Life insurance (prudential standard) determination Nos. 1 to 17 of 2012

EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority

Life Insurance Act 1995, subsections 230A(5) and 230A(1)
Legislative Instruments Act 2003, paragraph 6(d)

Pursuant to subsection 230A(5) of the Life Insurance Act 1995 (Life Act) APRA may, in writing, vary or revoke a prudential standard made in relation to prudential matters to be complied with by all life companies (including friendly societies) and non-operating holding companies of life companies registered under the Life Act (registered NOHCs). Pursuant to subsection 230A(1) APRA may, in writing, determine a prudential standard in relation to prudential matters to be complied with by all life insurance companies (including friendly societies) and registered NOHCs.

Pursuant to paragraph 6(d) of the *Legislative Instruments Act 2003* (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. The revised approach provides a clearer view of the financial position of insurers through a direct comparison of the amount of eligible capital with required capital. As a result of the changes, there is a common capital framework for required capital and eligible capital across general insurers and life companies. A life company 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. For life companies, the prescribed capital amount includes explicit risk charges for insurance 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.

Life companies 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 life company 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 life company's activities. The ICAAP involves an integrated approach to capital and risk management and is based on assessing the level of risk in the life company and matching the capital held to that risk profile.

Life companies are also required to make a range of public disclosures, aimed at assisting market observers to assess the capital adequacy of life companies and enhancing market discipline.

The changes in respect of prudential requirements in relation life companies and registered NOHCs arising from the LAGIC review are effected through the instruments described in section 2 below.

2. Purpose of the instruments

The purpose of making the instruments is to introduce new and amended prudential standards and revoke existing prudential standards in relation to life companies and registered NOHCs in order to implement the changes arising from the LAGIC review.

On 30 November 2012, APRA made the following determinations (the instruments) under subsections 230A(1) and 230A(5) of the Life Act:

1. Life insurance (prudential standard) determination Nos. 1 to 7 of 2012, which make the following prudential standards:

    (a) *Prudential Standard LPS 001 Definitions* (LPS 001)*;*

    (b) *Prudential Standard LPS 110 Capital Adequacy* (LPS 110)*;*

    (c) *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112)*;*

    (d) *Prudential Standard LPS 114 Capital Adequacy: Asset Risk Charge* (LPS 114)*;*

    (e) *Prudential Standard LPS 115 Capital Adequacy: Insurance Risk Charge* (LPS 115);

    (f) *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117)*; and*

(g) *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge* (LPS 118)*;*

2. Life insurance (prudential standard) determination No. 8 of 2012, which revokes *Prudential Standard LPS 2.04 Solvency Standard* made on 28 June 2010 (LPS 2.04) and determines a new *Prudential Standard LPS 100 Solvency Standard* (LPS 100);

3. Life insurance (prudential standard) determination No. 9 of 2012, which revokes *Prudential Standard LPS 220 Risk Management* made on 23 March 2007 (the existing LPS 220) and determines a new *Prudential Standard LPS 220 Risk Management* (LPS 220);

4. Life insurance (prudential standard) determination No. 10 of 2012, which revokes *Prudential Standard LPS 310 Audit and Related Matters* made on 2 March 2010 (the existing LPS 310) and determines a new *Prudential Standard LPS 310 Audit and Related Matters* (LPS 310);

5. Life insurance (prudential standard) determination No. 11 of 2012, which revokes *Prudential Standard LPS 320 Actuarial and Related Matters* made on 2 March 2010 (the existing LPS 320) and determines a new *Prudential Standard LPS 320 Actuarial and Related Matters* (LPS 320);

6. Life insurance (prudential standard) determination No. 12 of 2012, which revokes *Prudential Standard LPS 1.04 Valuation of Policy Liabilities* made on 28 June 2010 (LPS 1.04) and determines a new *Prudential Standard LPS 340 Valuation of Policy Liabilities* (LPS 340);

7. Life insurance (prudential standard) determination No. 13 of 2012, which revokes *Prudential Standard LPS 4.02 Minimum Surrender Values and Paid-up Values* made on 27 August 2010 (LPS 4.02) and determines a new *Prudential Standard LPS 360 Termination Values, Minimum Surrender Values and Paid-up Values* (LPS 360);

8. Life insurance (prudential standard) determination No. 14 of 2012, which revokes *Prudential Standard LPS 5.02 Cost of Investment Performance Guarantees* made on 27 November 2007 (LPS 5.02) and determines a new *Prudential Standard LPS 370 Cost of Investment Performance Guarantees* (LPS 370);

9. Life insurance (prudential standard) determination No. 15 of 2012, which revokes *Prudential Standard LPS 600 Statutory Funds* made on 5 May 2011 (the existing LPS 600) and determines a new *Prudential Standard LPS 600 Statutory Funds* (LPS 600);

10. Life insurance (prudential standard) determination No. 16 of 2012, which revokes *Prudential Standard LPS 700 Friendly Society Benefit Funds* made on 5 May 2011 (the existing LPS 700) and determines a new *Prudential Standard LPS 700 Friendly Society Benefit Funds* (LPS 700); and

11. Life insurance (prudential standard) determination No. 17 of 2012, which revokes the following prudential standards:

    (a) *Prudential Standards No. 3 Prudential Capital Requirement* made on 11 June 2002;

    (b) *Prudential Standard LPS 3.04 Capital Adequacy Standard* made on 28 June 2010;

    (c) *Prudential Standard LPS 6.03 Management Capital Standard* made on 28 June 2010;

    (d) *Prudential Standard LPS 7.02 General Standard* made on 28 June 2010; and

    (e) *Prudential Standard LPS 350 Contract Classification for the Purpose of Regulatory Reporting to APRA* made on 6 December 2007.

The instruments will take effect on 1 January 2013.

3. Operation of the instruments

The following instruments introduce new requirements to implement the revised capital framework under the LAGIC review.

Life insurance (prudential standard) determination No. 1 of 2012

LPS 001 defines key terms referred to in other prudential standards applicable to life companies.

Life insurance (prudential standard) determination No. 2 of 2012

LPS 110 requires a life company to maintain an adequate level and quality of capital commensurate with the scale, nature and complexity of its business and risk profile. A life company is also required to have a documented ICAAP, comply with any supervisory adjustment to capital imposed by APRA, and obtain APRA's written consent before reducing its capital.

Under LPS 110, a life company is required to maintain required levels of capital within each of its funds and for the company as a whole, and determine each fund's prescribed capital amount having regard to a range of risk factors that may adversely impact the company's ability to meet its obligations. These factors include insurance risk, asset risk, asset concentration risk and operational risk.

Life insurance (prudential standard) determination No. 3 of 2012

LPS 112 sets out the characteristics that an instrument must have to qualify for inclusion in the capital base of a life company and the various regulatory adjustments to be made to determine the capital base for each statutory fund, the general fund and the life company as a whole.

Life insurance (prudential standard) determination No. 4 of 2012

LPS 114 sets out the method for calculating the Asset Risk Charge, the minimum amount of capital a life company must hold against the asset risks associated with its activities. The Asset Risk Charge is one of the components of the Standard Method for calculating the prescribed capital amount for life company statutory funds and general funds, and relates to the risk of adverse movements in the value of a fund's on-balance sheet and off-balance sheet exposures.

Life insurance (prudential standard) determination No. 5 of 2012

LPS 115 sets out the method for calculating the Insurance Risk Charge, the minimum amount of capital a life company must hold against the insurance risks associated with its activities. The Insurance Risk Charge is one of the components of the Standard Method for calculating the prescribed capital amount for life company statutory funds and general funds, and relates to the risk of adverse impacts due to movements in future mortality, morbidity, longevity, servicing expenses and lapses.

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

LPS 117 sets out the method for calculating the Asset Concentration Risk Charge, the minimum amount of capital a life company must hold against asset concentration risks. The Asset Concentration Risk Charge is one of the components of the Standard Method for calculating the prescribed capital amount for life company statutory funds and general funds, and relates to the risk of a life company's concentration in particular assets resulting in adverse movements in the life company's capital base.

Life insurance (prudential standard) determination No. 7 of 2012

LPS 118 sets out the method for calculating the Operational Risk Charge, the minimum amount of capital a life company must hold against operational risks. The Operational Risk Charge is one of the components of the Standard Method for calculating the prescribed capital amount for life company statutory funds and general funds, and relates to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

Life insurance (prudential standard) determination No. 8 of 2012

LPS 100 is a temporary solvency standard which requires the capital base of each statutory fund to exceed 90 per cent of the fund's prescribed capital amount under the capital adequacy standards. A separate solvency and capital adequacy standard for life insurance statutory funds is required under the Life Act. The Government has released a consultation paper 'Strengthening APRA's Crisis Management Powers' proposing to amend the Life Act to implement a single capital requirement.[1] LPS 100 will cease to have effect from the time this change to the Life Act becomes effective.

The following instruments introduce amendments to prudential requirements that are in the main consequential to the revised capital framework under the LAGIC review

[1] http://www.treasury.gov.au/consultationsandreviews/submissions/2012/APRA

along with a small number of other amendments as set out below, to enhance readability and address minor prudential matters:

Life insurance (prudential standard) determination No. 9 of 2012

LPS 220 sets out the requirements for a life company to maintain a risk management framework and strategy that is appropriate to the nature and scale of its operations.

Additional paragraphs are added from those in existing LPS 220 to clarify that the requirements for the risk management framework and the ICAAP should be combined to produce an integrated approach to risk and capital management. The list of material risks covered under the risk management framework is also aligned under the revised capital framework, to facilitate closer alignment between capital management and risk management.

Life insurance (prudential standard) determination No. 10 of 2012

LPS 310 sets out the roles and responsibilities of a life company's Auditor, and the obligations of a life company to make arrangements to enable its Auditor to fulfil his or her responsibilities.

The table in Attachment A which specifies the auditable annual returns has been updated from the table in Attachment A in the existing LPS 310 to refer to the revised reporting arrangements.

Life insurance (prudential standard) determination No. 11 of 2012

LPS 320 sets out the requirements for the roles and responsibilities of an Appointed Actuary, and the obligations of a life insurer to make arrangements to enable its Appointed Actuary to fulfil those roles and responsibilities.

The existing LPS 320 is amended so that the principal responsibility for determining the policy liabilities, prescribed capital amount and the capital base lies with the life insurer and, ultimately, its Board. The Appointed Actuary is required to advise a value for these amounts in the Financial Condition Report including documenting the assumptions and methodologies adopted for the purpose of the calculations.

A life company is required to provide an explanation to APRA, on any areas where the advice of the Appointed Actuary is not adopted.

Life insurance (prudential standard) determination No. 12 of 2012

LPS 340 establishes a set of principles and practices for the consistent measurement and reporting of policy liabilities for life insurance contracts.

The existing LPS 340 is updated to incorporate relevant material from LPS 350, which will be revoked with effect from 1 January 2013.

Life insurance (prudential standard) determination No. 13 of 2012

LPS 360 sets out the requirements for determining termination values, minimum surrender values and minimum paid-up values.

Modifications are made to a number of definitions in LPS 4.02 to reflect the changed role for termination values under the revised capital framework. Where the minimum termination value for a type of policy is not specified in the prudential standard, the life insurer must obtain the approval of APRA for the proposed approach to determining the minimum termination value.

Life insurance (prudential standard) determination No. 14 of 2012

LPS 370 sets out revised requirements for calculating the cost of investment performance guarantees provided in association with investment-linked contracts, which is derived from the policy liability valuation. LPS 5.02 relied on the resilience reserve calculated under LPS 3.04 for determining the cost of any investment performance guarantees, which, under the revised capital framework, will no longer be calculated.

Life insurance (prudential standard) determination No. 15 of 2012

LPS 600 sets out requirements for the operations of statutory funds and any restructure of statutory funds, so that they are fair and equitable for policy owners.

Requirements regarding when a restructure of statutory funds has effect and the consequences of transfer between statutory funds by way of endorsement of a policy in the existing LPS 600 are clarified. In addition, minor wording changes are made to reduce and simplify the material setting out the calculation of starting amounts.

LPS 600 applies to all life companies other than friendly societies registered under the Life Act.

Life insurance (prudential standard) determination No. 16 of 2012

LPS 700 sets out the requirements for the establishment, structure and operation of an approved benefit fund of a friendly society so that it is fair and equitable for its policy owners. The amendments to the existing LPS 700 reflect consequential changes as a result of the revised capital framework.

LPS 700 applies to all life companies that are friendly societies registered under the Life Act.

Life insurance (prudential standard) determination No. 17 of 2012

This determination revokes a number of existing prudential standards which, due to the changes made as a result of the LAGIC review, will be obsolete from 1 January 2013.

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'[2];
- July 2010 – Technical papers 'Review of capital standards for general insurers and life insurers – Asset risk capital charge'[3] and 'Review of capital standards for general insurers and life insurers – Capital base and insurance risk capital charge for life insurers'[4];
- September 2010 – Technical paper 'Review of capital standards for general insurers and life insurers – Insurance concentration risk capital charge for general insurers'[5];
- Late 2010 – APRA invited insurers to participate in the first quantitative impact study[6];
- March 2011 – Response paper 'Review of capital standards for general insurers and life insurers'[7];
- April 2011 – APRA invited insurers to participate in the second quantitative impact study[8];
- December 2011 – Response paper 'Review of capital standards for general insurers and life insurers'[9], draft prudential standards;
- March 2012 – Letter to all CEOs (or equivalent) and Appointed Actuaries of life insurers 'Illiquidity premium'[10];
- May 2012 – Response paper 'Review of capital standards for general insurers and life insurers'[11], 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;

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2 http://www.apra.gov.au/CrossIndustry/Documents/GLI_DP_RCSGILI_032010_v7[1].pdf
3 http://apra.gov.au/CrossIndustry/Documents/GLI_TP_LGICR_062010_ex%5B1%5D.pdf
4 http://apra.gov.au/CrossIndustry/Documents/GLI_TP_CBIRCC_072010_v8%5B1%5D.pdf
5 http://apra.gov.au/CrossIndustry/Documents/Insurance-Conc-Risk-charge%5B1%5D.pdf
6 http://www.apra.gov.au/GI/PrudentialFramework/Pages/Review-Cap-Stds-QIS1-QIS2-TechSpecs.aspx
7 http://apra.gov.au/CrossIndustry/Documents/GLI_RS_RCSGILI_032011_ex_r%5B1%5D.pdf
8 http://www.apra.gov.au/GI/PrudentialFramework/Pages/Review-Cap-Stds-QIS1-QIS2-TechSpecs.aspx
9 http://apra.gov.au/GI/PrudentialFramework/Pages/General-and-Life-Insurance-Capital-Review-Consultation-on-Draft-Prudential-Standards.aspx
10 http://apra.gov.au/lifs/PrudentialFramework/Documents/120330_LTI_LAGIC_LI_illiquidity_premium_consultation.pdf
11 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'[12], 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'[13];

- September 2012 – Letter to all CEOs (or equivalent) of life insurers 'Solvency standard requirements under the *Life Insurance Act 1995*'[14];

- September 2012 – Letter to insurers 'Consultation on draft prudential practice guides and information paper'[15], draft versions of prudential practice guides and an information paper[16];

- October 2012 – Response paper 'Review of capital standards for general insurers and life insurers'[17], 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'[18], final versions of all forms and instructions and reporting standards.

APRA has considered both formal and informal feedback from industry throughout the 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.

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

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

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

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

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

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

18 http://www.apra.gov.au/lifs/ReportingFramework/Pages/LAGIC-final-reporting-requirements-LI-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.