# Prudential Standard HPS 114

# Capital Adequacy: Asset Risk Charge

## Objectives and key requirements of this Prudential Standard

This Prudential Standard requires a private health insurer to maintain adequate capital against the asset risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a private health insurer rests with its Board of directors. The Board must ensure the private health insurer 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 fund'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 private health insurers and their funds.

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## Authority

1. This Prudential Standard is made under subsection 92(1) of the *Private Health Insurance (Prudential Supervision) Act 2015* (the Act).

## Application and commencement

2. This Prudential Standard applies to all **private health insurers** except where expressly noted otherwise.

3. A private health insurer must apply this Prudential Standard separately to each of its **health benefits funds** and its **general fund,** unless otherwise noted. The term 'private health insurer' refers to the private health insurer as a whole. The term 'fund' refers to each health benefits fund and the general fund, unless otherwise noted.

4. This Prudential Standard applies to private health insurers from 1 January 2027.

## Interpretation

5. Terms that are defined in *Prudential Standard CPS 001 Defined terms* 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 each fund of a private health insurer.

7. The Asset Risk Charge relates to the risk of an adverse movement in a fund'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 for a fund is calculated as the 'aggregated risk charge component' determined in accordance with paragraph 9.

### *Aggregated risk charge component*

9. A private health insurer must calculate, for each of its funds, the 'risk charge components' defined in paragraph 10, by considering the impact on the capital base of a fund of a range of stresses. These risk charge components are then aggregated using the formula set out in paragraphs 76 to 78, which allows for the likelihood of the scenarios modelled by the stress tests occurring simultaneously. The result of applying the formula is defined as aggregated risk charge component.

### *Risk charge components*

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

(a) 'real interest rates' determined in accordance with paragraphs 28 to 33;

(b) 'expected inflation' determined in accordance with paragraphs 34 to 37;

(c) 'currency' determined in accordance with paragraphs 38 to 41;

(d) 'equity' determined in accordance with paragraphs 42 to 45;

(e) 'property' determined in accordance with paragraphs 46 to 50;

(f) 'credit spreads' determined in accordance with paragraphs 51 to 62; and

(g) 'default' determined in accordance with paragraphs 63 to 75.

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 a fund 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 reduce the **prescribed capital amount** by the aggregate amount of any insurance and asset tax benefits that can be netted against deferred tax liabilities. This reduction occurs in *Prudential Standard HPS 110 Capital Adequacy* (HPS 110).

## Assets and liabilities to be stressed

13. In determining each risk charge component, a private health insurer must include the effective exposure[1] of a fund'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.

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

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

[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, paragraph 7 of *Prudential Standard HPS 112 Capital Adequacy: Measurement of Capital*, but gross of any tax effects.

(a) assets whose value must be deducted from the capital base in *Prudential Standard HPS 112 Capital Adequacy: Measurement of Capital* (HPS 112) (e.g. goodwill in subsidiaries); and

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

16. In addition to paragraph 15, a private health insurer that is an employer sponsor of a defined benefit superannuation fund does not need to reassess any deficit in a fund as a result of the seven stress tests, unless the private health insurer has provided a guarantee in relation to the benefits.

17. The private health insurer must apply the stress tests to the **fair value** of each of the fund's assets. A private health insurer 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. The risk charge component for each asset is the value reported in the private health insurer's **statutory accounts**[2] less the sum of the stressed value of the assets in each fund.

### *Off-balance sheet exposures*

18. A fund 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 a fund's on-balance sheet assets and liabilities that would result from application of the stresses to a fund's off-balance sheet exposures. A private health insurer must use effective exposure for any off-balance sheet exposures of a fund. Detailed information on the treatment of off-balance sheet exposures is set out in Attachment A.

### *Collateral and guarantees*

19. The impact of applying the asset risk stresses may be reduced where the private health insurer 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*

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

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

21. For assets of a private health insurer held under a trust or in a controlled investment entity,[3] the private health insurer 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]

22. 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.

23. 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).

*Derivatives*

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

25. 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.

26. 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*

27. In certain circumstances, a private health insurer 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 rates stress

28. This stress measures the impact on the capital base of a fund from changes in real interest rates.

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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.

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

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

31. The stress adjustments to real interest rates are determined by multiplying the greater of three percent or the nominal risk-free interest rate, 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.

32. 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.

33. A private health insurer must calculate the impact on the capital base of a fund 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 76.

## Expected inflation stress

34. 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.

35. 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.

36. 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 percent per annum. If the nominal risk-free interest rate is between zero and one percent 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.

37. A private health insurer must calculate the impact on the capital base of a fund 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 76.

## Currency stress

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

39. A private health insurer must calculate the impact on the capital base of a fund 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 76.

40. 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.

41. For funds whose liabilities are only denominated in foreign currencies, the predominant currency of the liabilities may be used as the reference point for the stresses instead of the Australian dollar.

## Equity stress

42. 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).

43. 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.

44. 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 three 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.

45. 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.

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[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.

## Property stress

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

47. 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.

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

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

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

## Credit spreads stress

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

52. 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.

53. 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 |

54. 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.

55. 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.

56. 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.

57. 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

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

the underlying exposures is a securitisation exposure. In addition, an exposure to one or more re-securitisation exposures is a re-securitisation exposure.

58. For floating rate assets, the increase in yield must be assumed to apply for the period until a private health insurer 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.

59. For fixed rate assets where the private health insurer 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).

60. Unsecured loans that have a 100 per cent charge applied in the default stress in accordance with paragraph 70 must be assumed to be unaffected by the credit spreads stress.

61. The 'government' category applies to assets guaranteed by the Commonwealth Government and assets guaranteed by foreign governments that have a counterparty grade of 1 and are denominated in the official or national currency of the guarantor.

62. 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).

### Default stress

63. 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.

64. This stress includes the risk of counterparty default. A private health insurer 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.

65. Where a private health insurer has unpaid premiums, **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.

66. 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 later paragraphs in this section.

**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 |

67. For the purpose of the default stress, the value of reinsurance assets is to be the central estimate of reinsurance assets as measured in accordance with *Prudential Standard HPS 340 Insurance Liability Valuation* (HPS 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.

68. 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.

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

70. The following types of unsecured loans have a 100 per cent default factor applied:

    (a) loans to directors of the private health insurer, 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.

71. 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).

*Reinsurance assets due from non-APRA-authorised reinsurers*

72. Reinsurance assets due from **non-APRA-authorised reinsurers** are subject to the default stress factors that are higher than would otherwise apply under paragraph 66. 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 |

73. 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 66) to each reinsurance recoverable on and from the second annual balance date after the event giving rise to the reinsurance recoverable occurred.[7] 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.[8] 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 balance date.

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

[7] 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.

[8] 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.

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

74. 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.[9]

75. For the purposes of determining the amount of a reinsurance recoverable, if there is an offsetting arrangement between the private health insurer 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.

## Aggregation formula

76. 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

[9] Any dispute between the private health 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 HPS 340.

(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 $sign(x)$.

77. The correlation matrix is:

**Table 3: 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 |

78. 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

79. APRA may, by notice in writing to a private health insurer, adjust or exclude a specific requirement in this Prudential Standard in relation to that private health insurer.

80. 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 fund 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 a fund to asset risks must be applied to any off-balance sheet exposures of the fund. 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 private health insurer 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 private health insurer 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 HPS 110.

*Direct credit substitutes*

4. To the extent that a private health insurer has issued instruments of the following kind:

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

   (b) letters of credit; or

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

   the private health insurer is exposed to the risk of having to make payment on these instruments should a default event occur that requires the private health insurer 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.

# Attachment B – Treatment of collateral and guarantees as risk mitigants

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

2. For a private health insurer 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 9 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 private health insurer'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*

6. Where a private health insurer 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:

   (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 private health insurer;

(ii) deposits held by the private health insurer in Australia, which are controlled by the private health 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 private health insurer 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 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. 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 private health insurer may choose to hold assets in an SPV or other related entity, rather than on its own balance sheet. Where a private health insurer receives approval under paragraph 3 of this Attachment, the private health insurer 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 private health insurer's direct exposure to that entity. This treats the activities of the private health insurer and the related entity as comprising an Extended Licensed Entity (ELE).

2. The extent to which the risk of a private health insurer's exposure to a related entity is commensurate with the underlying holdings of that entity, depends on the extent to which the private health insurer has control over, or is integrated with the entity, as well as on the existence of material third party liabilities of the entity. The private health insurer 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 private health insurer may apply to APRA to have one or more related entities approved as part of its ELE. Once approved, APRA will allow the private health insurer 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 private health insurer 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 private health insurer's ELE, APRA will have regard to the following criteria in respect of the relationship between the private health insurer and the related entity:

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

   (b) the private health insurer 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 private health insurer;

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

(d) the private health insurer 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 private health insurer, 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 private health insurer, all funds must be on-lent directly to the private health insurer; and

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