutions in the Level 3 group. Therefore, APRA expects that the group liquidity management policy will not be able to be met by an extension of the Level 1 ADI liquidity policy required by *Prudential Standard APS 210 Liquidity*.

Chapter 5 – Group capital adequacy

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

The May 2013 response paper included eight tenets that underpinned the capital adequacy proposals, as follows:

1. *Level 3 ICAAP* – A Level 3 group must have an Internal Capital Adequacy Assessment Process (ICAAP).
2. *Capital adequacy requirements* – A Level 3 group must have sufficient capital such that the ability of its APRA-regulated institutions to meet their obligations to APRA beneficiaries is not adversely impacted by risks emanating from non-APRA-regulated institutions in the group. Operational separation or separability of non-APRA-regulated institutions can reduce contagion risk to APRA beneficiaries.
3. *Equity-equivalent capital* – Capital adequacy is determined on a Common Equity Tier 1 (CET1) basis.
4. *Two capital adequacy tests* – A Level 3 group must at all times have Level 3 EC (tenet 7) in excess of its Level 3 PCR (tenet 5), and a Level 3 group must have sufficient unrestricted surplus capital to cover any shortfall in Level 3 EC held by non-APRA-regulated institutions.
5. *Level 3 PCR* – The Level 3 PCR is determined by aggregating the required capital (RC) for six 'industry blocks', four APRA-regulated blocks and two non-APRA-regulated blocks plus a Level 3 supervisory adjustment, if any.
6. *Intra-group transactions and exposures* – The Level 3 PCR must exclude intra-group transactions and exposures (ITEs) which are eliminated on consolidation.
7. *Level 3 EC* – Level 3 Eligible Capital (Level 3 EC) is determined on a consolidated basis.
8. *Level 3 supervisory adjustment* – Where applicable, this is added to the Level 3 prescribed capital amount to determine the Level 3 PCR.

Submissions were generally supportive of the proposed tenets, however, some concerns were raised about specific aspects of the proposals. This chapter discusses submissions on the overarching approach to Level 3 capital adequacy. Chapters 6 and 7 discuss submissions on the determination of the Level 3 PCR and Level 3 EC, respectively.

5.1 Equity-equivalent capital

As set out in tenet 3, the May 2013 response paper proposed to determine Level 3 EC and Level 3 PCR on a CET1 basis. APRA received no submissions on this approach and has retained it in the Level 3 framework.

5.2 Test 1: Capital adequacy

As set out in tenet 4, the May 2013 response paper proposed that the Level 3 capital adequacy framework consist of two tests. The first test related to capital adequacy and captured material risks to APRA beneficiaries. It was proposed that the Level 3 capital adequacy requirements be based on:

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

A Level 3 Head must ensure that, at all times, the Level 3 group holds Level 3 EC in excess of the Level 3 PCR; no specific quantitative levels or thresholds were proposed for the size of this excess. APRA emphasised that the difference between Level 3 EC and the Level 3 PCR would not provide a measure of freely distributable capital as the Level 3 ICAAP and the second capital adequacy test, a capital shortfall assessment, needed to be applied.

Finally, APRA proposed that the location of capital in excess of the Level 3 PCR within the group would be at the discretion of the Level 3 Head, taking into account any impediments to its transferability, and that APRA-regulated institutions within the group must continue to meet industry-specific capital requirements at Levels 1 and 2.

Comments received

Respondents generally agreed with the proposed high-level approach to capital adequacy. However, clarity was requested about APRA's definition of 'material risk'. Submissions proposed a definition of materiality in the context of a 'risk of ruin', giving priority to the interests of APRA beneficiaries.

APRA's response

APRA has included its expectations on what constitutes a material risk in draft 3PG 110. In accordance with CPS 220, material risk is understood as a risk that could have a material impact, both financial and non-financial, on the Level 3 group or on the interests of APRA beneficiaries. APRA views it as appropriate for Level 3 Heads to determine materiality thresholds that adequately reflect their group risk and business profile.

5.3 Test 2: Capital shortfall assessment

The second test referred to in tenet 4 is the capital shortfall assessment. The May 2013 response paper proposed to limit the capital shortfall assessment to:

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

This assessment was proposed to be underpinned by an assessment that detailed specific capital transferability restrictions and required the assessment to be performed on a legal entity basis. The proposals provided limited scope for an assessment based on a sub-consolidation of legal entities rather than on an individual legal entity basis.

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

Comments received

APRA received a number of detailed submissions on the capital shortfall assessment. Topics covered included: replacing the capital shortfall assessment with a liquidity test; funding non-APRA requirements with Level 3 EC; simplifying the capital shortfall assessment; interactions between the five business day limit for transferring funds and the notification requirement under the *Corporations Act 2001*; holding transferable ICAAP surplus with a parent; whether the capital shortfall assessment is effectively a second minimum requirement; and various requests for clarification.

APRA's response

In light of the submissions, APRA has adopted a simpler, more principles-based approach that provides for flexibility in application while still achieving APRA's objectives.

The purpose of the shortfall assessment is to ensure that there are no undercapitalised subsidiaries (on a stand-alone basis) within a Level 3 group that lack access to sufficient additional capital from group members to cover the shortfall. This implies a strong link with the Level 3 PCR, as that would be the basis of any assessment of undercapitalisation. It is presumed that a subsidiary's required level of capitalisation equals its contribution to the Level 3 PCR. An institution with a zero contribution to the Level 3 PCR does not expose APRA beneficiaries to material risk and is therefore not undercapitalised for the purposes of the capital shortfall assessment.

The shortfall is assessed on a stand-alone basis. While the internal capital allocations (ICAs) for the funds management (FM) and other activities (OA) blocks are determined on a block basis rather than a legal entity basis, it is assumed that an ICA can be readily allocated across the various legal entities in the block that engage in materially risky activities.

The shortfall assessment is limited to non-APRA-regulated institutions as the capital adequacy of APRA-regulated institutions is already assessed on a Level 1 and/or Level 2 basis.

5.4 Internal Capital Adequacy Assessment Process

The May 2013 response paper proposed to require the Level 3 Head to establish and maintain an ICAAP appropriate to the size, business mix and complexity of the Level 3 group's operations and structure. The establishment of target capital levels would form part of the ICAAP and the Level 3 Head would, on an annual basis, be required to provide a report on the implementation of the Level 3 ICAAP to APRA. The specific requirements for the ICAAP would be based on the revised prudential requirements for ADIs and insurers and, in addition, would require the Level 3 group to perform a capital shortfall assessment as outlined in section 5.3.

The proposed ICAAP would include the Level 3 Head's assessment of capital needs as well as capital projections relative to target levels. The group's capital targets would be set to reflect the risk appetite of the Board of the Level 3 Head and could be a range or a single target level. However, APRA considered that the target levels will be informed by the Level 1 and Level 2 ICAAP target levels for APRA-regulated institutions. The Level 3 Head would be expected to manage the group's capital according to the ICAAP and its target capital policy.

Comments received

Respondents generally agreed with the proposed requirement for a Level 3 ICAAP. Submissions noted that APRA proposed to disallow the recognition of cross-block diversification benefits in setting the Level 3 PCR (refer to section 6.7) and queried whether, in setting Level 3 ICAAP capital targets, a Level 3 group would be allowed to take diversification benefits into account.

APRA's response

The capital targets must meet the requirements in 3PS 110, including the setting of triggers to alert management to potential breaches of the regulatory capital requirements.

The capital targets are intended to serve as early warning indicators and thereby provide the Board and management with time to rectify problems and restore capital while the Level 3 group continues to operate. It may be appropriate to recognise cross-block diversification in setting capital targets. It is expected, however, that the capital targets will be set at an appropriate level above the Level 3 PCR to ensure that they can properly function as early warning indicators.

Further, contagion risks increase during periods of extreme stress as correlations become stronger; recent international experience has highlighted the complexities inherent in the interaction of risks in the financial system. APRA also therefore expects a Level 3 group to consider, in setting appropriate capital targets, the potential for assumed cross-industry diversification benefits to be significantly reduced or for contagion risks to increase in times of stress.

Chapter 6 – Level 3 Prudential Capital Requirement

This chapter addresses APRA's response to issues raised in submissions in relation to the calculation of the Level 3 PCR.

6.1 Building block approach

The May 2013 response paper proposed that the Level 3 PCR be determined as the Level 3 prescribed capital amount plus any applicable Level 3 supervisory adjustment. The Level 3 prescribed capital amount would be calculated by summing the RC of the six industry blocks, to which all Level 3 institutions in a Level 3 group must be assigned, as appropriate:

- *ADI block* – the ADI Level 2 group, or, if there is no Level 2 group, the ADIs and equivalent overseas deposit-taking institutions;
- *GI block* – the general insurance Level 2 group, or, if there is no Level 2 group, the general insurers and equivalent overseas general insurers;
- *LI block* – the life companies (including friendly societies) and equivalent overseas institutions engaged in life insurance business;
- *Super block* – the RSE licensees;
- *FM block* – all institutions conducting funds management (FM) activities not captured in the ADI, LI or Super blocks (including the non-superannuation FM activities of dual regulated entities); and
- *OA block* – all other Level 3 institutions.

APRA received no submissions on the proposed approach to the industry blocks and has retained the approach.

6.2 ADI, GI and LI blocks

APRA proposed to base RC for the ADI, GI and LI blocks on the relevant prudential requirements. Specifically, RC for the ADI, GI and LI blocks at Level 3 would be the greater of⁴:

- CET1 PCR⁵;
- Tier 1 PCR – Additional Tier 1 Capital⁶; and
- Total Capital PCR – Additional Tier 1 Capital – Tier 2 Capital.

The proposed approach would ensure that, if at Level 1 or Level 2 part or all of the difference between the CET1 PCR and the Tier 1 PCR or Total Capital PCR must be met with CET1 Capital, this amount is added to the block's RC figure. The PCRs (in the case of ADIs, the risk-weighted assets) are net of any ITEs; refer to section 6.3. The ADI capital conservation and countercyclical buffers would be excluded from the determination of the Level 3 PCR.

For overseas equivalent ADIs or insurers that are not part of a Level 2 group, APRA proposed that RC for the relevant block would be based on the capital required in the host jurisdiction. APRA could, however, direct a Level 3 Head to instead apply a proxy based on APRA's industry-specific requirements if APRA considers that the host jurisdiction's minimum capital requirement is not appropriate for the purposes of the Level 3 capital adequacy calculation.

Comments received

Submissions noted that the Level 3 PCR is increased relative to the Level 1 or Level 2 CET1 PCR when the ADI or insurance subsidiary does not fully utilise its Additional Tier 1 and/or Tier 2 Capital allowances within the relevant Level 1 or Level 2 standards. It was argued that this could result in Level 3 groups increasing the level of gearing in their APRA-regulated institutions.

⁴ For ADIs, the PCR should be multiplied by risk-weighted assets to arrive at a dollar amount.

⁵ For insurers, the 'CET1 PCR' should be understood as 60 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

⁶ For insurers, the 'Tier 1 PCR' should be understood as 80 per cent (or a greater percentage as specified by APRA) of the prescribed capital amount.

It was further argued that the proposed approach creates an incentive for a Level 3 group to issue Additional Tier 1 and Tier 2 Capital instruments through its ADIs and insurers as only such issuances could reduce the RC of the relevant blocks. If a non-APRA-regulated group member issues a complying instrument and passes on the proceeds as CET1 Capital to the ADI or insurer, both the Level 3 PCR and Level 3 EC would remain unchanged; direct issuance by an ADI or insurer, on the other hand, would reduce the Level 3 PCR. Submissions anticipated that, following issuance of Additional Tier 1 or Tier 2 Capital instruments by the ADI or insurer, the relevant institution would likely reduce its CET1 Capital to maintain an equivalent level of capital. All else being equal, this incentive could reduce the amount of CET1 Capital held by ADIs and insurers within a Level 3 group.

Submissions noted that, where an ADI holds a group members' Additional Tier 1 or Tier 2 Capital instrument, this instrument is already deducted from the ADI's corresponding category of capital at Level 1 or Level 2. Excluding it from the GI or LI block's RC would then lead to a double deduction.

APRA's response

At Level 1 or Level 2, an ADI or insurer can reduce the minimum amount of CET1 Capital it is required to hold through the issuance of Additional Tier 1 or Tier 2 Capital instruments. This effect is mirrored at Level 3 through the proposed RC calculation for the ADI, GI and LI blocks. APRA has therefore retained the proposed approach.

The September 2013 reporting discussion paper proposed that Additional Tier 1 and Tier 2 Capital instruments not issued directly to the market must be excluded from the determination of the ADI, GI and LI blocks' RC. It added, however, that APRA may determine that part or all of the capital instruments held by other Level 3 institutions in the group are to be excluded from this adjustment. APRA intends to apply this adjustment in situations where an ADI or insurer issues an instrument to a Level 3 institution in the Level 3 group and the latter has issued an equivalent instrument to third parties. APRA will determine whether the external instrument has terms and features that are materially equivalent to those

of the internal Additional Tier 1 or Tier 2 Capital instrument. This approach ensures that Level 3 capital adequacy eliminates capital upgrading and avoids double counting capital.

3PS 110 has been amended so that the exclusion for intra-group capital instruments does not apply to an insurer's capital instrument held by an ADI in the Level 3 group that has already deducted the instrument at Level 1 or Level 2 from its corresponding category of capital.

6.3 Intra-group transactions and exposures

The May 2013 response paper proposed that the RC figures of the industry blocks be adjusted for ITEs. That is, where the Level 1 or Level 2 PCR includes RC for an exposure to another institution in the Level 3 group, this requirement should be removed as the exposure nets out at a consolidated level.

The response paper further proposed exceptions to the requirement to adjust for ITEs:

- market risk hedges that net out on consolidation should not be reversed as this could artificially increase the Level 3 PCR. Where a Level 3 institution hedges market risks with another institution in the Level 3 group, the latter institution must include the associated investment risk in the determination of its block's RC as it is ultimately exposed to the external risk;
- insurance risk charges for insurers that relate to ITEs should not be reversed as insurance risk is best captured by the general and life insurance regulatory capital frameworks;
- where a Level 3 institution that is not operationally separated or separable has an ITE with a Level 3 institution that is operationally separated or separable, this ITE must not be reversed as this exposure should be treated as equivalent to an exposure to an institution that is not part of the Level 3 group; and

- where significant effort would be required to accurately determine a specific ITE adjustment, a Level 3 Head may, subject to APRA's agreement, use a conservative approximation for the impact on the Level 3 PCR of the ITE adjustment or choose not to take the adjustment into account, where adjusting for the ITE would lead to a net reduction in the Level 3 PCR.

APRA further proposed that securitisation special purpose vehicles (SPVs) originated by the Level 3 group be assessed against the criteria in Attachment B of *Prudential Standard APS 120 Securitisation (APS 120)*, taking into account all exposures from all institutions in the Level 3 group, to assess whether the securitisation SPV meets the operational requirements for regulatory capital relief. A securitisation SPV failing to meet these criteria from a Level 3 perspective would be consolidated into the originating institution and be treated as part of the Level 3 group. A securitisation SPV meeting the operational requirements for regulatory capital relief from a Level 3 perspective would be treated as external to the Level 3 group and exposures by the group to such securitisation SPVs would not be considered ITEs.

Comments received

Submissions noted that under the life and general insurance frameworks, the Level 1 or Level 2 PCR is net of any tax benefits that would arise from scenarios modelled by the asset risk stresses. It was noted that certain insurers have tax indemnity arrangements in place where any tax benefits or liabilities flow to the Level 3 group. As the Level 1 or Level 2 insurance PCR is not tax-effected, the Level 3 PCR would also exclude tax effects. It was argued that in such a case, it would be appropriate for the RC of the GI and LI blocks to be tax effected through an ITE adjustment.

It was noted that the proposed exception for insurance risk could lead to double-counting where an ADI has originated mortgages against which the borrower has purchased lenders mortgage insurance (LMI) from an LMI insurer within the Level 3 group. In this case, the ADI's risk-weighted assets would include credit risk associated with the mortgages and the LMI insurer's PCR would include an insurance risk charge against the same.

Submissions considered that clean sale criteria from APS 120 are ADI-specific and therefore not appropriate for non-ADI originators in a Level 3 group. It was proposed that the criteria be limited to ADIs only.

APRA's response

APRA agrees that APRA-regulated insurers that have a tax indemnity arrangement with the Level 3 group to which they belong can tax-effect their PCR for the purposes of the RC calculations for the GI and LI blocks. This adjustment will be an ITE. Deferred tax liabilities already used as an offset for existing or potential deferred tax assets cannot be used for this purpose, and the prescribed capital amount used to determine the tax benefit must exclude all other ITEs.

APRA notes that there may be a reduction at Level 1 and Level 2 in the risk-weights associated with an ADI's mortgage assets if LMI has been purchased. This reduction depends on several factors, including the level of coverage provided by the LMI. Therefore, the RC for the ADI block would include the risk-mitigating impact of LMI. APRA has decided not to amend this proposal.

APRA is separately consulting on a simplified securitisation framework for ADIs that would involve significant revision to APS 210. APRA has decided not to amend the proposed Level 3 approach to securitisation SPVs until the revision of APS 120 has been finalised.

APRA has extended the exclusion for market risk hedges to also cover credit derivatives and guarantees between Level 3 institutions in a Level 3 group. For example, where a Level 3 institution provides another Level 3 institution in the group with a guarantee, the former institution assumes the risks associated with the guarantee from the latter. It must therefore include the associated risks in the determination of RC for its block as it is ultimately exposed to the external risk.

6.4 Operational separation or separability

The May 2013 response paper proposed that a Level 3 group could reduce contagion risk to APRA beneficiaries through the operational separation or separability of non-APRA-regulated institutions. This could potentially lead to a reduction in the Level 3 PCR. APRA would determine that a Level 3 group has credibly reduced the risk to APRA beneficiaries by considering, among other things, whether:

- there is structural separation (or whether this can readily be achieved, including in stressed scenarios);
- ITEs from non-separated Level 3 institutions in the group to operationally separated or separable institutions are subject to more stringent exposure limits than limits with other non-separated Level 3 institutions, and these limits must be outlined in the Level 3 group's ITE policy determined in accordance with 3PS 222;
- Boards and senior management of operationally separated or separable institutions are effectively independent from APRA-regulated institutions;
- the operationally separated or separable institutions have group badging and product distribution arrangements clearly separate from APRA-regulated institutions; and
- there is a recovery plan that demonstrates that the group can readily dispose of the operationally separated or separable institutions should it face financial distress.

APRA emphasised that it is highly unlikely that operational separation or separability would reduce the contagion risk to APRA beneficiaries to zero.

The response paper further proposed that Level 3 groups containing systemically important banks would not be able to credibly reduce the risk to APRA beneficiaries through operational separation or separability of the group's non-APRA-regulated institutions. In APRA's view, financial markets will

expect an ADI that dominates its group to cover losses sustained by group members, even if the affected members are operationally separated or separable from the ADI. Failure to do so would result in a loss in market confidence that could adversely affect the ADI's liquidity position and, ultimately, its viability.

Finally, the response paper clarified that the impact of operational separation or separability on the application of the Level 3 framework would be limited to capital adequacy. All Level 3 institutions in the group, regardless of group structure, would remain subject to the appropriate application of all requirements of the other three components of the Level 3 framework: group governance, risk exposures and risk management.

Comments received

Some submissions disagreed with the proposal that groups containing systemically important banks could not reduce their Level 3 PCR through operational separation or separability. It was argued that:

- following the global financial crisis, markets have come to expect that financial institutions could fail;
- APRA should differentiate between public trades and private trades with sophisticated counterparties;
- the proposed approach creates a difference with the treatment of groups containing systemically important insurers; and
- the potential benefits of operational separation should be available to groups containing systemically important banks.

Submissions requested additional information on the potential impact of operational separation or separability on RC for the FM and OA blocks.

Submissions argued that the impact of operational separation should be extended to capital deductions related to operationally separated or separable institutions.

APRA's response

APRA remains of the view that groups containing systemically important banks cannot restructure to address contagion risk arising from the group's non-APRA-regulated institutions. APRA considers that there is a serious risk that financial markets will expect an ADI that dominates its group to cover losses sustained by group members, even if the affected members are operationally separated or separable from the ADI. If this market expectation is not met, markets could form the view that the ADI is unable rather than unwilling to cover these losses. This loss in market confidence could adversely affect the ADI's liquidity position and, ultimately, its viability. Accordingly, APRA is retaining its proposed treatment. Additional information on APRA's approach to domestic systemically important banks is set out in the December 2013 APRA information paper on this subject.

APRA has yet to develop its framework for domestic systemically important insurers (D-SIIs) and the International Association of Insurance Supervisors D-SII framework is also yet to be finalised. As a part of developing its framework, APRA will consider the implications of operational separation for such groups in the context of the Level 3 framework.

The extent to which credible operational separation or separability affects an institution's contagion risk to APRA beneficiaries will depend on, among other things, the nature of the Level 3 group, the relevant institution's activities and risk profile and the extent to which the institution is separated from APRA beneficiaries. Draft 3PG 110 provides additional guidance on the impact of operational separation and separability on RC for the FM and OA blocks.

It is possible for different Level 3 institutions within a group to achieve different levels of risk reduction. As an example, two similar non-APRA-regulated institutions that have achieved different levels of operational separation could have different ICA risk contributions, with the more separated institution receiving the greater reduction in the block's ICA.

The impact of operational separation on deductions from Level 3 EC is addressed in section 7.2.4.

6.5 Funds management activities

The May 2013 response paper proposed to define FM activities as:

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

APRA further proposed that RC for FM activities would reflect only the risks relating to external funds at the point of entry into the group.

RC for the Super block would be based on the Operational Risk Financial Requirement (ORFR) target amount. It was noted that draft *Prudential Practice Guide SPG 114 Operational Risk Financial Requirement* (SPG 114) provided scope, in limited circumstances, to adjust the ORFR target amount set at Level 1 in order to take into account the impact of any duplication of financial requirements with a related APRA-regulated institution. As that proposal could interact with the Level 3 adjustments for internal pass-through, APRA resolved to revisit this issue following publication of the final SPG 114.

APRA also proposed that RC for the FM block would be the greater of the sum of applicable non-APRA regulatory capital requirements or the ICA for the FM block. APRA indicated that 0.15 per cent of net FM assets would be an appropriate expectation for the level of capital held for the risks in the FM block. A Level 3 group could take the difference in risk profile between funds under management (FUM) and funds under administration (FUA) into account when setting their ICA figure for the FM block so that a Level 3 group could potentially assign FUA a lower risk profile than FUM. However, if funds were to enter the group as FUA but were then passed through to another FM institution in the group as FUM (or to a life company as investment-linked policies), the risk profile of those funds would have increased and APRA would expect the group to take this increased risk profile into account when determining the ICA for these assets.

With respect to operationally separated or separable FM institutions in the FM block (refer to section 6.4), APRA noted that the reduced risk to APRA beneficiaries may lead to a lower RC figure for the external funds received by the FM institution. However, if these funds were passed through to an institution in the group that is not operationally separated or separable, the risks to the beneficiaries would correspondingly increase. To account for this, APRA proposed that the risks associated with those funds be included in the latter institution's RC figure rather than in the operationally separated or separable institution's RC figure.

Comments received

Submissions noted that, under APRA's proposals, the ORFR target amount would become part of the Level 3 PCR, which is a minimum requirement, whereas at Level 1 it is a target that the RSE licensee is not required to meet at all times. It was argued that this places a higher requirement on Level 3 groups than on RSE licensees.

Submissions requested confirmation that, if funds entered the group in an institution with a lower requirement and then were passed through to another institution with a higher requirement, the Level 3 PCR would reflect the lower requirement as that is the point of entry into the group. Clarification was requested on how a non-controlling equity investment in an FM institution (an associate) would be treated. In particular, submissions queried whether the Level 3 PCR would include RC for the funds of that associate, despite it being deducted from Level 3 EC and, if so, whether the RC would be for 100 per cent of the assets or for a percentage equal to the group's share of the voting rights. Submissions also queried whether the 0.15 per cent of net funds expectation for the FM block's ICA reflects operational risk only, or could also cover investments made by an FM institution for its own account.

APRA's response

APRA acknowledges the difference between the ORFR target amount, which is a target, and the Level 3 PCR, which is a minimum capital requirement. However, in order to adequately protect APRA beneficiaries against all material risks to which a conglomerate group is exposed, it is appropriate to base the Super block's RC figure on the ORFR target amount. Further, it is noted that RC at Level 3 for FM activities will tend to be less than the sum of the ORFR target amount and other Level 1 requirements due to the adjustment for pass-through. This will potentially reduce the impact of including the ORFR target amount in the Level 3 PCR.

3PG 110 includes additional guidance on the FM calculations. With regard to the specific issues raised in submissions:

- the requirement applicable at the point of entry is included in the Level 3 PCR. Any pass-through does not lead to an additional charge at Level 3, regardless of whether the recipient's requirement is greater or less than the first institution's requirement;
- institutions, including associates, that are not included in the Level 3 group are to be treated as investments in third parties. These investments may be required to be deducted from Level 3 EC depending on the Level 3 institution holding the investment. If they are deducted, no additional charge would be included in the Level 3 PCR. Where they are not deducted, the Level 3 PCR must reflect the investment risk associated with the equity exposure; and
- investments made by an FM institution for its own account expose the group to investment risk. Investment risk is not appropriately captured by the ICA for the FM block as this ICA is designed to capture operational risks arising from investing on behalf of third parties. These activities must therefore be allocated to the OA block. The operational risks associated with managing the third party clients' funds are addressed in the FM block.

The finalised SPG 114 clarifies that the ORFR target amount at Level 1 could be reduced to a minimum of 0.10 per cent, where the funds are held with a related entity subject to an APRA requirement. While this would be an appropriate outcome at Level 1, APRA notes that at Level 3 this could mean that the RC included in the Level 3 PCR is based on 0.10 per cent of external funds, an outcome that is less than the 0.15 per cent expectation that APRA has identified for non-APRA-regulated FM institutions. To achieve an appropriate outcome at Level 3, APRA has decided to apply a 0.15 per cent minimum in the RC for the Super block for external funds that are passed through to other group members. This ensures that RC for funds entering the group through the Super block is not lower than APRA's expectation regarding RC for funds entering the group through the FM block.

APRA observes that an 'entity that is subject to an APRA financial requirement' has not been defined in SPG 114. For the avoidance of doubt, the definition excludes FM institutions included in the FM block as these are not individually regulated by APRA.

6.6 Internal capital allocation

The May 2013 response paper proposed that the capital requirement for the FM and OA blocks be based on the ICA of the Level 3 group. APRA further proposed that the Board of a Level 3 Head must ensure that the group develops and maintains a process for determining the ICA. The ICA could differ from the outcome of the economic capital model (ECM) that the group uses for internal capital management purposes. The ICA was required to be a positive amount.

The ICA would also be subject to supervisory review and, where APRA considered that the ICA determined by a Level 3 Head is not adequate, it could impose a supervisory adjustment that would remain in place until its concerns were addressed.

APRA indicated that a level of 0.15 per cent of net FM assets would be an appropriate expectation for the level of capital held for the risks in the FM block. APRA did not, however, propose to prescribe a confidence level for the ICA against activities in the OA block. Instead, APRA would consider market benchmarks and

industry ratios for the relevant commercial industries to determine the appropriateness of the RC result. Whether the FM or OA block contains operationally separated or separable institutions would also inform the determination of the block's ICA. Finally, RC for the FM and OA blocks would have a minimum based on the sum of applicable non-APRA regulatory capital requirements.

Comments received

Submissions requested additional guidance on determining the ICA, including how to determine a CET1-equivalent requirement and how to adjust the internal ECM result to generate an ICA.

Submissions disagreed with the proposed minimum in the FM and OA blocks based on non-APRA-regulatory capital requirements. Unlike other elements of the Level 3 PCR, these non-APRA requirements could not be adjusted for ITEs and this would overestimate the risks to the APRA beneficiaries. Furthermore, unlike APRA's requirements, the non-APRA regulatory requirements are not necessarily of a CET1-equivalent nature. Requiring Level 3 groups to fund non-APRA requirements with Level 3 EC would therefore be excessively prudent.

Lastly, submissions proposed that the ICA be excluded from the Level 3 PCR and that the associated risks be reflected instead in the ICAAP capital targets. It was argued that this would be sufficient to ensure that a group is appropriately capitalised to absorb losses without placing APRA beneficiaries at risk.

APRA's response

3PG 110 includes draft guidance on how to determine an ICA. This includes guidance on quantifying the ICA, how to allocate risks to the FM and OA blocks, the interactions with the ECM that a group may use for its internal capital management, and APRA's expectations regarding appropriate documentation of the rationale, design and operational details of the ICA.

APRA has removed the minimum in the FM and OA blocks based on non-APRA regulatory requirements as this would likely not be a CET1-equivalent requirement. Instead, the ICA must at a minimum equal the aggregate of any non-APRA, common equity

equivalent regulatory or financial capital requirements that are applicable to institutions included in the FM and/or OA blocks.

APRA does not agree with the exclusion of the FM and OA blocks from the Level 3 PCR. Ensuring that material risks from non-APRA-regulated activities are sufficiently capitalised is one of the core objectives of the Level 3 framework.

6.7 Cross-block diversification benefits

The May 2013 response paper proposed that the RC figures for the six industry blocks would be summed to arrive at a Level 3 PCR and that no cross-block diversification benefits would be allowed.

Comments received

A number of submissions suggested that cross-block (i.e. group-wide) diversification benefits should be permitted at Level 3, arguing that the failure to recognise diversification benefits between industry blocks is inappropriate as it does not properly reflect the reduction in risk that arises from having multiple business lines with low correlation. In particular, it was argued that diversification between operationally separated or separable institutions in the FM and OA blocks does not expose APRA beneficiaries to additional risk.

APRA's response

APRA remains of the view that group membership leads to contagion risk, and that contagion risks increase during periods of extreme stress as correlations become stronger. The Level 3 PCR reflects all risks to the beneficiaries, including the risk of contagion from both the FM and OA blocks. A weakening of the Level 3 group's capital position anywhere in the group, including through assumed diversification benefits, can potentially impact APRA beneficiaries. For these reasons, APRA has not amended its proposal.

6.8 Level 3 supervisory adjustment

The March 2010 discussion paper proposed that, where there are prudential reasons for doing so, APRA may impose additional requirements on a Level 3 Head or on APRA-regulated institutions in the group on a case-by-case basis. The May 2013 response paper added that the process for setting the proposed Level 3 supervisory adjustment will be similar to the process for ADIs and insurers at Level 1 and Level 2.

No submissions were received on the proposed Level 3 supervisory adjustment. The amended CPG 110 includes a list of considerations APRA will take into account that may lead it to apply a Level 3 supervisory adjustment.

Chapter 7 – Level 3 Eligible Capital

This chapter addresses APRA's response to issues raised in submissions in relation to the calculation of Level 3 EC. In the May 2013 response paper, APRA proposed to measure Level 3 EC based on the consolidated accounts of the Level 3 group net of relevant adjustments. While respondents raised no objections to the proposed general approach, they did raise issues in relation to specific proposals.

7.1 Minority interests

The May 2013 response paper proposed to limit recognition of minority interests to those determined at Level 2 in accordance with *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (APS 111) and *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112).

APRA noted that it had considered extending the recognition of minority interests to other entities or industries, but concluded after an initial review that the additional complexity would outweigh the benefits of a more accurate assessment of loss-absorbing capital. It added, however, that it would be willing to review its position on this issue.

Comments received

Submissions proposed to extend the recognition of minority interests, as they considered that the exclusion of minority interests in the FM and OA blocks can lead to anomalous results:

- it is possible that the subsidiary's RC will exceed the actual investment in the entity as RC is based on 100 per cent ownership of the assets; and
- selling down a portion of the investment would not reduce risk and this was considered to be counterintuitive.

Submissions acknowledged that the current impact of an extension would be limited but argued that, in the future, the amount of eligible minority interests could increase and that the Level 3 framework should also cater to future developments.

It was further argued that the loss-absorbing capacity of minority interests in relation to assets that are treated as a deduction under the Level 3 proposals (e.g. intangible assets) should also be recognised. As these deductions are assumed to be fully written down, the associated loss will be partly borne by the third-party investors.

APRA's response

APRA has extended the recognition of minority interests. Level 3 EC now includes minority interests arising from the issue of ordinary shares to third parties by a Level 3 institution in the Level 3 group (other than the Level 3 Head) where the shares giving rise to the minority interests would, if issued by the Level 3 Head, meet the criteria for inclusion in Level 3 EC.

APRA considers that extending eligibility of minority interests to cover assets that are treated as a deduction would be a material deviation from the existing approach to the eligibility of minority interests at Level 2, and has decided against such an extension.

The amount of minority interests of a Level 3 institution in the Level 3 group eligible to be included in Level 3 EC is equal to:

- the total amount of the Level 3 EC of the institution attributable to third parties; less
- any positive surplus Level 3 EC amount above the institution's contribution to the Level 3 PCR, multiplied by the percentage of all Level 3 EC of the institution attributable to third parties.

To more closely align the Level 3 framework with the Level 2 frameworks, for its ADI and general insurance Level 2 groups, if any, a Level 3 group must include the amount of CET1 minority interests eligible at Level 2.

7.2 Regulatory adjustments

The May 2013 proposals included a series of regulatory adjustments to be applied to the calculation of Level 3 EC. Submissions questioned the appropriateness of certain regulatory adjustments and also proposed new regulatory adjustments.

7.2.1 Accounting mismatches in investment-linked policies

Comments received

Submissions noted that mismatches could arise under Australian Accounting Standards when certain assets held on behalf of life insurance policyholders are included in the accounts at different values to the value used in the calculation of the investment-linked policy liabilities in respect of those assets. The difference between the two values impacts on the shareholders' equity of the consolidated group and gives rise to accounting measurement mismatches. Examples of mismatches are movements in the value of life company investments in controlled entities over and above the net asset value, and movements in the value of policyholder investments in related-party deposits.

It was argued that these mismatches should be addressed as they have no economic substance and misstate the group's capital position.

APRA's response

A new regulatory adjustment has been included to address accounting measurement mismatches in investment-linked policies, unless already reflected elsewhere in Level 3 EC.

7.2.2 Deferred tax assets and deferred tax liabilities

The May 2013 response paper proposed that deferred tax liabilities may be used as an offset to losses on goodwill and other intangible assets. Draft 3PS 111 required a Level 3 group to exclude from the deduction any deferred tax assets and deferred tax liabilities attributable to assets and liabilities held by the Level 3 group on behalf of life insurance policyholders or beneficiaries of an RSE within the RSE

licensee's business operations, even if the assets and liabilities are held in the name of a Level 3 institution in the group.

Comments received

Submissions claimed that similar arguments to those that underpin the application of deferred tax liabilities as an offset to losses on goodwill and other intangible assets should also apply to retained earnings and accumulated other comprehensive income. It was proposed that the application of the offsetting nature of deferred tax liabilities in relation to asset revaluations should be extended to retained earnings and accumulated other comprehensive income in Level 3 EC, and that these two categories be included on a gross of tax effects basis.

Clarification was sought on the interaction between draft 3PS 111 and *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112) regarding the treatment of deferred tax assets minus deferred tax liabilities:

- LPS 112 (Attachment B, paragraph 9) requires that any 'Deferred tax assets and liabilities include any tax effects that would result from adjustments to policy liabilities.' However, this requirement is absent from 3PS 111; and
- draft 3PS 111 (Attachment B, paragraph 26) requires a Level 3 group to exclude from the regulatory adjustment 'any deferred tax assets and deferred tax liabilities attributable to assets and liabilities held by the Level 3 group on behalf of life insurance policyholders or beneficiaries of an RSE within the RSE licensee's business operations, even if the assets and liabilities are held in the name of a Level 3 institution in the group'.

It was queried whether these two differences were intentional.

APRA's response

An extension of the deferred tax offset to other categories of capital would constitute a material deviation from the ADI and insurance capital frameworks. Consequently, APRA has decided not to amend the proposed deferred tax offset.

APRA has updated 3PS 111 so that for institutions included in the LI block, deferred tax assets and liabilities include any tax effects that would result from adjustments to policy liabilities in accordance with *Prudential Standard LPS 340 Valuation of Policy Liabilities*.

APRA notes that the requirement in draft 3PS 111, Attachment B, paragraph 26 is intended to mirror the requirement in LPS 112, Attachment B, paragraph 4. The requirement in 3PS 111 is phrased in more generalised terms as it is intended to apply beyond life insurance.

7.2.3 Fair value adjustments

Draft 3PS 111 proposed that a Level 3 group must deduct from Level 3 EC any amount required by APRA, in writing, where APRA considers that fair values on the balance sheet are not prudent or reliable.

Comments received

Submissions noted that LPS 112 includes a second fair value adjustment that requires life companies to measure their assets at fair value for the purposes of determining their capital base. The asset risk charge included in the life company's prescribed capital amount therefore reflects adverse changes in the assets' fair value. Under the proposed Level 3 approach to Level 3 EC, fair value can only be used if this is in accordance with Australian Accounting Standards. The Level 3 PCR, on the other hand, uses the life company's prescribed capital amount as an input and is therefore based on the fair value of assets. This could lead to a situation where the LI block's RC (and therefore the Level 3 PCR) is based on the fair value of the underlying asset but Level 3 EC is based on the amortised cost value.

APRA's response

To be consistent with the Level 1 framework, APRA has included a regulatory adjustment in 3PS 111 requiring life company assets in a Level 3 group to be measured at fair value. This ensures that the life company's contribution to both the Level 3 PCR and Level 3 EC is determined on a consistent valuation basis. This amendment creates a difference in the valuation approach for assets held in a life company

compared with assets held elsewhere in the group. APRA has a strong expectation that Level 3 groups would not base a decision to relocate capital from the life company to another institution or vice versa on how this would impact on Level 3 EC.

7.2.4 Goodwill and other intangibles

APRA proposed full deduction of goodwill and other intangible assets, net of any associated deferred tax liabilities.

Comments received

Submissions argued that goodwill may not be worthless in the case of stressed conditions and that, in recent years, the accounting treatment of intangible assets has advanced to create a more robust accounting categorisation of intangible assets. In particular, an intangible asset is to be categorised as an 'identifiable' intangible asset. Identifiable intangible assets are then amortised over the period to which the identified value relates and, after a period of time, no longer count as capital. It was proposed that identifiable intangible assets held in operationally separate or separable institutions not be deducted from Level 3 EC but instead be included in the ICA.

APRA's response

APRA remains of the view that goodwill and other intangible assets do not hold economic value in distressed circumstances, regardless of their accounting categorisation.

The Level 3 PCR reflects all risks to beneficiaries, including contagion risk from non-APRA-regulated activities. Level 3 EC therefore must be fully loss-absorbing because it must cover all risks to beneficiaries. It cannot be increased through separation as the reduction in contagion risk has already been reflected in the Level 3 PCR and the remaining risks must be fully covered. As a consequence, the standards are unchanged and require full deduction of goodwill and other intangible assets regardless of their location in the group.

7.2.5 Equity holdings in third-party financial institutions

APRA proposed full deduction of equity holdings and other capital support provided by Level 3 institutions in the ADI, FM and OA blocks to third-party financial institutions.

Comments received

Submissions argued against the extension of the deduction to Level 3 institutions in the FM and OA blocks, in particular where these institutions are operationally separated or separable. As an alternative, it was proposed that the deduction for the FM and OA blocks be limited to exposures to third-party APRA-regulated institutions.

In relation to Additional Tier 1 and Tier 2 Capital holdings by Level 3 institutions in the FM and OA blocks, it was proposed as an alternative that a factor of 60 per cent be applied to the exposure prior to the deduction being made. This would be consistent with the 60 per cent factor applied to the notional 0.25 per cent of net funds in the FM block, where the 60 per cent factor was selected as being appropriate for a CET1 framework.

Submissions requested that APRA clarify whether the so-called ADI corresponding deduction approach is extended to Level 3. The corresponding deduction approach allows an ADI's investment in another financial institution's Additional Tier 1 or Tier 2 Capital instrument to be deducted from its own holdings of the corresponding category of capital, rather than from CET1 Capital.

Finally, submissions noted that in draft 3PS 111 only equity exposures held in other Level 3 institutions in the Level 3 group are excluded from the deduction. This implies that intra-group holdings of Additional Tier 1 and Tier 2 Capital instruments must be deducted. It was requested that APRA clarify its intention in this area.

APRA's response

The May 2013 response paper proposed to extend the deduction to Level 3 institutions in the FM and OA blocks to avoid double-counting of capital in the financial system and ensure that cross-holdings do not jeopardise the strength of the Australian financial system. A further concern is the potential for arbitrage where an ADI could indirectly invest in financial institutions through a related party in the FM or OA block. APRA remains of the view that where a Level 3 group invests in a financial institution, this investment must be deducted.⁷

Section 7.2.4 discusses why operational separation or separability should not impact on deductions from Level 3 EC.

In relation to the proposed 60 per cent factor for a deduction, APRA considers that such a partial deduction would not address its concerns as the recipient would be able to count 100 per cent of the investment as CET1 Capital, thereby creating double-counting of capital in the financial system.

An ADI with holdings of another financial institution's Additional Tier 1 or Tier 2 Capital instruments is not required to deduct these holdings from Level 3 EC if they are deducted at Level 1 or Level 2 from the ADI's Additional Tier 1 or Tier 2 Capital. This is clarified in 3PS 111.

APRA's intent is that intra-group holdings of Additional Tier 1 and Tier 2 Capital instruments are not required to be deducted. To this effect, APRA has generalised the exemption to refer to intra-group 'exposures' rather than intra-group 'equity exposures'.

7.3 Fair valuation

Draft 3PS 111, paragraph 11 proposed that a Level 3 group may measure its financial instruments at fair value for capital adequacy purposes provided it complies with Australian Accounting Standards.

⁷ Insurers are not required to deduct such investments. APRA's view is that this difference is appropriate due to the fundamental difference between the business models of ADIs and insurers.

Comments received

Respondents were unsure what 'financial instruments' were referred to as Level 3 EC excludes Additional Tier 1 and Tier 2 Capital instruments.

APRA's response

APRA considers that this paragraph is unnecessary, as Level 3 groups are able to apply fair value under Australian Accounting Standards, and has deleted it. However, APRA notes that it may require a Level 3 group to deduct any amount where APRA considers that fair values on the balance sheet are not prudent or reliable.

7.4 Genuine contribution to financial strength

Draft 3PS 111 stated that APRA may exclude from a Level 3 group's Level 3 EC any component of capital resulting from intra-group transactions that does not represent a genuine contribution to the financial strength of the group.

Comments received

Submissions noted that Level 3 EC is based on the consolidated accounts so that all intra-group transactions are eliminated. Respondents queried under what scenario APRA might apply the proposed provision.

APRA's response

The relevant paragraph is designed to capture any situation where Level 3 EC may be overstated due to intra-group capital transactions. It is primarily targeted at transactions with a wider conglomerate group to which a Level 3 group may belong. However, APRA does not discount the possibility that, in the future, it may encounter an intra-group capital transaction within the Level 3 group that it considers does not represent a genuine contribution to financial strength.

Chapter 8 – Public disclosure

In the May 2013 response paper, APRA proposed not to prescribe any public disclosure at this time but indicated that it would not prohibit Level 3 groups from publishing information relating to their Level 3 capital adequacy. APRA emphasised that it must review a Level 3 group's approach to such disclosures prior to their first release and whenever there are material changes to the group's disclosure approach. Importantly, the existing rules proscribing disclosure of Level 1 and Level 2 PCR and APRA supervisory adjustments (including at Level 3) remain in place.

APRA indicated that it would review its position on prescribing public disclosure at Level 3 once there is sufficient understanding of, and familiarity with, Level 3 capital information, including how it differs from Level 1 and Level 2 capital disclosures.

Comments received

It was requested that APRA release as soon as possible a list of Level 3 Heads in order to minimise market uncertainty.

APRA's response

APRA has identified eight APRA-regulated institutions that it intends to determine to be a Level 3 Head. This list will be updated as circumstances require. APRA will in due course publish a register of Level 3 Heads on its website, similar to the current registers in place for other APRA-regulated institutions.



Telephone
1300 55 88 49

Email
info@apra.gov.au

Website
www.apra.gov.au

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