Prudential Standard GPS 114

Capital Adequacy: Asset Risk Charge

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires a general insurer or Level 2 insurance group to maintain adequate capital against the asset risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a general insurer or Level 2 insurance group rests with its Board of directors. The Board must ensure the general insurer or Level 2 insurance group maintains an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile, such that it is able to meet its obligations under a wide range of circumstances.

The Asset Risk Charge is the minimum amount of capital required to be held against asset risks. The Asset Risk Charge relates to the risk of adverse movements in the value of a general insurer's or Level 2 insurance group's on-balance sheet and off-balance sheet exposures. Asset risk can be derived from a number of sources, including market risk and credit risk.

This Prudential Standard sets out the method for calculating the Asset Risk Charge. This charge is one of the components of the Standard Method for calculating the prescribed capital amount for general insurers and Level 2 insurance groups.

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Authority

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

Application and commencement

2. This Prudential Standard applies to each:

   (a) **general insurer** authorised under the Act (**insurer**); and

   (b) **Level 2 insurance group** as defined in *Prudential Standard CPS 001 Defined terms* (CPS 001).

   Where a requirement is made in respect of a Level 2 insurance group, the requirement is imposed on the **parent entity** of the Level 2 insurance group.

3. This Prudential Standard applies to insurers and Level 2 insurance groups (**regulated institutions**) from 1 July 2027.

Level 2 insurance groups

4. Certain adjustments to the methodologies and calculations in this Prudential Standard apply to Level 2 insurance groups. These adjustments are set out in Attachment D.

Interpretation

5. Terms that are defined in CPS 001 appear in bold the first time they are used in this Prudential Standard.

Asset Risk Charge

6. This Prudential Standard sets out the method for calculating the **Asset Risk Charge** for a regulated institution using the **Standard Method** to determine its **prescribed capital amount**.

7. The Asset Risk Charge relates to the risk of an adverse movement in a regulated institution's **capital base** due to credit or market risks. Both assets and liabilities may be affected. Off-balance sheet exposures may also be affected.

Asset Risk Charge calculation

8. The Asset Risk Charge is calculated as:

   (a) the 'aggregated risk charge component' determined in accordance with paragraph 9; less

   (b) any 'tax benefits' determined in accordance with paragraphs 12 to 14.

Aggregated risk charge component

9. A regulated institution must calculate the 'risk charge components', as defined in paragraph 10, by considering the impact on the capital base of the regulated institution of a range of stresses. These risk charge components are then aggregated using the formula set out in paragraphs 78 to 80, which allows for the likelihood of the scenarios modelled by the stress tests occurring simultaneously. The result of applying the formula is defined as the 'aggregated risk charge component'.

Risk charge components

10. The risk charge components are calculated by determining the fall in the capital base of the regulated institution in seven stress tests:

    (a) 'real interest rates' determined in accordance with paragraphs 31 to 36;

    (b) 'expected inflation' determined in accordance with paragraphs 37 to 40;

    (c) 'currency' determined in accordance with paragraphs 41 to 43;

    (d) 'equity' determined in accordance with paragraphs 44 to 47;

    (e) 'property' determined in accordance with paragraphs 48 to 52;

    (f) 'credit spreads' determined in accordance with paragraphs 53 to 64; and

    (g) 'default' determined in accordance with paragraphs 65 to 77.

    These stresses are applied either directly to asset values or by way of changes to economic variables that in turn affect the value of both assets and liabilities. Some assets and liabilities may be impacted by more than one of the seven stress tests and will need to be considered in each relevant stress test. For the stresses in (a), (b) and (c), the impact on the capital base will be two separate amounts and these need to be included in the aggregation formula.

11. For the purposes of paragraph 10, no risk charge component may be negative and, therefore, if there is no fall in the capital base of the regulated institution due to the application of the stresses, the risk charge component is assumed to be zero.

Tax benefits

12. The risk charge component for each stress test must be calculated so that no value is attributed to any tax benefits that may result from the stress test. However, tax benefits may be deducted from the aggregated risk charge component.

13. The tax benefits deducted from the aggregated risk charge component are the tax benefits resulting from scenarios modelled by the stress tests, reduced to allow for the reduction in Asset Risk Charge due to the aggregation formula. The tax benefits are therefore calculated as:

$$\text{tax benefits from stress tests} \times \frac{\text{aggregated risk charge component}}{\text{sum of risk charge components}}$$

14. The tax benefits from paragraph 13 must be recognised as a deduction from the Asset Risk Charge only if tax legislation allows them to be absorbed by the existing deferred tax liabilities. For this purpose, the deferred tax liabilities are those liabilities (if any) that remain after netting off the deferred tax assets and liabilities in the calculation of the deductions from Common Equity Tier 1 Capital in *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112).

Assets and liabilities to be stressed

15. In determining each risk charge component, a regulated institution must include the effective exposure[1] of the regulated institution's assets and liabilities to each of the risks if the exposure is impacted by the stress test. Some assets and liabilities may have effective exposures to multiple risks.

16. Investment income receivables must be included with the asset that generated the income and then subject to the appropriate stress tests.

17. The following assets and liabilities must not be stressed:

    (a) assets whose value must be deducted from the capital base (e.g. goodwill in subsidiaries) in GPS 112; and

    (b) any part of assets in excess of the asset concentration limits specified in *Prudential Standard GPS 117 Capital Adequacy: Asset Concentration Risk Charge*.

18. In addition to paragraph 17, a regulated institution that is an employer-sponsor of a defined benefit superannuation fund does not need to reassess any deficit in the fund as a result of the seven stress tests, unless the regulated institution has provided a guarantee in relation to the benefits.

19. The stress tests must be applied to the **fair value** of each of the regulated institution's assets. A regulated institution may measure its non-financial assets, short term receivables and intercompany receivables and payables using the requirements in Australian Accounting Standards rather than fair value.[2]

20. For **Category C insurers**, the Asset Risk Charge must be applied to the assets in Australia only of the Category C insurer, consistent with reporting standards made under the *Financial Sector (Collection of Data) Act 2001*.

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1 The effective exposure of an insurer's assets and liabilities must also include the regulatory adjustments to Common Equity Tier 1 Capital to allow for the effects of accounts receivable and accounts payable outlined in Attachment B of GPS 112, but gross of any tax effects.

2 For the purpose of calculating the result of the stress tests other than the default stress, a regulated institution must use the net insurance liabilities calculated in accordance with *Prudential Standard GPS 340 Insurance Liability Valuation* (GPS 340) instead of the equivalent **statutory account** values.

Off-balance sheet exposures

21. A regulated institution may be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet. Each of the stress tests must include any changes to the regulated institution's on-balance sheet assets and liabilities that would result from application of the stresses to the regulated institution's off-balance sheet exposures. A regulated institution must use effective exposure for any off-balance sheet exposures of the regulated institution. Detailed information on the treatment of off-balance sheet exposures is set out in Attachment A.

Collateral and guarantees

22. The impact of applying the asset risk stresses may be reduced where the regulated institution holds certain types of collateral against an asset, or where the asset has been guaranteed. Detailed information on the eligibility of collateral and guarantees is set out in Attachment B.

Treatment of specific asset classes

23. Hybrid assets such as convertible notes must be split into their interest-bearing and equity/option exposures. A regulated institution must consider the changes in value of the two exposures separately for each of the asset risk stresses.

24. For assets of a regulated institution held under a trust or in a controlled investment entity,[3] the regulated institution may calculate the Asset Risk Charge by looking-through to the assets and liabilities of the trust. Alternatively, the investment may be treated as an equity asset (a listed equity asset if the investment is listed, or an unlisted equity asset if the investment is unlisted). Look-through must be used if the trust or controlled investment entity is both unlisted and geared.[4]

25. A security that is the subject of a repurchase or securities lending agreement must be treated as if it were still owned by the lender of the security. Any counterparty risk that arises from the transaction must be recognised in the default stress.

26. Term deposits issued by an **authorised deposit-taking institution** (ADI) must be treated in the same way as a corporate bond issued by the ADI. If the ADI guarantees a minimum amount on early redemption, the minimum amount may be recognised as a floor to the stressed value of the asset in each of the real interest rates and expected inflation stresses. In the credit spreads stress, the minimum amount may be recognised as a floor to the stressed value, but it must be reduced by multiplying it by (1 – default factor).

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[3] For this purpose, an investment entity is an entity where the sole purpose of the entity is investment activities.

[4] For this purpose, a trust or entity may be geared through borrowings or through the use of derivatives.

Derivatives

27. Derivatives include forwards, futures, swaps, options and other similar contracts. Derivatives expose a regulated institution to the full range of investment risks, even though in many cases there may be no, or only a very small, initial outlay.

28. Changes to the capital base that would arise from changes in the value of derivatives must be included in the risk charges arising from each of the asset risk stresses.

29. A risk charge must be applied to the fair value of over-the-counter derivatives in the default stress to allow for the risk of counterparty default. This is in addition to any charges that would arise from other asset risk stresses.

Extended Licence Entity

30. In certain circumstances, a regulated institution may choose to hold assets in a **Special Purpose Vehicle** (SPV) or other **related entity**, rather than on its own balance sheet. Detailed information on the treatment of an 'Extended Licence Entity' (ELE) is set out in Attachment C.

Real interest rate stress

31. This stress measures the impact on the capital base of a regulated institution from changes in real interest rates.

32. Real interest rates are the portion of the nominal risk-free interest rates that remain after deducting expected CPI inflation.

33. All assets and liabilities whose values are dependent on real or nominal interest rates must be revalued using the stressed real or nominal rates.

34. The stress adjustments to real interest rates are determined by multiplying the greater of three per cent or the nominal risk-free interest rates by 0.25 (upward stress) or by -0.20 (downward stress). The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to real yields if these are used explicitly in the valuation of an asset or liability (e.g. inflation-indexed bonds). Post-stress real yields may be negative.

35. The maximum stress adjustment is 200 basis points in either direction. The minimum upward stress is 75 basis points and the minimum downward stress is 60 basis points. Nominal risk-free interest rates and real yields may be negative after applying the downward stress adjustment.

36. The regulated institution must calculate the impact on the capital base of an upward movement and a downward movement in real interest rates. The impact of each calculation must not be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 78.

Expected inflation stress

37. This stress measures the impact on the capital base of changes to expected Consumer Price Index (CPI) inflation rates. The expected inflation stress also affects nominal interest rates. The expected inflation stress does not apply to assets that are affected by the property or equity stresses.

38. In each scenario, assets and liabilities whose values are dependent on expected inflation or nominal interest rates must be revalued using the stressed expected inflation or nominal interest rates.

39. The stress adjustments to expected inflation rates are an increase of 125 basis points and a decrease of between 50 and 100 basis points. A downward stress of 50 basis points applies when the nominal risk-free interest rate is negative. A downward stress of 100 basis points applies when the nominal risk-free interest rate exceeds one per cent per annum. If the nominal risk-free interest rate is between zero and one per cent per annum the downward stress is determined as the sum of 50 basis points and half of the nominal risk-free interest rate. The stress adjustments must be added to the nominal risk-free interest rates. The stress adjustments must also be added to any expected inflation rates included in the valuation of assets or liabilities. Nominal risk-free interest rates and expected inflation rates may be negative after applying the downwards stress adjustments.

40. The regulated institution must calculate the impact on the capital base of an upward movement and a downward movement in expected inflation or nominal interest rates. The impact of each calculation must not be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 78.

Currency stress

41. This stress measures the impact on the capital base of changes in foreign currency exchange rates.

42. The regulated institution must calculate the impact on the capital base of both an increase and a decrease of 25 per cent in the value of the Australian dollar against all foreign currencies.[5] In each of these scenarios, the Australian dollar must be assumed to move in the same direction against all foreign currencies. The impact of each calculation must not be less than zero. Both impact calculations must be used for the purposes of the aggregation formula in paragraph 78.

43. An increase in the capital base arising from a movement of the Australian dollar against one foreign currency must not be used as an offset to reductions in the capital base arising from the movement of the Australian dollar against other foreign currencies.

[5] In the increase scenario, the Australian dollar values of foreign currency assets and liabilities will fall by 20 per cent. In the decrease scenario, the Australian dollar values of foreign currency assets and liabilities will increase by 33.3 per cent.

Equity stress

44. This stress measures the impact on the capital base of a fall in equity and other asset values. This stress applies to both listed and unlisted equity assets and to any other assets that are not considered in any of the other asset risk stresses. This stress also includes an increase to equity volatility. The volatility stress will affect an asset whose value is affected by movements in equity volatility (e.g. equity derivatives).

45. For listed equities, the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by 2.5 per cent. The same proportionate fall in value must be applied to both Australian and overseas listed equities.

46. For unlisted equities and other assets, the fall in value is to be determined by increasing the dividend yield on the ASX 200 index at the reporting date by 3 per cent. The same proportionate fall in value must be applied to all unlisted equities and other assets. The ASX 200 dividend yield must be determined using dividends for the 12 months prior to the reporting date and asset values at the reporting date.

47. For assets whose value is affected by movements in equity volatility, an addition of 15 per cent must be made to the forward-looking equity volatility parameter for all durations.

Property stress

48. This stress measures the impact on the capital base of changes in property and infrastructure asset values.

49. The fall in value of the assets must be determined by increasing the rental yield for property assets or earnings yield for infrastructure assets by 2.75 per cent.

50. For property assets, the rental yields are to be based on the most recent leases in force and are determined net of expenses.

51. For infrastructure assets, the yields to be used are the earnings yields before tax.

52. The rental yields and fall in value may be determined separately for each asset, or on a portfolio basis.

Credit spreads stress

53. This stress measures the impact on the capital base of an increase in credit spreads and the risk of default.

54. This stress applies to interest-bearing assets, including cash deposits and floating rate assets. Credit derivatives and zero-coupon instruments such as bank bills must also be included.

55. The stressed value of an asset must be determined by adding the spread specified in Table 1 to the current yield on the asset and then multiplying the reduced value

of the asset by (1 – default factor). The credit spreads and default factors depend on the **counterparty grade** and the nature of the asset:

Table 1: Credit spreads and default factors

Counterparty grade	Default (%)	Bonds[6] spread (%)	Structured/ securitised spread (%)	Re-securitised spread (%)
1 (government)	0.0	0.0	0.0	0.0
1 (other)	0.2	0.6	1.0	1.8
2	0.6	0.8	1.4	2.4
3	1.2	1.2	2.0	3.2
4	3.0	1.6	2.5	4.0
5	6.0	2.0	3.0	5.0
6	10.0	2.5	3.5	6.0
7	16.0	3.0	4.5	7.5

56. A 'securitised/structured asset' is an asset that provides an exposure to a pool or portfolio of assets or risks. This is typically in the form of a tranched exposure and includes credit-related securitisation exposures and insurance linked securities. Examples of these include Residential Mortgage-Backed Securities, Asset-backed Securities and catastrophe bonds. A covered bond issued by an ADI must not be treated as a securitised/structured asset.

57. An investment that provides exposure to an untranched pool of multiple reference entities, assets or risks must be treated:

    (a) on a 'look-through' basis;

    (b) as an equity asset (applying the equity stress instead of the credit spreads stress); or

    (c) as a securitised asset using the counterparty grade of the untranched pool.

58. Credit wrapped bonds must be treated as a securitised asset if the external rating of the bond makes some allowance for the structural protection offered by the credit wrap. Otherwise the bond must be treated as a bond with no credit wrap.

[6] and other non-securitised assets including covered bonds issued by an ADI.

59. A re-securitisation exposure is a securitisation exposure in which the risk associated with an underlying pool of exposures is tranched and at least one of the underlying exposures is a securitisation exposure. In addition, an exposure to one or more re-securitisation exposures is a re-securitisation exposure.

60. For floating rate assets, the increase in yield must be assumed to apply for the period until a regulated institution has the contractual right to redeem the asset at face value. For at-call floating rate assets, only the default factor must be applied. For floating rate assets that are not immediately redeemable, both the credit spread and default factors must be applied.

61. For fixed rate assets where the regulated institution has a contractual right to early redemption of the asset, the stressed value of the asset is subject to a minimum of the guaranteed redemption value multiplied by (1 – default factor).

62. Unsecured loans that have a 100 per cent charge applied in the default stress in accordance with paragraph 72 must be assumed to be unaffected by the credit spreads stress.

63. The 'government' category applies to:

    (a) **assets guaranteed by the Commonwealth Government;** and

    (b) assets guaranteed by foreign governments that have a counterparty grade of 1 and are denominated in the official or national currency of the guarantor.

64. Assets guaranteed by an Australian state or territory government may be rated up one grade. For example, assets with counterparty grade 1 must be treated as grade 1 (government) and assets with counterparty grade 2 must be treated as grade 1 (other).

Default stress

65. This stress applies to reinsurance assets, over-the-counter derivatives, unpaid premiums and all other credit or counterparty exposures that have not been affected by the credit spreads stress.

66. This stress includes the risk of counterparty default. A regulated institution must determine risk charges for the default stress for the risk of counterparty default on exposures that include (but are not limited to) reinsurance assets, unpaid premiums, futures and options, swaps, hedges, warrants, forward rate and repurchase agreements.

67. Where a regulated institution has unpaid premium, **unclosed business**, and non-reinsurance recoveries in respect of business ceded under a whole of account quota share arrangement, this stress may be applied to the net (rather than gross) of the quota share position.

68. The default factors are specified in Table 2. These factors apply to all assets affected by this stress, with the exception of certain types of assets specified in paragraphs 70 to 76.

Table 2: Default factors by counterparty grade

Counterparty grade	Default factor (%)
1 (government)	0
1 (other)	2
2	2
3	4
4	6
5	8
6	12
7	20

69. For the purpose of the default stress, reinsurance assets are to be the central estimate of reinsurance assets as measured in accordance with *Prudential Standard GPS 340 Insurance Liability Valuation* (GPS 340). For other assets, the default factor must be applied to the amount of loss that would be incurred if the counterparty defaulted and no recovery was made.

70. For unpaid premiums the factors are four per cent for premiums due less than six months previously and eight per cent for other premiums due.

71. For unclosed business a four per cent factor applies.

72. The following types of unsecured loans have a 100 per cent default factor applied[7]:

    (a) loans to **directors** of the regulated institution, or their spouses;

    (b) loans to directors of **related bodies corporate**, or their spouses;

    (c) loans to a parent or **related company** that are not on commercial terms; and

    (d) loans to employees exceeding $1,100.

73. Assets guaranteed by an Australian state or territory government must be rated up one grade. For example, assets with counterparty grade 1 must be treated as grade 1 (government) and assets with counterparty grade 2 must be treated as grade 1 (other).

[7] Unsecured loans that have a 100 per cent default factor applied in accordance with paragraph 72 are not subject to credit spreads stress, real interest rates stress, expected inflation stress and currency stress.

Reinsurance assets due from non-APRA authorised reinsurers

74. Reinsurance assets due from **non-APRA-authorised reinsurers** are subject to the default stress factors that are higher than would otherwise apply under paragraph 68. These are set out in Table 3 below.

Table 3: Default factors by counterparty grade for non-APRA-authorised reinsurance assets

Counterparty grade	Default factor (%)
1 (government)	2
1 (other)	2
2	4
3	6
4	8
5	12
6	20
7	20

75. The default factors for reinsurance recoverables from non-APRA-authorised reinsurers arising under reinsurance contracts incepting on or after 31 December 2008 are as specified in Table 4 below (in replacement of those specified in Table 2 in paragraph 68) to each reinsurance recoverable on and from the second annual balance date after the event giving rise to the reinsurance recoverable occurred.[8] This treatment applies only to the extent that the reinsurance recoverables are not supported by collateral, a guarantee or a letter of credit as specified in Attachment B.[9] Where, at the latest annual balance date on or after the second annual balance date following an event, there is an increase in reinsurance recoverables, the increased amount may be treated as supported where the relevant collateral, guarantee or letter of credit is put in place within 20 business days after that annual balance date.

[8] For a claims-made policy, the reference to "event" is to the date a claim notification was made. Novated contracts are regarded as incepting at the time specified in the contract they replaced, except where a later time is specified in the novation deed.

[9] For the avoidance of doubt, the default factors specified in Table 4 apply to the amount of relevant reinsurance recoverables that exceeds the amount of available collateral, guarantee or letter of credit.

Table 4: Default factors for reinsurance recoveries from non-APRA authorised reinsurers on and from the second balance date

Counterparty grade	Default factor (%)
1	20
2	40
3	60
4	100
5	100
6	100
7	100

76. A default factor of 100 per cent applies to a reinsurance recoverable due from a non-APRA-authorised reinsurer if:

    a) the recoverable has become a receivable (i.e. it is due and payable);

    b) the receivable is overdue for more than six months since a request for payment has been made to the reinsurer; and

    c) there is no formal dispute between the insurer and reinsurer in relation to that receivable.[10]

77. For the purposes of determining the amount of a reinsurance recoverable, if there is an offsetting arrangement between the regulated institution and the reinsurer that results in premium being withheld by the insurer in lieu of claim payments, the withholding of that premium is taken to be payment to the extent any claims payments are overdue. However, if there is a requirement for offsets to be approved by the reinsurer, the date of the offset request is taken to be the date that approval is given.

[10] Any dispute between the insurer and reinsurer in relation to a receivable arising from a reinsurance recoverable would have been taken into account in the valuation processes provided for under GPS 340

Aggregation formula

78. The aggregated risk charge component is calculated as:

$$A_{default} + \sqrt{\sum_{x,y} Max(0, Corr_{x,y} . A_x . A_y . sign(x) . sign(y))}$$

where

(a) A_x is the risk charge component for asset risk stress x;

(b) A_y is the risk charge component for asset risk stress y;

(c) $\sum_{x,y}$ is the sum over all combinations of asset risk stresses, excluding the default stress;

(d) $Corr_{x,y}$ is the correlation between asset risk stresses x and y;

(e) *sign (x)* is 1 for the equity, property and credit spreads stresses. For the real interest rates and expected inflation stresses, *sign (x)* is 1 if the stress is a decrease in rates, otherwise it is -1. For the currency stress, *sign (x)* is 1 if the stress is a depreciation of the Australian dollar against foreign currencies, otherwise it is -1; and

(f) *sign (y)* is defined in the same way as *sign (x)*.

79. The correlation matrix is:

Table 5: Asset Risk Charge correlation matrix

	RIR	INF	CUR	EQY	PROP	CSP
RIR	1	0.2	0.2	0.2	0.2	0.2
INF	0.2	1	0.2	0.4	0.4	0.2
CUR	0.2	0.2	1	0.6	0.2	0.4
EQY	0.2	0.4	0.6	1	0.4	0.8
PROP	0.2	0.4	0.2	0.4	1	0.4
CSP	0.2	0.2	0.4	0.8	0.4	1

80. The real interest rates, expected inflation and currency stresses apply in two directions. The aggregation needs to be performed twice for each of these stresses if both stresses produce a non-zero risk charge component, with the larger of the aggregates chosen. If two of the bidirectional stresses have a non-zero risk charge component for stresses in both directions, the aggregation will need to be performed four times — once for each combination of stresses. If all three of the bidirectional stresses have a non-zero risk charge component for stresses in both directions, the aggregation will need to be performed eight times.

Adjustments and exclusions

81. APRA may, by notice in writing to a regulated institution, adjust or exclude a specific requirement in this Prudential Standard in relation to that regulated institution.

Previous exercise of discretion

82. 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.

Attachment A – Off-balance sheet exposures

1. A regulated institution may be exposed to various asset risks through transactions or dealings other than those reflected on its balance sheet.

2. The principle of considering the effective exposure of the regulated institution to asset risks must be applied to any off-balance sheet exposures of the regulated institution. Changes to the capital base arising from off-balance sheet exposures must be recognised in each of the asset risk stresses.

3. As a general rule, a regulated institution must not be exposed to a counterparty for an unlimited amount and any exposure must be for a finite period. An exception to this rule is where a potential credit exposure results from reinsurance of an insurance contract that is required by law to be unlimited. Before a regulated institution does enter into an arrangement with a counterparty that does not have appropriate limits, it must:

   (a) notify APRA;

   (b) explain how this arrangement complies with its **Risk Management Strategy**; and

   (c) explain how it will be valued for the purposes of capital adequacy calculations.

   Such an exposure may cause APRA to apply a supervisory adjustment in accordance with *Prudential Standard GPS 110 Capital Adequacy*.

Direct credit substitutes

4. To the extent that a regulated institution has issued instruments of the following kind:

   (a) guarantees (including written put options serving as guarantees);

   (b) letters of credit; or

   (c) any other credit substitute (other than insurance) in favour of another party,

   the regulated institution is exposed to the risk of having to make payment on these instruments should a default event occur that requires the regulated institution to pay an amount under the instrument. The risk of such events occurring must be considered in the default stress. The default factors must be applied to the face value of each exposure. Where the credit substitute is supported by collateral or a guarantee, the provisions of relevant paragraphs from Attachment B may be applied.

Surety bonds

5. A regulated institution that issues a surety bond which meets the definition set out in paragraph 6 of this Attachment may approach APRA for treatment in

accordance with the approach set out in paragraph 7 of this Attachment, as an alternative to the treatment outlined in paragraph 4 of this Attachment.

6. For the purposes of paragraph 5 of this Attachment, a surety bond means an undertaking given by a regulated institution at the request of a person (Customer) pursuant to an agreement (Surety Agreement) between the regulated institution and the Customer made in the following circumstances:

   (a) the Customer enters into the Surety Agreement in order to enable the Customer to meet a requirement of another agreement (Principal Agreement) between the Customer, or a person associated with the Customer, and a person other than the regulated institution (Principal);

   (b) under the surety bond, the regulated institution undertakes to make a payment to, or perform an obligation for the benefit of, the Principal or another person nominated by the Principal (Beneficiary) in the circumstances specified in the surety bond;

   (c) the surety bond is issued to the Principal or the Beneficiary in relation to, or in connection with, an obligation owed by the Customer, or a person associated with the Customer, to the Principal under the Principal Agreement being an obligation that:

      (i) is a performance obligation or contains an element of performance on the part of the Customer, or a person associated with the Customer; and

      (ii) does not relate solely to an obligation on the part of the Customer, or a person associated with the Customer, to pay a stipulated amount to the Principal in the event that a specified event occurs; and

   (d) under the Surety Agreement, the Customer is liable to the regulated institution if the regulated institution makes a payment or incurs a liability to the Principal or the Beneficiary under the surety bond.

7. A regulated institution must seek written approval from APRA to treat any surety bonds the regulated institution has issued as if they were an insurance risk (for the purposes of meeting the requirements of the **GI Prudential Standards** only). This would require the regulated institution to include surety bond exposures within the insurer's assessment of insurance liabilities, as determined under GPS 340, and to apply the relevant capital factors specified in *Prudential Standard GPS 115 Capital Adequacy: Insurance Risk Charge*. For the purposes of calculating net outstanding claims liabilities and net premiums liabilities (as determined under GPS 340), the regulated institution may treat any risk mitigation arrangement as if it were reinsurance.

8. A regulated institution seeking APRA's approval for this approach outlined in paragraph 7 of this Attachment would need to include with its application a written confirmation from the regulated institution's **Appointed Actuary** that that person is able to appropriately measure the risk of the surety bond business within the regulated institution's insurance liabilities.

Attachment B – Treatment of collateral and guarantees as risk mitigants

1. The impact of applying the asset risk stresses may be reduced where the regulated institution holds certain types of collateral against an asset, or where the asset has been guaranteed, as a means of reducing risk.

2. For a regulated institution where the assets in question are reinsurance recoverables due from non-APRA-authorised reinsurers, different rules regarding treatment of collateral and guarantees apply (refer to paragraphs 6 to 10 of this Attachment).

Collateral

3. Collateral held against an asset may be considered in place of the asset if this would reduce the Asset Risk Charge. Where the fair value of the collateral does not cover the full value of the asset, the collateral must only replace that part of the asset that is covered by the collateral.

4. Collateral may be recognised in place of an asset only to the extent that it takes the form of a registered charge, registered mortgage or other legally enforceable security interest in, or over, an 'Eligible Collateral Item'. 'Eligible Collateral Items' are cash, government securities, or **debt obligations** (i.e. loans, deposits, placements, interest rate securities and other receivables) where the counterparty has a counterparty grade of 1, 2 or 3. The Eligible Collateral Item must also be held for a period not less than that for which the asset is held.

Guarantees

5. The stresses applied in the credit spreads and default stresses may be determined using the counterparty grade of a third-party guarantor if the guarantee is explicit, unconditional, irrevocable and legally enforceable for the remaining term to maturity of the related asset. The guarantor must have a counterparty grade (or for governments, a long-term foreign currency credit rating) of 1, 2 or 3. Guarantees provided by the regulated institution's parent or a related entity are not eligible for this treatment.

Collateral, guarantees and letters of credit in respect of reinsurance recoverables due from non-APRA authorised reinsurers[11]

6. Where a regulated institution possesses recognised collateral in Australia against reinsurance recoverables due from a non-APRA-authorised reinsurer, it may, in the default stress, apply the default factor relevant to the collateral to the value of the reinsurance recoverables (instead of applying the default factor that would otherwise apply to the reinsurance recoverables). For the purposes of this paragraph, collateral is recognised only:

[11] For the purpose of application of paragraphs 6 to 10 of this Attachment to a Level 2 insurance group, 'insurer' must be read to mean a **Level 1 insurer** (as defined in GPS 001).

(a) to the extent that it takes the form of:

(i) assets held in Australia that form part of a trust fund maintained by a trustee resident in Australia for the benefit of the insurer;

(ii) deposits held by the insurer in Australia, which are controlled by the insurer in Australia, made by the non-APRA-authorised reinsurer;

(iii) a combination of the two forms of collateral specified in paragraphs (i) and (ii); or

(iv) any other form of collateral as may be approved by APRA in writing in a particular case; and

(b) if it provides effective security against liabilities arising under the reinsurance contract; and

(c) if it is not available for distribution to creditors of the reinsurer other than the insurer in the event of the insolvency of the reinsurer.

7. Where the fair value of the collateral does not cover the full value of the reinsurance recoverables, only that part of the value of the reinsurance recoverables that is covered by collateral may be assigned the default factor applicable to the collateral.

8. Where a regulated institution possesses a guarantee or letter of credit in respect of the reinsurance recoverables due from a non-APRA-authorised reinsurer, the default factor to be used is that applicable to the guarantor or the issuer of the letter of credit, as the case may be. This paragraph applies only if each of the following conditions is satisfied:

(a) the guarantor or issuer of the letter of credit is an ADI or, in the case of a **Category E insurer**, its parent entity or other related entity, provided the entity has a counterparty grade of 1, 2 or 3;

(b) the guarantee or letter of credit is explicit, unconditional and irrevocable;

(c) the guarantor or issuer of the letter of credit is obliged to pay the insurer in Australia; and

(d) the obligation of the guarantor or issuer of the letter of credit to pay the insurer is specifically linked to performance of the reinsurance contract or contracts under which the reinsurance recoverables arise.

9. Except in the case of a Category E insurer, a guarantee or letter of credit provided to an insurer by its parent entity or other related entity is not eligible for the treatment provided for in paragraph 8 of this Attachment.

10. The collateral, guarantee or letter of credit referred to in paragraphs 6 to 8 of this Attachment must be effective for the expected period for payment of claims under the reinsurance contract under which the reinsurance recoverables arise. If this is impractical, the collateral, guarantee or letter of credit must be effective for a

period of at least 24 months and must include a termination provision requiring the issuer to give the insurer 12 months written notice of the issuer's intention to terminate the collateral, guarantee or letter of credit.

Attachment C – Extended Licensed Entity

1. In certain circumstances, a regulated institution may choose to hold assets in an SPV or other related entity, rather than on its own balance sheet. Where a regulated institution receives approval under paragraph 3 of this Attachment, the regulated institution will be able to determine its Asset Risk Charge based on the individual assets and liabilities of the related entity rather than simply on the regulated institution's direct exposure to that entity. This treats the activities of the regulated entity and the related entity as comprising an Extended Licensed Entity (ELE).

2. The extent to which the risk of a regulated institution's exposure to a related entity is commensurate with the underlying holdings of that entity, depends on the extent to which the regulated institution has control over, or is integrated with the entity, as well as on the existence of material third party liabilities of the entity. The regulated institution must consider any potential complications under a scenario where underlying asset holdings must be liquidated during financial stress.

3. Subject to the specific requirements set out in paragraph 4 of this Attachment, a regulated institution may apply to APRA to have one or more related entities approved as part of its ELE. Once approved, APRA will allow the regulated institution to 'look-through' the legal structures involved, and to 'consolidate' the balance sheet of the related entity with its own, for the purpose of determining the Asset Risk Charge. In effect, this allows the regulated institution to treat its own balance sheet and that of the approved related entity as a single entity for the purpose of calculating the Asset Risk Charge.

4. In deciding whether to approve an entity as part of a regulated institution's ELE, APRA will have regard to the following criteria in respect of the relationship between the regulated institution and the related entity:

   (a) the related entity must be wholly owned and controlled by the regulated institution, with a **Board** of directors/trustees that is comprised entirely of members of the regulated institution's Board or senior management;

   (b) the regulated institution must demonstrate to APRA that there are no legal or regulatory barriers (e.g. restrictions imposed by law or a regulator in a foreign jurisdiction) to the transfer of the assets back to the regulated institution;

   (c) the regulated institution's risk management systems and controls must apply fully to the operations of the related entity. The senior management of the regulated institution must be in a position to monitor the operations of the related entity to the same extent as the operations of the regulated institution itself. Systems for monitoring and maintaining control over the related entity must be included within the internal and external audit programs of the regulated institution;

(d) the regulated institution must be able to furnish stand-alone accounting records for the related entity and provide APRA with full and unfettered access to this information at any time (including during on-site visits);

(e) where the related entity holds or invests in assets on behalf of the regulated institution, the related entity must have no material third party liabilities, other than exempt tax liabilities and employee entitlements;

(f) where the related entity borrows on behalf of the regulated institution, all funds must be on-lent directly to the regulated institution; and

(g) the related entity must not conduct any business that the regulated institution would otherwise be prevented from conducting under the Act.

Attachment D – Level 2 insurance groups

1. The following adjustments to the methodologies and calculations in this Prudential Standard must be applied by the Level 2 insurance group:

Tax benefit

(a) Level 2 insurance groups may recognise tax benefits as a deduction from the Asset Risk Charge if tax legislation allows them to be absorbed by the existing deferred tax liabilities within the Level 2 insurance group. However, a Level 2 insurance group must not recognise tax benefits whose value is contingent on the tax benefits being absorbed by deferred tax liabilities of entities outside the Level 2 insurance group;

Currency stress

(b) Level 2 insurance groups must make all consolidation adjustments for intra-group arrangements before applying the currency stress outlined in this Prudential Standard;

Default stress

(c) Level 2 insurance groups must make all consolidation adjustments for intra-group arrangements before applying the stress outlined in this Prudential Standard; and

(d) The modification to the default stress relating to reinsurance recoverables from non-APRA-authorised reinsurers, as set out in paragraphs 74, 75 and 76 of this Prudential Standard, does not apply to the reinsurance recoverables of the **international business** of the Level 2 insurance group.[12]

2. A Level 2 insurance group must consult with APRA prior to entering into a material securitisation transaction in order to reduce the Asset Risk Charge.

3. A Level 2 insurance group may use a best endeavours basis to determine the identification of asset or counterparty exposures for international business. The best endeavours basis must use 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.

[12] For clarity, this means that the reinsurance recoverables from non-APRA-authorised reinsurers of entities within the Level 2 insurance group that are not insurers are not subject to the default factors in Table 3, subject to the default factors in Table 4 or the default factor as determined by paragraph 76 for the default stress test.