Life Insurance (prudential standard) determination

No. 10 of 2023

Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge

Life Insurance Act 1995

I, Helen Rowell, a delegate of APRA:

(a) under subsection 230A(5) of the *Life Insurance Act 1995* (the Act) revoke Life Insurance (prudential standard) determination No. 7 of 2012, including *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge* made under that Determination; and

(b) under subsection 230A(1) of the Act determine *Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge*, which applies to all life companies, including friendly societies.

This instrument commences on 1 July 2023.

Dated: 24 May 2023

[Signed]

Helen Rowell
Deputy Chair

Interpretation

In this instrument:

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 Schedule to the Act.

Schedule

Prudential Standard LPS 118 Capital Adequacy: Operational Risk Charge, comprises the document commencing on the following page.

Prudential Standard LPS 118

Capital Adequacy: Operational Risk Charge

Objectives and key requirements of this Prudential Standard

This Prudential Standard requires a life company to maintain adequate capital against the operational 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 Operational Risk Charge is the minimum amount of capital required to be held against operational risks. The Operational Risk Charge relates to the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

This Prudential Standard sets out the method for calculating the Operational 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.

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Authority

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

Application and commencement

2. This Prudential Standard applies to all life companies including **friendly societies** (together referred to as **life companies**) registered under the Act[1], 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

   (b) for a friendly society: to its management fund.

4. This Prudential Standard only applies to the business of an **Eligible Foreign Life Insurance Company** which is carried out through its Australian statutory funds but not otherwise.[2]

5. This Prudential Standard applies to life companies from 1 July 2023.

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.

Operational Risk Charge

7. The **Operational Risk Charge**:

   (a) for a statutory fund of a life company that is not a friendly society, is the amount of capital that the fund is required to hold for operational risk in accordance with this Prudential Standard;

   (b) for a benefit fund of a friendly society, is zero;

   (c) for the shareholders' fund of a life company that is not a friendly society, is zero; and

   (d) for the management fund of a friendly society, is the amount of capital that the friendly society is required to hold for operational risk in accordance with this Prudential Standard.

8. The Operational Risk Charge is the minimum amount of capital required to be held against the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.

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

2 Refer to section 16ZD of the Act.

Calculation of the Operational Risk Charge

9. The Operational Risk Charge is calculated as the sum of:

   (a) the Operational Risk Charge for **risk business** (ORCR) defined in paragraph 11;

   (b) the Operational Risk Charge for investment-linked business (ORCI) defined in paragraph 14; and

   (c) the Operational Risk Charge for other business (ORCO) also defined in paragraph 14.

10. For the purposes of paragraphs 11 to 16, 'accrued premium' includes all premiums for life policies with the exception of premiums that are sourced from benefits paid under another life policy issued by the life company. Accrued premium is calculated as follows:

    Accrued premium = Premiums received - A + B

    where:

    (a) A = Premiums in advance at the end of the specified period - Premiums in advance at the start of the specified period;

    (b) B = **Unpaid premiums** at the end of the specified period – Unpaid premiums at the start of the specified period;

    (c) 'premium' is defined as gross of commissions and before profit share rebates (group insurance). Premium must also be inclusive of stamp duty, policy fees, loadings and discounts; and

    (d) for the calculation of ORCI and ORCO, 'accrued premium' must also include deposits received.

11. The ORCR is calculated as follows:

    $$ORCR = A \times \{\text{maximum}(GP_1, NL_1) + \text{maximum}(0, |GP_1 - GP_0| - 0.2 \text{ x } GP_0)\}$$

    where:

    (a) A is 2 per cent for a statutory fund that is a **specialist reinsurer** and 3 per cent for other funds;

    (b) GP_1 is accrued premiums (gross of reinsurance) for the 12 months ending on the reporting date;

    (c) NL_1 is the **adjusted policy liabilities** (net of reinsurance) at the reporting date;

    (d) GP_0 is accrued premiums (gross of reinsurance) for the 12 months ending on the date 12 months prior to the reporting date; and

(e) $|GP_1 - GP_0|$ is the absolute value of the difference between GP_1 and GP_0.

12. For the management fund of a friendly society, GP_1, NL_1 and GP_0 must be summed across all of the risk business in the friendly society's benefit funds.

13. For a statutory fund of a life company that is not a friendly society, GP_1, NL_1 and GP_0 must be summed across all of the risk business in the statutory fund.

14. The ORCI and the ORCO are calculated as follows:

$$\text{ORCI or ORCO} = B\times \{NL_1 + \text{maximum}(0, GP_1 - 20\% \text{ x } GL_0) + \text{maximum}(0, C_1 - 20\% \text{ x } GL_0)\}$$

where:

(a) B is 0.15 per cent for a statutory fund that is a specialist reinsurer and 0.25 per cent for other funds;

(b) NL_1 is the adjusted policy liabilities (net of reinsurance) at the reporting date;

(c) GP_1 is accrued premiums (gross of reinsurance) for the 12 months ending on the reporting date;

(d) GL_0 is the adjusted policy liabilities (gross of reinsurance) at the date 12 months prior to the reporting date; and

(e) C_1 is all payments to meet liabilities to policy owners (gross of reinsurance) for the 12 months ending on the reporting date. This excludes payments that are used as premiums for another life policy issued by the life company.

15. For the management fund of a friendly society, NL_1, GP_1, GL_0 and C_1 in paragraph 14 must be summed across all of the investment-linked business of the society (for ORCI) and all the other business of the friendly society that is neither risk business nor investment-linked business (for ORCO).

16. For a statutory fund of a life company that is not a friendly society, NL_1, GP_1, GL_0 and C_1 in paragraph 14 must be summed across all of the investment-linked business in the statutory fund (for ORCI) and all of the other business in the statutory fund that is neither risk business nor investment-linked business (for ORCO).

Adjustments and exclusions

17. 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.

Previous exercise of discretion

18. A life company must contact APRA if it seeks to place reliance, for the purposes of complying with this Prudential Standard, on a previous exemption

or other exercise of discretion made by APRA under a previous version of this Prudential Standard.