Response to Submissions

Review of capital standards for general insurers and life insurers

10 October 2012

Preamble

APRA has now completed a significant review of its capital standards for general insurers and life insurers.

Consultation on the capital framework commenced with the release of a discussion paper in May 2010 and three technical papers in the third quarter of 2010. There have been three subsequent rounds of consultation and two quantitative impact studies. In March 2012, APRA released a consultation letter on the illiquidity premium for life insurers. In May 2012, APRA released final capital prudential standards except for the composition of capital base prudential standards. These composition of capital base standards, along with non-capital prudential standards, were released in draft form in May 2012.

This response paper sets out APRA's final response in relation to the composition of capital base prudential standards as well as other refinements to the prudential standards. Accompanying this paper are the final prudential standards that become effective on 1 January 2013.

This response paper and the suite of final prudential standards are available on APRA's website at: www.apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-October-2012.aspx

Contents

Glossary

ADI	An authorised deposit-taking institution under the *Banking Act 1959*
APRA	Australian Prudential Regulation Authority
Additional Tier 1 Capital	Capital instruments that provide loss-absorption, but that do not satisfy all of the criteria for inclusion in Common Equity Tier 1 Capital.
Appointed Actuary	The actuary appointed under the *Life Insurance Act 1995* or the *Insurance Act 1973*
Capital base	The capital that is eligible under the relevant prudential standards for meeting the Prudential Capital Requirement.
Common Equity Tier 1 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.
Friendly society	A friendly society as defined in the *Life Insurance Act 1995*
General insurer	A general insurer authorised under the *Insurance Act 1973*
Insurer	A general insurer or a life insurer
Level 2 insurance group	A consolidated general insurance group headed by either an APRA-authorised Level 1 insurer or an APRA-authorised non-operating holding company and including all general insurance controlled entities.
Life insurer	A life company, including friendly societies, registered under the *Life Insurance Act 1995*[1]
Non-capital prudential standards	The relevant prudential standards with amendments that are consequential to the proposed capital framework.
Prudential Capital Requirement	The required level of capital for regulatory purposes. It is determined as the prescribed capital amount plus any Pillar 2 supervisory adjustment.
Prescribed capital amount	The capital amount determined in accordance with the quantitative rules as set out in the prudential standards, including any Pillar 1 supervisory adjustment, but before any Pillar 2 supervisory adjustment is applied.
Supervisory adjustment	An adjustment that APRA may require to the required capital of a life insurance fund, life company or general insurer. A Pillar 1 supervisory adjustment forms part of the prescribed capital amount. A Pillar 2 supervisory adjustment is separate from the prescribed capital amount.
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 provides loss-absorption, but that do not satisfy the criteria for Common Equity Tier 1 Capital or Additional Tier 1 Capital.

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

Executive summary

APRA has now completed its review of capital standards for general insurers and life insurers. The aims of the review were to:

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

This paper provides APRA's final response on the review of the prudential standards for general insurers and life insurers. Released with this paper are the final versions of all the prudential standards[2].

Consultation with industry

Consultation on the capital framework commenced with the release of a discussion paper in May 2010 and three technical papers in the third quarter of 2010. There have been three subsequent rounds of consultation and two quantitative impact studies. In addition, APRA undertook a consultation in June 2012 and August 2012 on the revised reporting framework to reflect the revised capital framework.

Over the consultation period, APRA received more than 140 written submissions and more than 100 insurers participated in the quantitative impact studies. Submissions consistently indicated a broad level of support for APRA's aims in undertaking the review and APRA has refined its approach in a number of areas to address issues raised in submissions.

Recent communication with industry

On 12 September 2012, APRA commenced consultation with life insurers[3] regarding temporary solvency standard requirements (*Prudential Standard LPS 100 Solvency Standard* (LPS 100)) that will be required until the *Life Insurance Act 1995* is amended, as proposed by the Government. Further information can be found in Section 9.3.2 of the Government's consultation paper *Strengthening APRA's Crisis Management Powers*[4]. Consultation on LPS 100 will close on 12 October 2012. APRA will review submissions and release a final version of LPS 100 in November 2012.

On 27 September 2012, APRA commenced consultation with general insurers and life insurers on two draft prudential practice guides (PPGs) and a draft information paper[5]. The PPGs provide guidance on good practice and cover the Internal Capital Adequacy Assessment Process (ICAAP) and supervisory review and insurance concentration risk for general insurers.

The information paper provides insurers with additional information to assist in the calculation of the Asset Risk Charge.

Submissions on the draft PPGs and draft information paper close on 21 December 2012.

2 Except for *Prudential Standard LPS 100 Solvency Standard* that is currently under consultation with life insurers, as set out further below.

3 http://www.apra.gov.au/CrossIndustry/Consultations/Documents/120912_LAGIC_letter_life_insurance_temporary_solvency_standard.pdf

4 http://www.treasury.gov.au/ConsultationsandReviews/Submissions/2012/APRA

5 http://www.apra.gov.au/CrossIndustry/Consultations/Pages/LAGIC-Prudential-Practice-Guides-September-2012.aspx

Final prudential standards

APRA has made a number of amendments to *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112) and *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112) in response to submissions made on the May 2012 consultation package. The amendments also reflect changes as a result of APRA's response paper on implementing Basel III capital reforms for authorised deposit-taking institutions (ADIs)[6]. Further details on the amendments to these prudential standards can be found in Chapter 2.

In addition, APRA received some feedback on the other capital and non-capital standards released in May 2012. Minor amendments have been made to these standards to address comments in submissions and to improve clarity. Further details on the amendments can be found in Chapter 3 (for general insurers and Level 2 insurance groups) and Chapter 4 (for life insurers).

In May 2012, APRA indicated its intention to make a small number of minor amendments to the cross-industry prudential standards to reflect the amendments to the general insurance prudential standards. APRA has made those amendments and has also taken the opportunity to align the structure of these prudential standards with the other prudential standards applicable to insurance, banking and superannuation.

With the exception of LPS 100, all prudential standards that give effect to the revised capital framework for general and life insurers have been released with this response paper. Appendices 1 and 2 set out the prudential standards that become effective on 1 January 2013 for general insurers and life insurers, respectively.

Next steps

At the end of October 2012, APRA will release a response to submissions and the final reporting forms and instructions for the revised reporting framework.

The new capital framework will be effective from 1 January 2013, with the first reporting under the revised framework commencing in 2013 for reporting periods ending on or after 1 January 2013.

APRA expects to issue the final PPGs and information paper in the first quarter of 2013.

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

Chapter 1 – Introduction

1.1 Background

APRA commenced its review of the capital standards with the release of a discussion paper in May 2010. This paper indicated that the main objectives of the review were to:

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

Subsequent to the discussion paper, APRA released three technical papers (July and September 2010), three response papers (March 2011, December 2011 and May 2012) and two quantitative impact studies (August 2010 and April 2011). With the exception of the composition of capital base prudential standards for general insurers, APRA released draft capital prudential standards in December 2011. The composition of capital base and non-capital prudential standards were released in draft form in May 2012.

APRA also released a letter on the illiquidity premium to life insurers (March 2012) and two draft PPGs and an information paper to all insurers (September 2012). In addition, APRA undertook consultation in June 2012 and August 2012 on the revised reporting framework to reflect the revised capital framework.

Over the consultation period, APRA received over 140 written submissions and more than 100 insurers participated in the quantitative impact studies. Over the same period, APRA met with a number of insurers and other stakeholders to discuss its proposals and the feedback provided in submissions. APRA also held workshops to discuss implementation issues.

Submissions consistently indicated a broad level of support for APRA's aims in undertaking the review and APRA has refined its approach in a number of areas to address issues raised in submissions. The submissions received in the latest round of consultation focused on the composition of capital base prudential standards and also raised a small number of minor issues with the remaining suite of prudential standards.

1.2 Composition of the capital base

In May 2012, APRA released for consultation draft GPS 112 and draft LPS 112. These draft prudential standards were broadly aligned with draft *Prudential Standard APS 111 Capital Adequacy: Measurement of Capital* (draft APS 111) that was released for consultation for ADIs in March 2012. Draft GPS 112 and LPS 112 included a number of insurance-specific amendments, which were outlined in the December 2011 and May 2012 response papers.

APRA received a number of submissions on the draft prudential standards (APS 111, GPS 112 and LPS 112), which have been considered concurrently by APRA and amendments have been made in a number of areas. The final position is consistent across the three industries, except where it is appropriate for APRA to maintain insurance-specific differences.

Further detail on APRA's response to submissions regarding the composition of the capital base is set out in Chapter 2.

1.3 Other prudential standards

In May 2012, APRA also released a suite of final capital prudential standards (except composition of the capital base), updated drafts of the definitions standards and drafts of non-capital prudential standards. As a result of feedback received, APRA has made a small number of minor amendments to these capital and non-capital prudential standards. Final versions of the full suite of prudential standards have been released with this paper. Further details on the amendments to these prudential standards are set out in Chapter 3 for general insurers and Level 2 insurance groups and Chapter 4 for life insurers.

1.4 Cross-industry prudential standards

In the May 2012 response paper, APRA also indicated its intention to make a small number of minor amendments to the cross-industry prudential standards[7]. These proposed changes were to update footnotes that made reference to general insurance prudential standards that will be amended as part of the capital review.

In conjunction with these updates, APRA has taken the opportunity to make a small number of other minor amendments to the cross-industry prudential standards to align the structure of these standards with the other prudential standards applicable to insurance, banking and superannuation. There has been no change to the prudential requirements in these standards.

Final versions of these cross-industry prudential standards have been released with this paper.

1.5 Timetable

The remaining milestones in the review of the capital framework for insurers are:

- release of response to submissions and final reporting forms and instructions – end October 2012;
- release of LPS 100 – November 2012;
- consultation closes on draft PPGs and information paper – 21 December 2012; and
- release of final PPGs and information paper – quarter 1, 2013.

1.6 Structure of this paper

Chapter 2 sets out APRA's response to the main issues raised in submissions on the May 2012 consultation package in relation to the composition of the capital base. This chapter is applicable to general insurers, Level 2 insurance groups and life insurers. Chapter 3 discusses the issues raised in submissions on the prudential standards applicable to general insurers and Level 2 insurance groups. Chapter 4 discusses the issues raised in submissions on prudential standards applicable to life insurers. Appendices 1 and 2 set out the prudential standards that become effective on 1 January 2013 for general insurers and life insurers, respectively.

7 These cross-industry prudential standards are *Prudential Standard CPS 231 Outsourcing*, *Prudential Standard CPS 232 Business Continuity Management*, *Prudential Standard CPS 510 Governance* and *Prudential Standard CPS 520 Fit and Proper.*

Chapter 2 – Composition of the capital base

In May 2012, APRA released for consultation draft GPS 112 and LPS 112 detailing APRA's approach to the measurement and composition of the capital base for insurers. These draft prudential standards aligned the composition of the capital base to the requirements for ADIs, as detailed in draft APS 111 that was released for consultation in March 2012. The insurance prudential standards contained a number of industry-specific amendments to reflect the nature of insurance business. These amendments were outlined in the response papers issued in December 2011 and May 2012.

APRA received a number of submissions from the ADI and insurance industries in response to the draft prudential standards and these submissions have been considered concurrently by APRA. This chapter discusses the key amendments made to GPS 112 and LPS 112 in response to submissions. APRA has also made a small number of minor, technical amendments to GPS 112 and LPS 112 to ensure clarity of the prudential requirements or to enhance readability. The final policy position is consistent across the three industries, except where it is appropriate for APRA to maintain insurance-specific differences.

2.1 Common Equity Tier 1 Capital: dividend reinvestment plans and bonus option plans

APRA proposed declared dividends be deducted from current year earnings for the purposes of Common Equity Tier 1 Capital.

Comments received

A number of submissions raised concerns that APRA's draft prudential standards did not allow dividend reinvestment plans (DRPs) or bonus option plans (BOPs) to be offset against declared current year dividends. The concern was that APRA's approach would distort the capital position for the period between dividend declaration date and the date shares are issued under DRPs/BOPs. Submissions suggested that this capital volatility could be addressed by allowing expected DRP take-up to be reflected in the capital base on the DRP announcement date, followed by an adjustment once the final DRP participation rate is known on the record date. This would allow recognition of dividends and DRPs within the same reporting quarter.

APRA's response

APRA has revised its position to allow new shares purchased under DRPs to offset declared dividends. The estimated take-up rate for DRPs must be agreed in advance with APRA and reviewed semi-annually. Where there is a material departure from the estimated level of subscription, an insurer is required to notify and agree with APRA a revised future DRP take-up rate for regulatory capital purposes.

APRA's policy to allow DRPs to be recognised is based on the assumption that DRPs result in an increase of capital. This can only occur where dividend payments that would otherwise be made are used to fund new shares, not to purchase existing ones. APRA has therefore included in GPS 112 and LPS 112 a condition that DRPs may only be recognised where new shares are issued and additional capital is generated.

In APRA's view, BOPs are not relevant for offsetting dividends as no new capital is generated.

2.2 Additional Tier 1 Capital and Tier 2 Capital: incentives to redeem

Draft GPS 112 and LPS 112 prohibit Additional Tier 1 Capital and Tier 2 Capital instruments from including provisions that operate as incentives to redeem the instruments.

Comments received

This prohibition prompted a number of submissions as to whether particular features would constitute such an incentive. Submissions queried:

- APRA's proposal to disallow a call date less than two years prior to a mandatory conversion. One submission suggested that this period should be reduced to six months while another proposed aligning it with coupon payment dates. A further suggestion was that APRA retain the two-year moratorium but consider each call request on a case-by-case basis;
- whether an instrument can include contractual provisions under which, in a change of control event, an insurer that does not exercise a right to redeem must instead convert the instrument into ordinary shares; and
- the factors that APRA will consider in determining whether a replacement instrument with a higher credit spread is an incentive to redeem.

APRA's response

APRA remains of the view that there should be a clearly defined period between a call date and a conversion date in order for the call option not to be, in substance, an incentive to redeem. APRA does not accept that a period shorter than two years is appropriate.

In APRA's view, a right to convert where an insurer has an option to redeem (whether on a change of control event or otherwise) constitutes an incentive to redeem and is therefore prohibited.

In general, APRA does not consider it prudent to attempt to pre-define instrument characteristics that provide an 'incentive to redeem'. APRA will continue to make this determination on a case-by-case basis.

2.3 Additional Tier 1 Capital and Tier 2 Capital: calls or conversion within five years

Draft GPS 112 and LPS 112 only allow Additional Tier 1 Capital and Tier 2 Capital to be called within five years of issue for tax or regulatory events (subject to supervisory approval).

Comments received

A number of respondents sought APRA's confirmation that a change in accounting standards constitutes a regulatory event. Clarification was sought, firstly, as to whether conversion into Common Equity Tier 1 Capital within the first five years as a result of a change of control event is permitted and, secondly, as to whether an insurer could call an instrument on a change of control event within five years where this could be achieved without affecting the insurer's capital position.

APRA's response

A primary objective of APRA's amendments to the composition of the capital base is to improve the quality of regulatory capital. Allowing capital instruments to be called within five years clearly defeats this objective and APRA only allows such calls in exceptional circumstances. APRA does not accept that a change in an accounting standard *per se* is a regulatory event warranting early redemption as it would not necessarily result in a change to regulatory capital. However, a change in an accounting standard that affects the eligibility of the instrument as regulatory capital may be considered by APRA to be a regulatory event. Insurers should consult with APRA on a case-by-case basis where they believe that a change in accounting standards constitutes exceptional circumstances.

APRA does not object to conversion to ordinary shares within five years of an instrument's issue date. However, if an option to convert associated with a change in control sees the capital transferred to another entity, the replacement capital injection must occur simultaneously with the substitution of issuer and must be unconditional. Where a capital instrument is converted into a like capital instrument, the new capital instrument must in its own right meet all the eligibility criteria for that category of capital instrument.

APRA does not, however, propose allowing calls to be made within the first five years of an instrument for a change of control event.

2.4 Additional Tier 1 Capital and Tier 2 Capital: non-viability requirements

In the draft GPS 112 and LPS 112, APRA set out its requirements for capital instruments, other than ordinary shares, to convert to ordinary shares or be written-off in certain circumstances. Under these requirements, an Additional Tier 1 or Tier 2 capital instrument must include a provision under which, on the occurrence of a non-viability trigger event, it will convert or be written off (the non-viability requirements).

A number of submissions queried aspects of the non-viability requirements, which are addressed below.

2.4.1 Governing law

In the May 2012 response paper, APRA proposed that, to be eligible for inclusion in the capital base, Additional Tier 1 and Tier 2 capital instruments would be required to be subject to Australian law. This proposal was to facilitate the effective operation of the non-viability requirements in a crisis.

Comments received

Submissions raised a number of concerns about APRA's proposal, arguing:

- it would be difficult to apply Australian law to all contractual terms relating to an instrument, given the range of different documents and ancillary agreements;
- that instruments issued across jurisdictions are regularly governed by English or New York law with resolution mechanisms (such as liquidation) subject to the governing laws of the issuing institution's domestic jurisdiction;
- Australian law is not well understood and accepted in overseas capital markets;
- that APRA's approach may be adopted by other supervisors, causing jurisdictional conflict and potential impediments to timely conversion/write-off;
- APRA's concerns may be met by requiring an insurer to submit an independent legal opinion confirming that conversion/write-off will be achieved under the law governing the instrument; and
- the proposal potentially reduces the ability of offshore subsidiaries of insurers to access capital markets independently.

APRA's response

APRA acknowledges the concerns raised in submissions. It notes that it is not uncommon for resolution mechanisms to be governed by the law applying to the issuer where the other provisions are governed by the law of another jurisdiction. APRA's policy objective will be met by requiring Australian law to apply only to the terms and conditions of capital instruments implementing the non-viability requirements. GPS 112 and LPS 112 have been amended to reflect this. APRA notes that there is precedent for this approach: for example, ADI capital instruments have been issued where Australian law governs liquidation provisions.

2.4.2 Guidance on triggering non-viability

Comments received

Several submissions sought guidance on the factors APRA was likely to consider in triggering the non-viability provisions.

APRA's response

It is not possible to define in advance the circumstances or factors that would lead APRA to conclude that an insurer has become 'non-viable'. Nonetheless, APRA is considering whether it may be helpful to provide broad guidance.

2.4.3 Tax effects

APRA proposed that insurers should account for potential taxation liabilities in determining the amount of Common Equity Tier 1 Capital that would arise if non-viability requirements were triggered.

Comments received

Several submissions were concerned by this requirement. A particular concern was that this obligation will also apply to the 'fail-safe' write-off provision mandated by APRA to come into effect for those capital instruments that had conversion as the primary requirement but where conversion did not take place as anticipated. It was suggested that the likelihood of conversion failing and a net tax liability on write-off occurring at the point of non-viability is so remote as to make it unreasonable to discount potential taxation liabilities at the date of issuance. Submissions argued that accounting for these potential tax liabilities at the time of issuance would make these instruments uneconomical.

APRA's response

APRA accepts the argument that triggering such fail-safe write-off provisions is highly unlikely. Therefore, insurers do not need to account for the potential tax liabilities that may be involved. However, where write-off is the primary rather than the fail-safe non-viability mechanism, tax liability and other haircuts must be accounted for from the date of issue.

2.4.4 Dilution floor

APRA proposed a dilution floor, such that the maximum conversion ratio is based on 20 per cent of the share price at issuance.

Comments received

Several submissions suggested that the 20 per cent dilution floor be removed, or, alternatively, periodically adjusted to reflect other capital structure adjustments such as discounted rights issues.

APRA's response

APRA's position on the dilution floor is that it is necessary to enable an insurer to readily quantify the maximum dilution effect upfront and to ensure the insurer has prior shareholder approval for any future issue of the required number of shares. Allowing further adjustments would unnecessarily complicate the calculation of the number of shares to be issued. APRA is therefore retaining its requirement for conversions to be subject to a 20 per cent dilution floor. This also applies to any conversion provisions other than the non-viability requirements.

2.4.5 Conversion into listed shares

APRA requires that, on the occurrence of a non-viability trigger event, Additional Tier 1 and Tier 2 capital instruments with conversion provisions be immediately and irrevocably converted into the ordinary shares of the insurer, which must be listed at the time the instrument is issued.

Comments received

APRA's proposal that instruments must convert into listed shares prompted a number of submissions. These queried the practical operation of this requirement where there is no listed institution in the group or where the capital has been issued by a non-listed institution to a listed parent (in which case, conversion would result in the listed parent holding its own shares).

APRA's response

APRA intends to retain its general requirement that conversion of non-common equity instruments must be into listed shares. However, APRA will allow conversion into unlisted equity in the following circumstances:

- where there is no listed upstream entity in the relevant group; or
- where the insurer's non-common equity instrument is issued to its listed parent entity.

2.4.6 Application of non-viability at the group level (Level 2 insurance groups only)

APRA proposed that for Level 2 insurance groups the non-viability requirements would apply to all capital instruments across the group, including all capital instruments issued by subsidiaries.

Comments received

Submissions questioned the application of non-viability requirements for Level 2 insurance groups and, in particular, the proposed requirements for instruments issued by subsidiaries to include non-viability provisions that can be triggered by APRA as well as host regulators. It was submitted that these non-viability triggers should be exercised only by the host regulator to avoid any conflict in regulatory requirements and the consequent difficulties in framing an instrument's terms or describing the level of risk to investors.

APRA's response

APRA is of the view that the relevant jurisdiction in determining a trigger event is the jurisdiction in which the capital instrument is recognised for regulatory purposes. Capital issued by a consolidated subsidiary that is to be included on a group basis must specify an additional trigger event empowering the group supervisor to determine non-viability requiring conversion/write-off. APRA's non-viability requirements reflect this approach.

2.5 Reductions in capital

Prudential Standard GPS 110 Capital Adequacy (GPS 110) and *Prudential Standard LPS 110 Capital Adequacy* (LPS 110) require an insurer to seek APRA's prior written consent to make certain reductions in its capital base. This includes dividend or interest payments on Additional Tier 1 or Tier 2 capital instruments that exceed an insurer's after-tax earnings (known as the 'profits test').

Comments received

Several submissions queried APRA's proposed 'profits test'. It was noted that one credit rating agency has indicated that APRA's 'profits test' will cause a one-notch downgrade in the rating of Additional Tier 1 and Tier 2 capital instruments.

APRA's response

As outlined in its letter to industry of 4 September 2012[8], APRA remains of the view that requiring prior approval for planned capital reductions arising from ordinary share dividends is a valuable supervisory tool. However, taking into account submissions received and the fundamental changes to the nature and required levels of non-common equity capital, APRA now considers that the costs associated with the profits test for Additional Tier 1 and Tier 2 capital instruments are likely to outweigh the supervisory benefits. GPS 110 and LPS 110 have therefore been amended to remove the profits test requirement in relation to those instruments.

8 http://www.apra.gov.au/CrossIndustry/Documents/120904_LAGIC_reductions_in_capital_letter.pdf

2.6 Assets under a fixed or floating charge

APRA requires a number of regulatory adjustments to Common Equity Tier 1 Capital, including for assets that are under a fixed or floating charge, mortgage or other security.

Comments received

Several submissions commented that the treatment of assets subject to a fixed or floating charge as currently expressed in draft GPS 112 and LPS 112 produces an inappropriate outcome. Draft GPS 112 and LPS 112 did not ascribe any value to any asset against which security is held, effectively further reducing the capital base by the asset amount in excess of the associated liability.

APRA's response

This was not APRA's intention: the words 'to the extent of the indebtedness secured on those assets' were inadvertently omitted from draft GPS 112 and LPS 112. This omission has been addressed in the final versions of GPS 112 and LPS 112.

2.7 Definition of associate

APRA requires the deduction of investments in subsidiaries, joint ventures and associates from Common Equity Tier 1 Capital. This regulatory adjustment ensures that there is no double-counting of capital.

Comments received

Submissions noted that the term 'associate' is ambiguous, given that it is not clear whether 'associate' is to be defined by reference to *Australian Accounting Standard AASB 128 Investments in Associates and Joint Ventures* (AASB 128) or to the *Corporations Act 2001*.

APRA's response

The term 'associate' is intended to be interpreted consistently with the definition in AASB 128. AASB 128 defines an associate as 'an entity over which the investor has significant influence', where 'significant influence' is 'the power to participate in the financial and operating policy decisions of the investee but is not in control or joint control of those policies'.

To ensure clarity, APRA has included a definition of 'associate' in *Prudential Standard GPS 001 Definitions* (GPS 001) and *Prudential Standard LPS 001 Definitions* (LPS 001) that refers to the definition in AASB 128.

2.8 Deferred tax assets (life insurance only)

Subject to conditions set out in LPS 112, APRA requires life insurers to deduct deferred tax assets (DTA) net of deferred tax liabilities (DTL) as part of the regulatory adjustments to Common Equity Tier 1 Capital.

Comments received

Submissions from life insurers commented that this requirement could be read as requiring deduction of DTAs in respect of investment-linked benefits. As these DTAs may be included in the unit price, they should not automatically be eliminated. Submissions questioned whether the exemptions for assets with values linked to the value of liabilities could be applied to such DTAs.

APRA's response

LPS 112 provides that, if policy benefits can be reduced in response to a fall in the value of an asset that is otherwise required to be deducted from Common Equity Tier 1 Capital, the asset does not have to be deducted. Instead, the asset will be subject to the Asset Risk Charge under *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge* (LPS 114). Appropriate reductions to policy liabilities may be made as an offset to the asset stresses.

2.9 Transitional arrangements for non-complying instruments (general insurance only)

Draft GPS 112 set out that an insurer must determine the base amount of Additional Tier 1 and Tier 2 capital instruments that do not meet the new eligibility criteria (non-complying instruments) at 1 January 2013. It was proposed that insurers use the Australian dollar value of foreign currency-denominated instruments at that date.

Comments received

Submissions recommended that the base amount for certain foreign currency hybrids classified as accounting equity and measured at historical cost should be reflected at the value as presented on an insurer's balance sheet at 1 January 2013 (and not based on the foreign exchange spot rate as at 1 January 2013). It was suggested that this approach would avoid the double-counting of the foreign currency impact in capital and ensure that the capital treatment of the foreign currency hybrid is unaffected by the accounting classification (i.e. debt or equity).

APRA's response

APRA has revised the final transitional arrangements in GPS 112 to reflect this approach.

2.10 Minority interests and capital held by third parties (Level 2 insurance groups only)

In the May 2012 response paper and draft GPS 112, APRA set out its proposed approach to the recognition of minority interests in the ordinary equity of fully consolidated subsidiaries. The paper also set out the approach to the recognition of non-common equity issued by fully consolidated subsidiaries, based on whether or not these instruments met the new eligibility criteria for inclusion in the capital base.

Comments received

Submissions argued that the calculation of surplus Common Equity Tier 1 Capital proposed in draft GPS 112 unduly penalised a Level 2 insurance group that funded its subsidiary with only common equity.

Submissions also raised a number of questions on the implementation of the minority interest and capital held by third parties proposal, including the calculation method for the prescribed capital amount of the subsidiary, the requirement for the subsidiary to be subject to equivalent prudential requirements and the introduction of a materiality threshold.

Finally, submissions queried whether it was appropriate for the transitional arrangements for non-complying instruments issued by fully consolidated subsidiaries to be dissimilar to the arrangements for non-complying instruments generally.

APRA's response

APRA acknowledges that the text in draft GPS 112 does not appropriately calculate the surplus Common Equity Tier 1 Capital of a subsidiary for all possible capital structures. APRA has corrected this drafting in the final GPS 112.

APRA confirms that the calculation of the prescribed capital amount for the subsidiary must be based on the APRA capital prudential standards and the Level 2 insurance group must apply the methodology for all subsidiaries consolidated in the group that are subject to equivalent prudential requirements, irrespective of size.

APRA has amended its position on transitional arrangements. The transitional arrangements will only depend on whether the instrument complies with the eligibility criteria for inclusion in the capital base, or is non-complying.

For Additional Tier 1 and Tier 2 capital instruments that comply with the eligibility criteria, APRA will recognise 100 per cent of non-common equity capital. For Common Equity Tier 1 Capital, APRA will recognise all but the surplus Common Equity Tier 1 Capital attributable to third parties from 1 January 2013, without transition. For Level 2 insurance groups with significant minority interests, the group may apply to APRA for case-by-case transition arrangements on this requirement.

For non-complying instruments issued by consolidated subsidiaries, the transitional arrangements will be the same as for non-complying instruments generally - if eligible for transition, they will be included in an insurer's base amount and amortised over nine years (or until the first call date), subject to APRA's approval.

Chapter 3 – Other prudential standards applicable to general insurance

This chapter addresses submissions on APRA's proposals relating to general insurers for items other than the composition of the capital base. The chapter discusses a small number of final amendments to the capital and non-capital prudential standards.

3.1 Capital prudential standards

In May 2012, APRA released final prudential standards relating to the calculation of the prescribed capital amount for general insurers. While these capital prudential standards were released in final form, the May 2012 response paper noted that APRA would accept feedback on the wording of the section on the ICAAP in GPS 110 and the Insurance Concentration Risk Charge prudential standard (*Prudential Standard GPS 116 Capital Adequacy: Insurance Concentration Risk Charge* (GPS 116)).

This section addresses submissions received and outlines refinements made to these prudential standards to further clarify and enhance their readability.

3.1.1 Insurance Concentration Risk Charge

APRA received a small number of submissions in relation to GPS 116.

In most cases, these submissions raised implementation issues that have been addressed in the draft PPG released in September 2012. APRA will continue dialogue with industry on implementation via the consultation process on the draft PPG.

One submission queried the implementation of reinstatement costs for the horizontal requirement. The submission noted that the wording in GPS 116 implied that a full layer needed to be reinstated, even if the full capacity of that layer is not needed.

The reinstatement costs in the horizontal requirement need only be to the level required for the requisite number of events. APRA has clarified its intention in GPS 116.

3.1.2 Treatment of unrated assets

GPS 001 details the counterparty grades for various assets. Non-publicly rated assets would receive a default counterparty grade of 6.

Comments received

Submissions commented that the treatment of non-publicly rated assets is unduly penal and out of alignment with the requirements for ADIs.

APRA's response

APRA has amended GPS 001 such that the counterparty grade for non-publicly rated assets that are not rated by any other method is grade 5, which broadly aligns the treatment of these assets with the requirements for ADIs. This treatment is applied irrespective of whether or not the asset is secured.

3.1.3 Clarifications and minor amendments

APRA has made a small number of clarifications or amendments to the capital prudential standards to address application, wording and other minor changes. The list below highlights the more significant changes made and is not exhaustive.

GPS 110 – Capital Adequacy

- The Chief Executive Officer declaration required in relation to the ICAAP report must certify that the information contained in the report is accurate 'in all material respects'.

GPS 114 – Asset Risk Charge

- 'Geared' for the purposes of *Prudential Standard GPS 114 Capital Adequacy: Asset Risk Charge* (GPS 114) includes both gearing through direct borrowings and gearing undertaken through derivative transactions.
- For the real interest rate and expected inflation stresses, post-stress real yields can be negative but post-stress nominal yields are subject to a floor of zero.

- For Level 2 insurance groups, the 100 per cent default factor applicable to recoverables from non-APRA authorised reinsurers that are overdue for more than six months should not be applied to recoverables on international business.
- For consistency with other general insurance prudential standards, the attachments that relate to Level 2 insurance groups were moved to the end of GPS 114.

3.2 Non-capital prudential standards

The May 2012 response paper detailed a number of consequential amendments to the non-capital prudential standards for general insurers. These standards were amended to reflect the proposed changes to the capital framework for general insurers and Level 2 insurance groups.

APRA received a small number of submissions on the proposed amendments to the non-capital prudential standards for general insurers. As a result, APRA has made minor clarifications or amendments to these standards. Of note, the requirement for the Appointed Actuary to comment on gross uncertainty in the liability valuation will remain; however, the wording has been amended to 'assessment of uncertainty in the gross estimate of insurance liabilities' to better reflect the process undertaken by the Actuary.

APRA did not receive any submissions on the proposed changes to the reinsurance declaration and as such the final prudential standard reflects the new due date and requirements for this declaration.

Chapter 4 – Other prudential standards applicable to life insurance

This chapter addresses submissions on APRA's proposals relating to life insurers for items other than the composition of the capital base. The chapter discusses a small number of final amendments to the capital and non-capital prudential standards.

4.1 Capital prudential standards

In May 2012, APRA released final prudential standards relating to the calculation of the prescribed capital amount for life insurers. While these capital prudential standards were released in final form, the May 2012 response paper noted that APRA would accept feedback on the wording of the section of the ICAAP in LPS 110.

This section addresses submissions received and outlines refinements made to these prudential standards to further clarify and enhance their readability.

4.1.1 Definitions of risk business and traditional business

LPS 001 sets out a definition of 'risk business' that is relevant to both *Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values* (LPS 360) and *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge* (LPS 118).

Comments received

Submissions commented that the proposed definition of risk business in LPS 001 was unclear, and that this made the treatment of funeral bonds in LPS 360 difficult to interpret.

APRA's response

APRA has amended the definitions of risk business, traditional business and unbundled investment business in LPS 001 to improve their clarity. The revised definitions treat funeral bond business as a separate and distinct class of business for the purposes of LPS 360.

4.1.2 Treatment of unrated assets

LPS 001 details the counterparty grades for various assets. Non-publicly rated assets would receive a default counterparty grade of 6.

Comments received

Submissions commented that the treatment of non-publicly rated assets is unduly penal and out of alignment with the requirements for ADIs.

APRA's response

APRA has amended LPS 001 such that the counterparty grade for non-publicly rated assets that are not rated by any other method is grade 5, which broadly aligns the treatment of these assets with the requirements for ADIs. This treatment is applied irrespective of whether or not the asset is secured.

4.1.3 Clarifications and minor amendments

APRA has made a small number of clarifications or amendments to the capital prudential standards to address application, wording and other minor changes. The list below highlights the more significant changes made and is not exhaustive.

LPS 110 – Capital Adequacy

- The Chief Executive Officer declaration required in relation to the ICAAP report must certify that the information contained in the report is accurate 'in all material respects'.

LPS 114 – Asset Risk Charge

- 'Geared' for the purposes of LPS 114 includes both gearing through direct borrowings and gearing undertaken through derivative transactions.
- For the real interest rate and expected inflation stresses, post-stress real yields can be negative but post-stress nominal yields are subject to a floor of zero.

4.2 The illiquidity premium

Insurers made a range of submissions on the illiquidity premium consultation in response to APRA's letter of March 2012. The key issues raised and APRA's response are set out below.

The formula is overly conservative

- In the March 2012 letter to insurers, APRA acknowledged that the formula was conservative and explained why this was appropriate. Submissions did not give any compelling reasons as to why a less conservative measure would be more appropriate.

The 150 basis points cap restricts the market sensitivity of the illiquidity premium

- The maximum value of the proxy formula during the period from 2006 to 2011 would have been approximately 120 basis points. APRA's March 2012 letter explained that a cap was proposed due to uncertainty about whether the formula would remain appropriate in extremely stressed circumstances. APRA has not changed this approach in the final prudential standards. APRA notes that it has the ability to waive or modify the cap in future if market conditions are such that the illiquidity premium is not operating as intended.

The 10 year transition point, where the illiquidity premium shifts from a formula based on corporate bond spreads to a fixed amount of 20 basis points, is not market sensitive and occurs at too short a duration

- APRA explained in its March 2012 letter that 10 years represented an appropriate intermediate point, as there are few corporate bonds with maturity beyond five years and semi-government bonds are available in reasonable quantities for maturities up to 12 years. APRA has not changed this approach in the final prudential standards.

The terminology used in LPS 112 that an illiquidity premium 'may' be added to the risk-free discount rate implied that the use of the specified illiquidity premium was not mandatory

- APRA's intention is that the use of the illiquidity premium be compulsory for the specified types of policies. APRA has accordingly amended the word 'may' to 'must' in LPS 112 and LPS 360. This is appropriate as it ensures that all life insurers use a consistent discount rate for the same liabilities. It is also consistent with the principle applied in the accounting standards and *Prudential Standard LPS 340 Valuation of Policy Liabilities* (LPS 340) that discount rates reflect the nature, structure and term of the liability cash flows, and not the expected investment return on the insurer's assets. If the best estimate of future investment returns is less than the discount rate, this issue should be discussed by the Appointed Actuary in the Financial Condition Report and by the insurer in the ICAAP.

4.3 Non-capital prudential standards

The May 2012 response paper detailed a number of consequential amendments to the non-capital prudential standards for life insurers. These prudential standards were amended to reflect the proposed changes to the capital framework for life insurers. The May 2012 response paper also noted that an updated version of *Prudential Standard LPS 310 Audit and Related Matters* (LPS 310) would be issued to reflect the amended audit requirements due to the revised reporting framework. LPS 310 accompanies this paper and APRA's final response on the reporting framework will be released later in October 2012.

APRA received a small number of submissions on the proposed amendments to the non-capital prudential standards for life insurers. As a result, APRA has made minor clarifications or amendments to these standards. Of note, LPS 360 has been amended to specify that policies that have no or zero minimum termination value also have a zero paid-up value. In addition, LPS 340 has been clarified such that the risk-free rate for the purposes of LPS 340 is not required to meet the definition of 'risk-free discount rate' in LPS 001, i.e. it is not required to be the yield on Commonwealth Government Securities.

Appendix 1 – Prudential standards for general insurers

The prudential standards effective from 1 January 2013 for general insurers and Level 2 insurance groups are:

Final prudential standards	Comparison to standards effective until 31 December 2012
GPS 001 Definitions	Revised
GPS 110 Capital Adequacy	Revised
GPS 112 Capital Adequacy: Measurement of Capital	Revised
GPS 112 Frequently Asked Questions	Unchanged
GPS 113 Capital Adequacy: Internal Model-Based Method	Revised
GPS 114 Capital Adequacy: Asset Risk Charge	Revised
GPS 114 Frequently Asked Questions	Unchanged
GPS 115 Capital Adequacy: Insurance Risk Charge	Revised
GPS 116 Capital Adequacy: Insurance Concentration Risk Charge	Revised
GPS 117 Capital Adequacy: Asset Concentration Risk Charge	New
GPS 118 Capital Adequacy: Operational Risk Charge	New
GPS 120 Assets in Australia	Revised
GPS 220 Risk Management	Revised
GPS 230 Reinsurance Management	Revised
CPS 231 Outsourcing	Revised
CPS 232 Business Continuity Management	Revised
GPS 310 Audit and Related Matters	Revised
GPS 320 Actuarial and Related Matters	New
GPS 410 Transfer and Amalgamation of Insurance Business for General Insurers	Unchanged
CPS 510 Governance*	Revised
CPS 520 Fit and Proper*	Revised

* These prudential standards apply to authorised insurance non-operating holding companies rather than Level 2 insurance groups

Appendix 2 – Prudential standards for life insurers

The prudential standards effective from 1 January 2013 for life insurers are:

Final prudential standards	Comparison to standards effective until 31 December 2012
LPS 001 Definitions	New
LPS 100 Solvency Standard	New (and to be issued in November)
LPS 110 Capital Adequacy	New
LPS 112 Capital Adequacy: Measurement of Capital	New
LPS 114 Capital Adequacy: Asset Risk Charge	New
LPS 115 Capital Adequacy: Insurance Risk Charge	New
LPS 117 Capital Adequacy: Asset Concentration Risk Charge	New
LPS 118 Capital Adequacy: Operational Risk Charge	New
LPS 220 Risk Management	Revised
LPS 230 Reinsurance	Unchanged
CPS 231 Outsourcing*	Revised
CPS 232 Business Continuity Management*	Revised
LPS 310 Audit and Related Matters	Revised
LPS 320 Actuarial and Related Matters	Revised
LPS 340 Valuation of Policy Liabilities	Revised (and renamed)
LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values	Revised (and renamed)
LPS 370 Cost of Investment Performance Guarantees	Revised (and renamed)
CPS 510 Governance*	Revised
CPS 520 Fit and Proper*	Revised
LPS 600 Statutory Funds	Revised
LPS 700 Friendly Society Benefit Funds	Revised

* These prudential standards also apply to registered life NOHCs

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