



Life Insurance (prudential standard) determination No. 6 of 2012

Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge

Life Insurance Act 1995

I, Ian Laughlin, delegate of APRA, under subsection 230A(1) of the *Life Insurance Act 1995* (the Act) DETERMINE *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge*, in the form set out in the Schedule, which applies to all life companies, including friendly societies.

This instrument takes effect on 1 January 2013.

Dated: 30 November 2012

[Signed]

Ian Laughlin
Member

Interpretation

In this Determination:

APRA means the Australian Prudential Regulation Authority.

friendly society has the meaning given in section 16C of the Act.

life company has the meaning given in the Dictionary to the Act.

Schedule

Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge comprises the 8 pages commencing on the following page.



Prudential Standard LPS 117

Capital Adequacy: Asset Concentration Risk Charge

Objective and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the asset concentration risks associated with its activities.

The ultimate responsibility for the prudent management of capital of a life company rests with its Board of directors. The Board must ensure that the life company 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 Concentration Risk Charge is the minimum amount of capital required to be held against asset concentration risks. The Asset Concentration Risk Charge relates to the risk of a life company's concentration in particular assets resulting in adverse movements in the life company's capital base.

This Prudential Standard sets out the method for calculating the Asset Concentration Risk Charge. This charge is one of the components of the Standard Method for calculating the prescribed capital amount for life company statutory funds and general funds.

Authority

1. This Prudential Standard is made under paragraph 230A(1)(a) of the *Life Insurance Act 1995* (the Act).

Application

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act¹, except where expressly noted otherwise.
3. A life company must apply this Prudential Standard separately:
 - (a) for a life company other than a friendly society: to each of its statutory funds and its shareholders' fund; and
 - (b) for a friendly society: to each of its approved benefit funds and its management fund.
4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** which is carried on through its Australian statutory funds but not otherwise.²
5. This Prudential Standard applies to life companies from 1 January 2013.

Interpretation

6. Terms that are defined in *Prudential Standard LPS 001 Definitions* appear in bold the first time they are used in this Prudential Standard.
7. Unless otherwise indicated:
 - (a) the term **statutory fund** will be used to refer to a statutory fund of a life company other than a friendly society, or an approved benefit fund of a friendly society, as relevant;
 - (b) the term **general fund** will be used to refer to the shareholders' fund of a life company other than a friendly society, or the management fund of a friendly society, as relevant; and
 - (c) the term 'fund' will be used to refer to a statutory fund or a general fund, as relevant.

¹ Refer to subsection 21(1) of the Act.

² Refer to section 16ZD of the Act.

Asset Concentration Risk Charge

8. This Prudential Standard sets out the method for calculating the **Asset Concentration Risk Charge** for a life company's statutory funds and its general fund.
9. The method for calculating **Asset Risk Charge** is set out in *Prudential Standard LPS 114 Asset Risk Charge* (LPS 114). It is calibrated for funds whose investments in each asset class are well diversified. Additional capital is therefore required if there are excessive concentrations of investments in individual assets or in exposures to single counterparties (or groups of related counterparties).
10. The Asset Concentration Risk Charge is the amount by which the values of individual asset and credit exposures (or groups of related exposures) exceed certain limits. The limits, by type of asset exposure, are set out in Attachment A. Modifications to the limits that apply to **specialist reinsurers** are set out in paragraph 29.
11. Individual assets that are exposed to common risks (e.g. strata titles in the same property, or exposures to a single creditor) must be aggregated.
12. The prescribed limits are expressed as percentages of the value of the assets of the statutory fund or general fund (VAF), as percentages of the **capital base** of the fund, or as fixed dollar limits.
13. For the purpose of determining the asset concentration risk charge, liabilities ceded under reinsurance (reinsurance assets) are to be treated as an asset of the fund.
14. For the purpose of determining the asset concentration limits for non-reinsurance assets, VAF is the total assets of the fund as per the life company's **statutory accounts**.
15. For the purpose of determining the asset concentration limits for reinsurance assets:
 - (a) these assets must be valued on a stressed basis. The stressed value of reinsurance assets is the amount by which the stressed policy liabilities determined under *Prudential Standard LPS 115 Insurance Risk Charge* would increase, if the stressed policy liabilities were determined gross of reinsurance; and
 - (b) VAF includes the stressed value of reinsurance assets instead of the amounts included in the life company's statutory accounts.
16. All exposures to a reinsurer or reinsurance group are to be considered a single counterparty exposure (for the purposes of applying the relevant limits in Attachment A).

17. Where arrangements with a reinsurer involve both liability and asset components, these may be taken as a single net exposure to the extent they are subject to a legally enforceable right of offset (including in a winding up of the reinsurer).
18. Exposures must be the effective exposures of the fund to each asset or counterparty, including both on-balance sheet and off-balance sheet exposures. If collateral or a third party guarantee has been used in place of an asset under LPS 114, the collateral or exposure to the guarantor must also be used in place of the asset for the purposes of this Prudential Standard. If a look-through basis has been used for assets under LPS 114, the same look-through basis must be used for the purposes of this Prudential Standard.
19. Where the fund has a significant cumulative exposure through different classes of assets to a single counterparty or related counterparties the limit for that counterparty in respect of any particular asset class must be reduced by the lesser of the actual exposure or the exposure limit to that same counterparty in respect of all asset classes with lower limits in Attachment A.
20. Where the policy liabilities are in respect of investment-linked benefits linked to the asset or credit exposure in question and there has been full disclosure to policy owners of the risks to which they are exposed, no asset concentration limits apply.
21. Where the asset or credit exposure is in respect of bank bills or bank deposits, bank for this purpose means:
 - (a) an **authorised deposit-taking institution**; and
 - (b) in the case of overseas business, a bank in the same country as that in which the business is written, provided that country has capital requirements in respect of banking business comparable to those in the Banking Act.
22. The value of an asset can be offset by deferred tax provisions or other liabilities related to the asset, if those provisions/liabilities would be realised if the asset was sold.
23. The value of an asset can be reduced by any amounts that have been treated as deductions from the capital base, as determined under *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital*.
24. A reinsurance asset must be treated as an unsecured loan unless, subject to a six month grace period from risk inception, the asset arises under an executed and legally binding contract which is enforceable by the life company.

Treatment of collateral and guarantees as risk mitigants

25. The impact of applying the asset concentration limits 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.

26. Collateral held against an asset may be considered in place of the asset if this would reduce the asset concentration risk charge. Where the fair value of the collateral does not cover the full value of the asset, the collateral can only replace that part of the asset that is covered by the collateral.
27. Collateral can be recognised 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 the period for which the asset is held.
28. Credit risk may be assessed using the counterparty grade of a third-party guarantor if the guarantee is explicit, unconditional, irrevocable and enforceable for the remaining term to maturity. 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 life company's parent or **related entities** are not eligible for this treatment.

Specialist reinsurers

29. In the case of a specialist reinsurer, the following asset concentration limits apply in respect of retrocessions by that specialist reinsurer to an overseas parent, associated, or subsidiary company which, with APRA's agreement, has been identified as an appropriate retrocessionaire for the purposes of this paragraph:
 - (a) where the retrocessionaire has a current counterparty grade of 1, 2 or 3 – 50 per cent of VAF;
 - (b) where the retrocessionaire does not have a current counterparty grade of 1, 2 or 3, but had such a grade at the time the retrocession arrangement was entered into;
 - (i) within the first three months after the downgrade below Grade 3 – 50 per cent of VAF;
 - (ii) within the next nine months – 33 per cent of VAF;
 - (iii) within the second 12 months after the downgrade – 17 per cent of VAF; and
 - (iv) thereafter, the retrocession arrangements do not qualify for the concessional treatment afforded to specialist reinsurers;
 - (c) in all other circumstances, the retrocession arrangements do not qualify for the concessional treatment afforded to specialist reinsurers.

Adjustments and exclusions

30. APRA may, by notice in writing to a life company, adjust or exclude a specific requirement in this Prudential Standard in relation to that life company.

Transition

31. On application by a life company, APRA may grant transitional relief from the obligation for the life company to comply with any requirement in this Prudential Standard. Any relief granted by APRA under this paragraph will have effect until no later than 31 December 2014.

Attachment A

	Asset exposure	Limit
(a)	Assets guaranteed by an Australian State or Federal government or by the national government of the country in whose currency the liabilities of the statutory fund or general fund are denominated:	No limit
(b)	A life insurance policy issued to the life company by a registered life company which is a related entity of the life company:	No limit
(c)	Bank bills; or Assets guaranteed by an overseas provincial government (equivalent in status to an Australian State government), in the country in whose currency the liabilities of a statutory fund or a general fund are denominated:	The greater of: i) 25% of VAF; and ii) AUD 20 million.
(d)	Bank deposits	The greatest of: i) 50% of VAF less the value of the assets of the fund secured by bank bills; ii) 25% of VAF; and iii) AUD 20 million.
(e)	A reinsurance arrangement with a registered life company that is not a related entity of the life company; or With APRA's written approval, a reinsurance arrangement in respect of overseas business, with a related entity of a registered life company that has a statutory fund which is a specialist reinsurer:	The greater of: i) 25% of VAF; and ii) AUD 20 million.
(f)	Outstanding premiums receivable by a reinsurer under a reinsurance policy with a registered life company:	The greater of: i) 25% of VAF; and ii) AUD 20 million.

(g)	i) any other actively traded security; ii) a non-traded security, loan, or reinsurance arrangement with a counterparty grade of 1, 2 or 3; iii) real estate; or iv) other income producing real property asset:	The greater of: i) 5% of VAF; and ii) 25% of capital base.
(h)	Any asset not covered by any of the above categories:	The greater of: i) 2.5% of VAF; and ii) 12.5% of capital base.