



Prudential Standard GPS 111

Capital Adequacy: Level 2 Insurance Groups

Objective and key requirements of this Prudential Standard

This Prudential Standard aims to ensure that a Level 2 insurance group maintains an appropriate level of capital in order for APRA-authorized insurers within the group to remain financially sound and to ensure that policyholder interests are protected.

This Prudential Standard is to be read in conjunction with other capital standards applicable to Level 1 insurers. A Level 2 insurance group's capital adequacy assessment is essentially based on the same prudential requirements that apply to Level 1 insurers. Any additional or alternative prudential requirements for Level 2 insurance groups are specified in this Prudential Standard.

The key requirements of this Prudential Standard are that a Level 2 insurance group must:

- maintain minimum levels of capital determined according to the Internal Model-based Method or the Prescribed Method;
- determine its Minimum Capital Requirement having regard to a range of risk factors that may threaten the ability of any Level 1 insurer within the Level 2 group to meet policyholder obligations. Under the Prescribed Method, these are insurance risk, investment risk and concentration risk. A Level 2 insurance group using the Internal Model-based Method is expected to include at least these risks, but also all other relevant risk factors across the entire Level 2 insurance group, within its method of calculation;
- make certain public disclosures about its capital adequacy position; and
- seek APRA's approval for reductions in capital.

Authority

1. This Prudential Standard is made under section 32 of the *Insurance Act 1973 (the Act)*.

Application

2. This Prudential Standard applies¹ to each:
 - (a) **general insurer (insurer)**;
 - (b) authorised NOHC.; and
 - (c) **subsidiary** of an insurer or authorised NOHC that is **parent entity** of a Level 2 insurance group.
3. Insurers and authorised NOHCs must, ~~subject to paragraph 62~~, comply with this Prudential Standard from 1 December 2011 ~~31 March 2009~~ (**effective date**).
4. While *Prudential Standard GPS 110 Capital Adequacy (GPS 110)* sets out the framework for capital adequacy at **Level 1** (i.e. on an individual insurer basis), this Prudential Standard sets out the framework for capital adequacy at **Level 2** (i.e. on a consolidated insurance group basis). Unless otherwise specified in this Prudential Standard, the following **capital standards** apply to a Level 2 insurance group as if references to “insurer” in those standards were references to “Level 2 insurance group”:
 - (a) *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (GPS 112)*;
 - (b) *Prudential Standard GPS 113 Capital Adequacy: Internal Model-based Method (GPS 113)*;
 - (c) *Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge (GPS 114)*;
 - (d) *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Capital Charge (GPS 115)*; and
 - (e) *Prudential Standard GPS 116 Capital Adequacy: Concentration Risk Capital Charge (GPS 116)*.
5. In general, **Level 2 insurance groups** are subject to the same capital adequacy requirements as **Level 1 insurers**. Where Level 2 insurance groups are subject to additional or alternative prudential requirements, these requirements are specified in this Prudential Standard.

¹ Refer to sections 32 and 35 of the *Insurance Act 1973 (the Act)*.

6. Where a requirement is expressed to be imposed on a Level 2 insurance group in this Prudential Standard, the parent entity of the group must ensure that the group meets the requirement.

Interpretation

7. Unless otherwise defined in this Prudential Standard, expressions in bold are defined in *Prudential Standard GPS 001 Definitions (GPS 001)*.
8. For the purposes of this Prudential Standard **equity exposures** are as defined in Attachment A.
9. As a consequence of the key role played by capital in the financial strength of insurance groups, every Level 2 insurance group must maintain sufficient capital to enable the obligations of the group to be met under a wide range of circumstances. This required level of capital for regulatory purposes is referred to as the **Minimum Capital Requirement (MCR)**.

Definition of capital base

10. In assessing the adequacy of a Level 2 insurance group's capital base, attention must be paid not only to the types of events or problems that it might encounter, but also to the quality of the support provided by various types of capital instruments. The following matters are relevant to whether an instrument is suitable for capital adequacy purposes, namely the extent to which each instrument:
 - (a) provides a permanent and unrestricted commitment of funds;
 - (b) is freely available to absorb losses from business activities;
 - (c) does not impose any unavoidable servicing charges against earnings; and
 - (d) ranks behind the claims of policyholders and creditors in the event of the winding-up of an entity within the Level 2 insurance group.
11. Not all types of capital instruments meet these criteria equally. Due to the need to ensure that the capital base of a Level 2 insurance group provides adequate support for the group's operations, APRA imposes some restrictions on the composition of capital eligible to meet the MCR. The capital instruments deemed eligible for inclusion in an insurer's capital base, and the conditions as to their inclusion, are specified in GPS 112. GPS 112 defines the different categories and components of eligible capital and the limits applicable to each category of eligible capital. These requirements will apply to Level 2 insurance groups with some modifications as set out in paragraphs ~~47 46~~ to ~~63 61~~.
12. The consolidated balance sheet of a Level 2 insurance group may contain certain assets (such as deferred tax assets, goodwill and other intangibles) that are acceptable from an accounting perspective. However, for supervisory purposes, such assets are either generally not available, or of

questionable value, should the group encounter difficulties. Level 2 insurance groups are therefore required to deduct from their capital base any holdings in these types of assets. Details of these deductions are as specified in GPS 112 except where modified by this Prudential Standard.

13. Minority interests arising from consolidation of Tier 1 capital of controlled entities are to be treated as Fundamental Tier 1 capital for the purposes of determining the Level 2 insurance group's capital base.

14. For the purposes of determining the Level 2 insurance group's capital base, reserves from equity-settled share-based payments (shares or share options) granted to employees as part of their remuneration package may only be included in reserves if:

(a) paragraph 17(a) of GPS 112 is met; and

(b) the ordinary shares represent new ordinary shares to be issued by the parent entity of the Level 2 insurance group; or new ordinary shares already issued by the parent entity of the Level 2 insurance group for the specific purpose of equity-settled share-based remuneration.

~~14.~~15. A Level 2 insurance group must, at all times, maintain a capital base sufficient to enable its obligations to be met under a range of circumstances. A Level 2 insurance group must, at all times, hold eligible capital² in excess of its MCR. Where a Level 2 insurance group proposes any reduction in its capital base, it must obtain APRA's prior written consent.³

~~15.~~16. In determining its capital base, a Level 2 insurance group must ensure that the category of capital applied to each individual component of capital for each Level 1 insurer is not upgraded to a higher category of capital when that component of capital is captured in the measurement of the Level 2 insurance group's capital base. Any such component of capital must be reclassified to the appropriate lower category of capital when measured at Level 2.

~~16.~~17. For the purposes of paragraph 23 of GPS 112, 'financial year' of a Level 2 insurance group refers to the last two half-years for which the Level 2 insurance group was required to submit half-yearly returns⁴ to APRA preceding the date of the proposed payment of interest or dividend.

Responsibility for capital management

~~17.~~18. It is the responsibility of the Board of directors (**Board**) of the parent entity of a Level 2 insurance group to ensure that the group maintains a

² For further detail regarding the types of eligible components of capital, refer to *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital (GPS 112)*.

³ Refer to paragraphs ~~43 42~~ to ~~46 45~~.

⁴ In accordance with reporting standards made under the *Financial Sector (Collection of Data) Act 2001 (Collection of Data Act)*.

level and quality of capital commensurate with the risks to which the group is exposed.

~~18.~~19. In determining the appropriate level of capital for the Level 2 insurance group, the Board must have regard to:

- a) the potential for risk to compound across the group;
- b) concentration of capital and risk within individual entities in the group;
- c) guarantees and other commitments between entities in the group;
- d) the capital needs of individual entities in the group;
- e) the nature of capital held by the group, including its maturity, servicing costs and any double counting or upgrading of capital within the group; and
- f) the ability to readily transfer surplus or free capital within the group and the type of capital which would be available to individual entities from other group entities if required.

~~19.~~20. In order to ensure a Level 2 insurance group has sufficient capital to cover its risks and to meet its regulatory, insurance and strategic needs, the Board of the parent entity of the group must:

- (a) establish policies on group capital adequacy taking into account, but not limited to, the elements specified in paragraph 19 ~~18~~ of this Prudential Standard;
- (b) ensure that appropriate systems and procedures are in place to identify, assess, measure and monitor capital and group risks on a continuous basis; and
- (c) ensure that the group has sufficient capital freely available to meet unexpected losses and adverse shocks experienced by the group.

Minimum Capital Requirement (MCR)

~~20.~~21. A Level 2 insurance group's capital base must be adequate for the scale, nature and complexity of the business and its risk profile. To this end, this Prudential Standard establishes a risk-based approach to the measurement of capital adequacy of a Level 2 insurance group. The MCR is intended to be commensurate with the full range of risks to which the group is exposed (including risks relating to insurance claims, investments, counterparty default, asset-liability mismatches, catastrophic events, and operational errors and problems).

~~21.~~22. The MCR may be determined using either:

- (a) an internal model developed by the Level 2 group to reflect the circumstances of its business – the Internal Model-based (IMB) Method (refer to paragraph ~~26~~ ~~25~~);
- (b) the standardised framework detailed in this Prudential Standard – the Prescribed Method (refer to paragraphs ~~27~~ ~~26~~ to ~~40~~ ~~39~~); or
- (c) a combination of the methods specified in paragraphs (a) and (b).

~~22.23.~~ APRA recognises that any measure of the adequacy of a Level 2 insurance group's capital base involves judgement and estimation, and requires the quantification of risks that may be difficult to quantify. As a result, APRA may adjust a Level 2 insurance group's MCR where it believes that the amount determined using any of the methods specified in paragraph ~~22~~ ~~24~~ does not adequately reflect the risk profile of the group. In exercise of this discretion to adjust a Level 2 insurance group's MCR, APRA will have regard to the following:

- (a) the length of time the group has been operating substantially in its current form;
- (b) whether the group is in or appears likely to be in financial or operational difficulty;
- (c) whether the group is deemed by APRA to have a disproportionate exposure to a particular type of risk;
- (d) whether particular risks faced by the group are adequately dealt with by the prudential standards; and
- (e) any other relevant matters.

~~23.24.~~ In the normal course of business, a Level 2 insurance group must have in place group capital management processes. These must be set out in the group's Business Plan in accordance with *Prudential Standard GPS 221 Risk Management: Level 2 Insurance Groups (GPS 221)*.

~~24.25.~~ APRA may, by notice in writing, require a Level 2 insurance group to hold total eligible capital that exceeds the MCR determined in accordance with paragraphs ~~22~~ ~~24~~ and ~~23~~ ~~22~~ above by a specified proportion of that MCR. In exercise of this discretion APRA will have regard to the particular circumstances of the Level 2 insurance group, its approach to capital management and the factors set out in paragraph ~~23~~ ~~22~~.

Internal Model-based Method

~~25.26.~~ A Level 2 insurance group may develop an in-house capital model to assess the MCR for the group. Use of the IMB Method is conditional on APRA's approval and requires Level 2 insurance groups to satisfy a range of criteria, as set out in GPS 113 read with this Prudential Standard. Level 2 insurance groups which do not develop an internal model that

meets the criteria specified in GPS 113 must use the Prescribed Method described below.

Prescribed Method

~~26.27.~~ For Level 2 insurance groups using the Prescribed Method, the MCR will be determined as the sum of the capital charges for:

- (a) insurance risk;
- (b) investment risk; and
- (c) concentration risk.

Insurance risk

~~27.28.~~ The Insurance Risk Capital Charge relates to the risk that the actual value of net insurance liabilities is greater than the value determined according to *Prudential Standard GPS 311 Audit and Actuarial Reporting and Valuation: Level 2 Insurance Groups (GPS 311)*. The method for determining the Insurance Risk Capital Charge is set out in GPS 115.

~~28.29.~~ This capital charge has two components: a charge in respect of outstanding claims risk (**Outstanding Claims Capital Charge**); and a charge in respect of premiums liability risk (**Premiums Liability Capital Charge**). Outstanding Claims Capital Charge and Premiums Liability Capital Charge are as defined in GPS 110 and GPS 115, except that references to *Prudential Standard GPS 310 Audit and Actuarial Reporting and Valuation (GPS 310)* are to be read as references to GPS 311 in the context of a Level 2 insurance group.

~~29.30.~~ If a Level 2 insurance group securitises insurance liabilities, the net insurance liabilities may reduce. The Level 2 insurance group must consult APRA prior to entering into a material securitisation transaction in order to be able to assess the Insurance Risk Capital Charge and the Concentration Risk Capital Charge.⁵

Investment risk

~~30.31.~~ The Investment Risk Capital Charge relates to the risk of adverse movements in the value of a Level 2 insurance group's assets or off-balance sheet exposures or both. Investment risk can be derived from a number of sources, including market risk and credit risk.

~~31.32.~~ Subject to paragraphs ~~33 32~~ to ~~37 36~~, the Investment Risk Capital Charge is determined as the value of each investment multiplied by the relevant Investment Capital Factor for that investment, summed across all assets and certain off-balance sheet exposures. For the purposes of this

⁵ Consultation with APRA is only required where the securitisation transactions are material to the Level 2 insurance group. Materiality levels are to be agreed between APRA and the Level 2 insurance group.

Prudential Standard, assets and exposures must be valued according to the relevant reporting standards made under the *Financial Sector (Collection of Data) Act 2001 (Collection of Data Act)*. The method for determining the Investment Risk Capital Charge is set out in GPS 114.

~~32.33.~~ The following adjustments to GPS 114 must be made in relation to any entities within the Level 2 insurance group carrying on **international business** for the purposes of determining the MCR of the group:

- (a) the investment capital factors set out in GPS 114 that apply specifically to reinsurance assets receivable from non-APRA authorised reinsurers do not apply in respect of those entities; and
- (b) the investment capital factors referable to reinsurance recoverables from APRA-authorized reinsurers must be substituted for all reinsurance assets of those entities.

The reinsurance recoverables on international business will, in effect, attract an investment risk capital charge according to the capital factors which apply to reinsurance recoverables from APRA-authorized reinsurers.

~~33.34.~~ The Investment Risk Capital Charge may reduce through the reduction in investment risk arising from the availability of risk mitigants (e.g. collateral security or guarantees), subject to the criteria specified in GPS 114.

~~34.35.~~ When calculating the investment risk capital charge, paragraphs 27 and 28 of GPS 114 do not apply to the international business of the Level 2 insurance group.

~~35.36.~~ A Level 2 insurance group must hold additional capital, in the form of an Investment Concentration Charge, if its exposure to a particular asset or counterparty exceeds the thresholds set out in GPS 114. In respect of any overseas entities within the group carrying on insurance business, identification of asset or counterparty exposures is to be carried out on a best endeavours basis using information held by entities within the Level 2 insurance group, or otherwise publicly available information, in a manner consistent with the group's documented credit risk management policies.

~~36.37.~~ If a Level 2 insurance group securitises assets, the group must consult APRA prior to entering into a material securitisation transaction in order to be able to reduce the Investment Risk Capital Charge.⁶

Concentration risk

~~37.38.~~ At a minimum, the Concentration Risk Capital Charge relates to the risk associated with an accumulation of exposures to a single catastrophic

⁶ Consultation with APRA is only required where the securitisation transactions are material to the level 2 insurance group. Materiality levels are to be agreed between APRA and the Level 2 insurance group.

event at a single site. However, APRA will require a whole of portfolio approach to be implemented by a Level 2 insurance group where APRA assesses that the single event approach is inadequate in evaluating that group's reinsurance needs. If this is required of a Level 2 insurance group and it does not comply with the requirement, the group's MCR may be increased in accordance with paragraph ~~23~~ ~~22~~. The method for determining the Concentration Risk Capital Charge is set out in GPS 116 as read with this Prudential Standard.

~~38~~~~39~~. The Concentration Risk Capital Charge is set equal to the Level 2 insurance group's Maximum Event Retention (MER), plus the cost of one reinstatement of the catastrophe reinsurance cover in cases where the reinstatement reinsurance cover has not been pre-paid by the group. APRA will monitor a Level 2 insurance group's calculation of its MER and may, where it is not satisfied with the methods or assumptions used, allow or require adjustments to be made to the calculation.⁷

~~39~~~~40~~. In calculating the MER, a Level 2 insurance group may take into account:

- (a) potential reinsurance recoverables ~~assets~~ receivable from a reinsurance arrangement of a Level 1 insurer within the group only if the reinsurance arrangement:
 - (i) complies with the two month rule and six month rule imposed under *Prudential Standard GPS 230 Reinsurance Management (GPS 230)*; or
 - (ii) fails to comply with those rules as at the date of the relevant deadline⁸ but:
 - (A) subsequent to the deadline specified under the two month rule, the reinsurance arrangement is documented in accordance with the other requirements of the two month rule (in which case the reinsurance recoverables ~~assets~~ from the reinsurance arrangement may be taken into account for the purposes of calculating the MER until the reinsurance arrangement fails to comply with the six month rule); or
 - (B) subsequent to the deadline specified under the six month rule, the reinsurance arrangement is documented in accordance with the other requirements of the six month rule; or
 - (iii) has been treated by APRA, under GPS 230, as complying with the two month rule and six month rule;

⁷ Exercising the power under paragraph 22 of *Prudential Standard GPS 116 Capital Adequacy: Concentration Risk Capital Charge (GPS 116)*.

⁸ Refer to the 'two month rule' and 'six month rule' under paragraphs 38 and 39 respectively in *Prudential Standard GPS 230 Reinsurance Management (GPS 230)*.

- (b) potential reinsurance recoverables ~~assets~~ receivable from a reinsurance arrangement of any other consolidated entity within the group carrying on insurance business in a foreign jurisdiction unless the reinsurance arrangement fails to comply with requirements for documentation of reinsurance contracts applicable in that jurisdiction; and
- (c) inwards reinstatement premiums provided that contractually binding netting arrangements are in place and that the reinstatement premiums relate to the event that creates the Level 2 insurance group's MER.

Disclosure

~~40.~~41. To improve policyholder and market understanding of the group's capital adequacy position, a Level 2 insurance group must publish annually the following items:

- (a) the amount of eligible Tier 1 capital, with separate disclosure of each of the components specified in GPS 112;
- (b) the aggregate amount of any deductions from Tier 1 capital;
- (c) the amount of eligible Tier 2 capital, with separate disclosure of each of the components specified in GPS 112;
- (d) the aggregate amount of any deductions from Tier 2 capital;
- (e) the total capital base of the group derived from the items (a) to (d);
- (f) the MCR of the group; and
- (g) the capital adequacy multiple of the group (item (e) divided by item (f)).⁹

~~41.~~42. Compliance with paragraph ~~41~~ 40 by Level 2 insurance groups does not replace the obligation of Level 1 insurers to comply with the disclosure requirements of GPS 110. However, the parent entity of the Level 2 insurance group may make the disclosures required by GPS 110 on behalf of each Level 1 insurer within the group.

Reductions in capital

~~42.~~43. A Level 2 insurance group must seek APRA's written approval before making a reduction in its capital. APRA's approval may be subject to conditions.

~~43.~~44. A reduction in a Level 2 insurance group's capital includes, but is not limited to:

- (a) share buybacks in relation to the parent entity's shares;

⁹ The different categories of capital referred to in this paragraph are defined in GPS 112.

- (b) the redemption, repurchase or early repayment of any qualifying Tier 1 and Tier 2 capital instruments issued by the parent entity or an SPV;
- (c) trading in the parent entity's shares or capital instruments (refer to paragraph ~~28~~ 29 of GPS 112);
- (d) payment of dividends on ordinary shares that exceeds the group's after-tax earnings, after including any payments on more senior capital instruments issued by the Level 2 insurance group, in the financial year¹⁰ to which they relate; or
- (e) dividend or interest payments (whether whole or partial) on Upper Tier 2, Innovative Tier 1 and Non-innovative Residual Tier 1 capital that exceed the group's after-tax earnings, including any payments made on more senior capital instruments issued by the Level 2 insurance group, calculated before any such payments are applied in the financial year¹¹ to which they relate.

~~44.45.~~ A Level 2 insurance group proposing a capital reduction must provide APRA with a forecast showing the projected future capital position after the proposed capital reductions. The forecast must extend for at least three years.

~~45.46.~~ Any reference to the earnings or retained earnings of a Level 2 insurance group in paragraph ~~44~~ 43 is a reference to the earnings or retained earnings of the group determined in a manner consistent with the group's prudential reporting to APRA under the Collection of Data Act. ~~rather than in accordance with Australian Accounting Standards as required for statutory financial reporting under the Corporations Act.~~

Intra-group capital transactions¹²

~~46.47.~~ APRA may require a Level 2 insurance group to exclude from its capital base any component of capital which APRA has reasonable grounds to believe does not represent a genuine contribution to the financial strength of the Level 2 insurance group. The matters APRA may consider in assessing whether a component of capital does not represent a genuine contribution to financial strength include, but are not limited to, whether a component of capital:

- (a) is clearly supplied from debt raised from other group members;
- (b) results from intra-group transactions with no economic substance;

¹⁰ "Financial year", for these purposes, refers to the last two six monthly periods for which the Level 2 insurance group was required to submit semi-annual returns according to reporting standards made under the Collection of Data Act. For the avoidance of doubt, the definition of "Financial year" in GPS 001 does not apply for these purposes.

¹¹ As defined in the footnote above.

¹² A Level 2 insurance group may be contained within a wider corporate group as defined in the Corporations Act. Paragraph ~~47~~ 46 relates to transactions between the Level 2 insurance group and this wider corporate group. Paragraph 50 relates to all transactions within the Level 2 insurance group and also with the wider corporate group.

- (c) is contributed by a member of the group using funding sourced, directly or indirectly, from the recipient group member; or
- (d) is contributed by a group member and the funding of which contains cross-default clauses that would be triggered as a result of the recipient group member failing to meet any servicing obligations.

47.48. In assessing the overall capital strength of a Level 2 insurance group, APRA will have regard to the ability of the parent entity to readily transfer capital from entities within the consolidated Level 2 insurance group should the need arise to recapitalise the parent entity or any group entity. In the event that capital support from within the group is not available, APRA may require the parent entity of the Level 2 insurance group to adjust its MCR to reflect the lack of available capital.

48.49. The parent entity of a Level 2 insurance group, in measuring the group's capital, must exclude any instrument issued by an entity in the Level 2 insurance group where that instrument is guaranteed by another member of the group. This does not apply to guarantees of capital issued by Special Purpose Vehicles (SPVs) in accordance with the requirements of GPS 112.¹³

50. In assessing the overall capital strength of a Level 2 insurance group, APRA may request that a Level 2 insurance group provide APRA with details of its intra-group exposures, including capital transactions and intra-group guarantees. The information on intra-group exposures would typically include details of all intra-group exposures provided by the parent entity of the Level 2 insurance group. APRA may also request details of material exposures between entities controlled by the parent entity.

Holding of shares in group members by other group members

49.51. Capital instruments¹⁴ of the parent entity of a Level 2 insurance group or of a controlled entity within the group that are held as direct investments by a vehicle¹⁵ subject to consolidation within the group's **accounts** may be included in Tier 1 capital and Tier 2 capital only if:

- (a) the parent entity (or other group entity) did not fund the acquisition of the capital instrument;
- (b) the risk and rewards associated with the investments are borne primarily by third parties; and
- (c) the parent entity of the group can demonstrate to APRA, if required, that decisions to acquire or sell such capital instruments are made

¹³ Refer to GPS 112 under 'Criteria for capital issues involving the use of SPVs'.

¹⁴ Capital instruments include ordinary shares and other capital instruments eligible to be included in Tier 1 or Tier 2 capital.

¹⁵ These vehicles exclude any SPV such as a trust involved with employee share-based remuneration.

independently of the issuer of the capital instruments and in the interests of the third parties who primarily bear the risks and rewards of the investments in the instruments.

~~50.~~52. Direct investments in shares of an insurer, or an entity that carries on international business within a Level 2 insurance group, by an SPV (e.g. trust) established under a share-based employee remuneration scheme may only be included in a Level 2 insurance group's Tier 1 capital where they satisfy the requirements specified in GPS 112.¹⁶ When calculating the capital of the Level 2 insurance group, the SPV holding shares must be excluded from the consolidated group. As a consequence, any associated change in the fair value of shares held by an SPV must be excluded from both the group's capital and the assets subject to a risk charge.

Capital support

~~51.~~53. For the purposes of determining whether an instrument constitutes capital support, including a guarantee provided to a related party, APRA will have regard to, amongst other things, whether:

- (a) the facility represents a recognised capital instrument or is otherwise accepted as standing in place of capital required to be held by a related entity; or
- (b) the provider of the facility, in terms of either repayment or maturity, ranks below other senior unsecured or unsubordinated creditors, or
- (c) the facility is provided by an insurer or other group entity and the funding provided flows through one group entity (including any SPV) to another group entity and the funding received by the second entity meets either (a) or (b).

~~52.~~54. In the event that a facility covered in paragraph ~~53~~ 54 represents a form of capital support, it must be considered for the purposes of this Prudential Standard to form part of the Level 2 insurance group's "**other capital investments**". In the event that such investments are not deducted from Tier 1 capital or Tier 2 capital, they attract an investment risk capital charge of 20 per cent.

Deductions from a Level 2 insurance group's capital base

~~53.~~55. For the purposes of calculating its capital base, a Level 2 insurance group must deduct from its capital base:

- (a) any items specified as capital deductions in GPS 112 applicable at Level 1 read with this Prudential Standard except for those items mentioned in paragraph ~~56~~ 54; and
- (b) any other items specified as capital deductions in this Prudential Standard.

¹⁶ Refer to GPS 112 under 'Holding of shares in insurer by special purpose vehicle (SPV)'.

~~54.56.~~ Deductions relating to the reinsurance documentation test and governing law requirements ~~and the premiums receivable deduction~~ arising from the operations of any consolidated entity within a Level 2 insurance group carrying on insurance business in a foreign jurisdiction, need not be made unless such a deduction is required in that jurisdiction.

~~55.57.~~ In applying the capital deductions in GPS 112 in conjunction with this Prudential Standard to a Level 2 insurance group, the group must deduct any surplus, net of deferred tax liabilities, in any defined benefit superannuation fund of which an insurer or other group entity is an employer-sponsor unless otherwise approved by APRA. Any excluded surplus must reverse any associated deferred tax liability from Tier 1 capital.

~~56.58.~~ The capital deduction in GPS 112 relating to any deficit after taking into account adjustments in the amount available in the respective revaluation reserves for investments in controlled entities not held at fair value does not apply to a Level 2 insurance group as the assets of controlled entities are consolidated for Level 2 insurance groups.

~~57.59.~~ Equity exposures and other capital investments¹⁷ in non-consolidated subsidiaries or controlled entities, whether regulated or unregulated, must be deducted 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital subject to the materiality of the controlled entity (to be determined in consultation with APRA).¹⁸ This deduction does not apply to a controlled entity, where it acts as a holding company for pass-through of equity exposures and other capital investments in Level 1 insurers or equivalent overseas entities carrying on insurance business. In the event that a controlled entity holds equity exposures and other capital investments in controlled entities not eligible for consolidation, the Level 2 insurance group must deduct its equity exposures and other capital investments in the holding company net of the value of the holding company's investment in any Level 1 insurer or equivalent overseas entities carrying on insurance business.

~~58.60.~~ Goodwill and any other intangible component of the investments in non-consolidated subsidiaries must be deducted from the group's Tier 1 capital at Level 2.

Undercapitalised non-consolidated subsidiaries

~~59.61.~~ APRA may require a Level 2 insurance group to deduct from capital an amount to cover the undercapitalisation¹⁹ of a non-consolidated

¹⁷ As defined in paragraphs ~~53 54~~ and ~~54 52~~.

¹⁸ Paragraph ~~60 58~~ of this Prudential Standard requires the goodwill component of these investments to be deducted from Tier 1 capital. This deduction is to be performed prior to deducting the (remaining) value of the investment from Tier 1 and Tier 2 capital as required under paragraph ~~59 57~~.

¹⁹ The adequacy of capital levels of non-consolidated subsidiaries must be assessed by the Level 2 insurance group in the first instance. Details of this assessment must be included in the group's business plan.

subsidiary of the parent entity of the Level 2 insurance group, as determined by APRA.²⁰ Any such deduction must be made 50 per cent from Tier 1 capital and 50 per cent from Tier 2 capital. The matters APRA may consider in determining the extent of undercapitalisation of a non-consolidated subsidiary of the parent entity of the group include, amongst other things, the:

- (a) Level 2 insurance group's own assessment of the adequacy of capital levels of non-consolidated subsidiaries;
- (b) size and scale of the operations of the non-consolidated subsidiary;
- (c) materiality of the controlled entity's operations to group income and strategic outlook;
- (d) level of net tangible assets of the controlled entity;
- (e) where the controlled entity is prudentially supervised in a foreign jurisdiction, the local minimum capital requirement;
- (f) risk profile of the controlled entity;
- (g) level of exposure of the Level 2 insurance group to the controlled entity; and
- (h) size of any identified capital shortfall and the likelihood of such a shortfall being remedied in the near future.

General rules for deductions

~~60.62.~~ All amounts of assets corresponding to deductions from capital of the Level 2 insurance group attract a zero investment risk charge applied to them when determining the total investment risk capital charge for the Level 2 insurance group.

~~61.63.~~ A Level 2 insurance group that does not hold sufficient capital to absorb required deductions from Tier 2 capital must deduct an amount equivalent to the shortfall in its Tier 2 capital from its Tier 1 capital.

Transition, adjustments and exclusions

~~62. APRA may grant a period of transition to a Level 2 insurance group by determining a later effective date for this Prudential Standard for the group where the parent entity has applied for such transitional relief. The effective date determined by APRA will be no later than 31 December 2009.~~

~~63. APRA may grant transitional relief, where the parent entity so applies, from the obligation for a Level 2 insurance group to comply with any requirement in this Prudential Standard up to 31 December 2009.~~

²⁰ This requirement will only apply where APRA considers the non-consolidated subsidiary to be material.

64. APRA may approve a capital instrument for inclusion in the capital base of a Level 2 insurance group if APRA is of the opinion that it is appropriate to do so having regard to features of the instrument and the extent to which it meets the Level 1 requirements for the relevant category of capital at the time of issue.
65. On the application of a Level 2 insurance group, APRA may by notice in writing to the parent entity of the Level 2 insurance group adjust or exclude a specific prudential requirement in this Prudential Standard in relation to that Level 2 insurance group.

Determinations made under previous prudential standards

66. An exercise of APRA's discretion (such as an approval, waiver or direction) under a previous version of this Prudential Standard continues to have effect as though exercised pursuant to a corresponding power (if any) exercisable by APRA under this Prudential Standard. For the purposes of this paragraph, 'a previous version of this Prudential Standard' includes *Prudential Standard GPS 111 Capital Adequacy: Level 2 Insurance Groups* made on 17 December 2008.

Attachment A

Equity exposures

1. Equity exposures include ownership interests, both direct and indirect,²¹ whether voting or non-voting, in the assets and income of entities, including commercial enterprises and financial institutions. Equity exposures are defined on the basis of their economic substance and include instruments that meet the following criteria:
 - (a) the instrument is irredeemable in that the realisation of invested funds can be achieved only by the sale of the investment, the sale of the rights to the investment or by the liquidation of the issuer; and
 - (b) the instrument does not embody an obligation of the issuer.
2. Debt obligations and other securities, units in trusts derivatives or other instruments structured with the intent or effect of conveying the economic substance of equity ownership must be treated as equity exposures. This includes options and warrants on equities and short positions in equity securities. In addition, if a debt instrument is convertible into equity at the option of a Level 2 insurance group, it should be deemed equity on conversion. If such an instrument is convertible at the option of the issuer or automatically by the terms of the instrument, it should be categorised by the Level 2 insurance group as equity from inception.
3. Instruments with returns directly linked to equities should be characterised as equity exposures.
4. Equity instruments that are structured with the intent of conveying the economic substance of debt holdings are not required to be treated as equity exposures.

²¹ Indirect equity interests include holdings of derivative instruments tied to equity interests and holdings in corporations, partnerships, limited liability companies, trusts or other types of entities that issue ownership interests and are engaged principally in the business of investing in equity instruments.