

Insurance (prudential standard) determination No. 15 of 2012

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority

Insurance Act 1973, paragraphs 32(1)(a) and (b) and subsections 32(4)
Legislative Instruments Act 2003, paragraph 6(d)

Paragraphs 32(1)(a) and (b) of the Insurance Act 1973 (the Insurance Act) provide that APRA may determine, in writing, standards relating to prudential matters that must be complied with by general insurers and authorised non-operating holding companies. Subsection 32(4) of the Insurance Act gives APRA the power to vary or revoke prudential standards so determined.

Pursuant to paragraph 6(d) of the Legislative Instruments Act 2003 (the Legislative Instruments Act), such prudential standards are legislative instruments for the purposes of the Legislative Instruments Act.

1. Background

APRA commenced a review of the regulatory capital framework for general insurers and life companies (LAGIC review) in 2010. The broad aims of the review were to:

- improve the risk sensitivity and appropriateness of the capital standards in general insurance and life insurance (including friendly societies); and
- where appropriate, improve the alignment of the capital standards across the industries that APRA supervises.

APRA has made a range of amendments to its prudential framework to give effect to the findings of the review. As a result of the changes, there is a common capital framework for required capital and eligible capital across general insurers and life companies. An insurer is required to have sufficient capital to absorb unexpected shocks that may arise over a one-year period and be able to meet its liabilities at the end of that period.

The minimum capital requirement is known as the Prudential Capital Requirement (PCR). This comprises a prescribed capital amount plus any supervisory adjustment determined by APRA.

Specifically, in the case of general insurers, the prescribed capital amount includes explicit risk charges for insurance risk, insurance concentration risk, asset risk, asset concentration risk and operational risk as well as an aggregation benefit. The supervisory adjustment is a discretionary amount set by APRA and could be used to address strategic risks, reputational risks, unusual operational risks, or risks related to poor corporate governance or risk management systems.

General insurers must at all times satisfy minimum requirements for the composition of their capital bases and ensure that the capital base exceeds the PCR.

In addition to the quantitative requirements described above, a general insurer is required to have a well documented Internal Capital Adequacy Assessment Process (ICAAP) that is approved by the Board, and is appropriate to the nature, scope and complexity of the general insurer's activities. The ICAAP involves an integrated approach to capital and risk management and is based on assessing the level of risk in the insurer and matching the capital held to that risk profile.

In addition, general insurers are required to make a range of public disclosures, aimed at assisting market observers to assess the capital adequacy of general insurers and enhancing market discipline.

2. Purpose of the instruments

The purpose of making the instrument is to introduce an amended prudential standard governing the measurement of capital and revoke the existing prudential standard in relation to the measurement of capital in order to implement the changes arising from the LAGIC review.

On 4 December 2012, APRA made the following determination (the instrument) under subsections 32(1) and 32(4) of the Insurance Act:

1. Insurance (prudential standard) determination No. 15 of 2012, which revokes *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* made on 18 June 2010 (the existing GPS 112) and determines a new *Prudential Standard GPS 112 Capital Adequacy: Measurement of Capital* (GPS 112);

The instrument will take effect on 1 January 2013.

3. Operation of the instruments

The following instrument introduces new requirements to implement the revised capital framework under the LAGIC review:

Insurance (prudential standard) determination No. 15 of 2012

GPS 112 sets out the characteristics that an instrument must have to qualify for inclusion in the capital base of a general insurer or Level 2 insurance group and the various regulatory adjustments to be made to determine the capital base.

4. Consultation

APRA undertook consultation on the LAGIC review between May 2010 and October 2012, including four rounds of industry consultation, three technical papers and two quantitative impact studies.

APRA released the following consultation materials:

- May 2010 – Discussion paper ‘Review of capital standards for general insurers and life insurers’¹;
- July 2010 – Technical papers ‘Review of capital standards for general insurers and life insurers – Asset risk capital charge’² and ‘Review of capital standards for general insurers and life insurers – Capital base and insurance risk capital charge for life insurers’³;
- September 2010 – Technical paper ‘Review of capital standards for general insurers and life insurers – Insurance concentration risk capital charge for general insurers’⁴;
- Late 2010 – APRA invited insurers to participate in the first quantitative impact study⁵;
- March 2011 – Response paper ‘Review of capital standards for general insurers and life insurers’⁶;
- April 2011 – APRA invited insurers to participate in the second quantitative impact study⁷;
- December 2011 – Response paper ‘Review of capital standards for general insurers and life insurers’⁸, draft prudential standards;
- March 2012 – Letter to all CEOs (or equivalent) and Appointed Actuaries of life insurers ‘Illiquidity premium’⁹;
- May 2012 – Response paper ‘Review of capital standards for general insurers and life insurers’¹⁰, final versions of the capital adequacy standards, draft versions of the composition of the capital base and non-capital prudential standards containing amendments that are in the main consequential to the revised capital framework;

¹ [http://www.apra.gov.au/CrossIndustry/Documents/GLI_DP_RCSGILI_032010_v7\[1\].pdf](http://www.apra.gov.au/CrossIndustry/Documents/GLI_DP_RCSGILI_032010_v7[1].pdf)

² http://apra.gov.au/CrossIndustry/Documents/GLI_TP_LGICR_062010_ex%5B1%5D.pdf

³ http://apra.gov.au/CrossIndustry/Documents/GLI_TP_CBIRCC_072010_v8%5B1%5D.pdf

⁴ <http://apra.gov.au/CrossIndustry/Documents/Insurance-Conc-Risk-charge%5B1%5D.pdf>

⁵ <http://www.apra.gov.au/GI/PrudentialFramework/Pages/Review-Cap-Stds-QIS1-QIS2-TechSpecs.aspx>

⁶ http://apra.gov.au/CrossIndustry/Documents/GLI_RS_RCSGILI_032011_ex_r%5B1%5D.pdf

⁷ <http://www.apra.gov.au/GI/PrudentialFramework/Pages/Review-Cap-Stds-QIS1-QIS2-TechSpecs.aspx>

⁸ <http://apra.gov.au/GI/PrudentialFramework/Pages/General-and-Life-Insurance-Capital-Review-Consultation-on-Draft-Prudential-Standards.aspx>

⁹ http://apra.gov.au/lifs/PrudentialFramework/Documents/120330_LTI_LAGIC_LI_illiquidity_premium_consultation.pdf

¹⁰ <http://apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-Consultation-May-2012.aspx>

- June 2012 – Discussion paper ‘Review of capital standards for general insurers and life insurers – proposed revisions to reporting requirements’¹¹, draft versions of reporting forms and instructions, reporting standards and capital adequacy calculation workbooks and instructions;
- August 2012 – Letter to insurers ‘Additional proposed changes to the reporting standards’¹²;
- September 2012 – Letter to all CEOs (or equivalent) of life insurers ‘Solvency standard requirements under the *Life Insurance Act 1995*’¹³;
- September 2012 – Letter to insurers ‘Consultation on draft prudential practice guides and information paper’¹⁴, draft versions of prudential practice guides and an information paper¹⁵;
- October 2012 – Response paper ‘Review of capital standards for general insurers and life insurers’¹⁶, final versions of all prudential standards amended as a result of the LAGIC review; and
- October 2012 – Response paper ‘Review of capital standards for general insurers and life insurers – reporting requirements’¹⁷, final versions of all forms and instructions and reporting standards.

APRA has considered both formal and informal feedback from industry throughout the above multi-year process. APRA has also considered feedback from the authorised deposit-taking (ADI) industry in relation to requirements for the composition of the capital base which are common to insurers and ADIs. Submissions made by industry were broadly supportive of the changes. Issues considered to be significant or to have merit were incorporated into the revised capital framework.

¹¹ <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/LAGIC-Reporting-Requirements-June-2012.aspx>

¹² <http://www.apra.gov.au/CrossIndustry/Consultations/Documents/120806-letter-to-industry-LAGIC-proposed-changes-to-reporting-standards.pdf>

¹³ http://www.apra.gov.au/CrossIndustry/Consultations/Documents/120912_LAGIC_letter_life_insurance_temporary_solvency_standard.pdf

¹⁴ <http://www.apra.gov.au/CrossIndustry/Consultations/Pages/LAGIC-Prudential-Practice-Guides-September-2012.aspx>

¹⁵ Final versions of the prudential practice guides and information paper will be released in 2013.

¹⁶ <http://www.apra.gov.au/CrossIndustry/Pages/Life-and-General-Insurance-Capital-Review-October-2012.aspx>

¹⁷ <http://www.apra.gov.au/lifs/ReportingFramework/Pages/LAGIC-final-reporting-requirements-LL-October-2012.aspx>

5. Regulation Impact Statement

A Regulation Impact Statement is required. It has been prepared and is attached as supporting material.

6. Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

The legislative instruments the subject of this explanatory statement do not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*. Accordingly, in APRA's assessment, these legislative instruments are compatible with human rights.