

# Life Insurance (prudential standard) determination No. 1 of 2024

## EXPLANATORY STATEMENT

Prepared by the Australian Prudential Regulation Authority (APRA)

*Life Insurance Act 1973*, section 230A

Under the *Life Insurance Act 1973* (the Act), APRA has power to determine standards in relation to prudential matters (prudential standards) to be complied with by life companies (including friendly societies), and registered non-operating holding companies (registered life NOHCs), and subsidiaries of life companies and registered life NOHCs. Under subsection 230A(5) of the Act, APRA may vary or revoke a prudential standard.

On 9 July 2024, APRA made Life Insurance (prudential standard) determination No. 1 of 2024 (the instrument), which revokes *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* made under *Life Insurance (prudential standard) determination No. 7 of 2023* and determines a new *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* (LPS 112).

The instrument commences on 1 October 2024.

### 1. Background

APRA's role is to protect the financial interests of Australians by maintaining the safety and soundness of financial institutions. To do this, APRA sets legal requirements and guidance for the entities it regulates (the prudential framework).

The prudential framework comprises:

- legally binding prudential standards;
- legally binding reporting standards; and
- supporting guidance (such as prudential practice guides).

LPS 112 is a legally binding prudential standard. It is part of a group of prudential standards relating to the capital that a life company must hold as a buffer against unexpected losses.

From November 2023, the Reserve Bank of Australia ceased publishing the information required by life companies to calculate the illiquidity premium. As a result, the formula specified in LPS 112 can no longer be applied.

APRA sent a letter<sup>1</sup> to life companies in December 2023 outlining an interim approach to calculating the illiquidity premium. LPS 112 remakes the previous version of the prudential standard with minor amendments by integrating the interim measure into the prudential framework, which will allow life companies to calculate the illiquidity premium.

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<sup>1</sup> See APRA's letter on LPS 112 Illiquidity premium interim measure

## **2. Purpose and Operation**

The purpose of the instrument is to revoke the previous LPS 112 and replace it with a new version. The new version makes a minor change by including the new formula for calculating the illiquidity premium.

Adequate capital is critical to protect policyholders. APRA sets requirements on minimum capital to ensure life insurers can absorb unexpected losses in their business. This is a core tool of prudential regulation and supports system-level financial stability.

The overarching purpose of LPS 112 is to ensure a life company holds adequate capital against the risks it faces. The standard specifies both the amount and type of capital that must be held.

The key requirements of LPS 112 are set out in Attachment A to this Explanatory Statement.

## **3. Consultation**

On 4 April 2024, APRA consulted<sup>2</sup> on a set of minor updates to the prudential framework, including changes to LPS 112. APRA has previously consulted on the provisions in LPS 112 that were unchanged.

APRA did not receive any submissions for LPS 112 from life companies during the consultation.

## **4. Scope of administrative powers**

### ***Exercise of discretion by APRA***

LPS 112 provides for APRA to exercise various discretions. Decisions made by APRA in exercising those discretions are not subject to merits review. This is because these decisions are preliminary decisions that may facilitate or lead to substantive decisions which are subject to merits review.

Under the Act, a breach of a prudential standard is a breach of the Act, as the Act provides that regulated entities must comply with the standard. However, there are no penalties prescribed for such breaches. Instead, an insurer's breach of a provision in the Act is grounds for APRA to make further, substantive decisions under the Act in relation to the insurer.

Those decisions may include the decision:

- (a) to issue a direction to the insurer, including a direction to comply with the whole or part of a prudential standard (section 230B of the Act); and
- (b) to revoke an authority to carry on registration of life insurance business (section 26 of the Act) or a life NOHC authorisation (section 28C of the Act).

It is only at this stage that an insurer is exposed to a penalty, loss of licence or imposition of a penalty if it breaches the direction (50 penalty units each day under section 230F of the Act).

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<sup>2</sup> See: <https://www.apra.gov.au/prudential-framework-minor-updates-0>.

In nearly all cases,<sup>3</sup> the decision is preceded by a full consultation with the insurer to raise any concerns it may have in relation to the decision.

A decision of APRA to impose a direction is subject to merits review under section 236 of the Act, which is appropriately available at the point where an insurer could be exposed to a penalty.

Revocation of registration as a life insurance company or a life NOHC authorisation is subject to merits review (section 236 of the Act).

### ***Adjust and exclude discretion***

LPS 112 gives APRA the discretion to adjust or exclude a provision of the prudential standard (paragraph 6). The power to create such a discretion is provided for under subsection 230A(4) of the Act.

APRA may exercise this power when it is satisfied that the adjustment or exclusion of a specific requirement for one or more specified regulated entities will better support APRA in meeting its objectives. For example, the adjustment or exclusion may be necessary to obtain a better prudential outcome than would be the case if the prudential requirement were applied unaltered to a particular regulated entity. A tailored approach would give APRA comfort that the prudential requirements apply appropriately to protect the interests of policyholders. APRA will also take into account other considerations, such as efficiency, competition, contestability, competitive neutrality and regulatory burden, including comparisons with the entity's peer group.

The exercise of APRA's powers is governed by a robust decision-making framework which is documented in APRA's internal policies. This framework supports APRA in fulfilling its mandate by limiting decision making to those senior APRA officers with the appropriate experience and skill to exercise prudent judgement. The framework also requires decision makers to seek advice from internal technical experts.

## **5. Incorporation by reference**

Under section 14(1)(a) of the *Legislation Act 2003*, the standard incorporates by reference as in force from time to time:

- Acts of Parliament and associated delegated laws;
- Prudential Standards determined by APRA under subsection 230A(1) of the Act;
- Reporting Standards determined by APRA under subsection 13(1) of the *Financial Sector (Collection of Data) Act 2001*;
- the Australian Accounting Standards determined by the Australian Accounting Standards Board under section 334 of the *Corporations Act 2001* (Cth); and
- the Australian Auditing Standards determined by the Auditing and Assurance Standards Board under section 336 of the *Corporations Act 2001* (Cth).

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<sup>3</sup> Subsection 26(5) of the Act specifically provides that APRA does not need to consult where APRA is satisfied that doing so could result in a delay in revocation that would be contrary to the national interest.

These documents may be freely obtained on the Federal Register of Legislation at [www.legislation.gov.au](http://www.legislation.gov.au) (all documents listed above except for Australian Accounting and Auditing Standards), <https://www.aasb.gov.au/pronouncements/accounting-standards/> (Australian Accounting Standards) and <https://auasb.gov.au/standards-guidance/auasb-standards/auditing-standards/> (Australian Auditing Standards).

## **6. Impact Analysis**

The Office of Impact Analysis has confirmed that formal impact analysis is not required as the remaking of LPS 112 is unlikely to have more than a minor regulatory impact.

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

A Statement of compatibility prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* is provided at Attachment B to this Explanatory Statement.

## ATTACHMENT A

### Key requirements of LPS 112

#### *1. Capital base of a life company*

The capital base must be assessed for the life company as a whole and for each of its funds. Paragraphs 14 to 50 set out the requirements for the life company as a whole.

The capital base of a life company consists of Common Equity Tier 1 (CET1), Additional Tier 1 (AT1) and Tier 2 (T2) Capital. Attachment A lists the criteria for an instrument to be classified as paid-up ordinary shares in CET1 Capital. Attachment C sets out the criteria for an instrument to be classified as ATI Capital. Attachment D outlines the criteria for an instrument to be included as T2 Capital.

#### *2. Regulatory adjustments to CET1 Capital*

Attachment B sets out regulatory adjustments required to be made to ensure the capital base is adequate to support the activities of the life insurer.

A life company must deduct the liability adjustment. Liability adjustments are outlined in Attachment B paragraphs 25-26, requiring insurance liabilities in the statutory accounts to be replaced with adjusted policy liabilities when determining the capital base. The method of determining the adjusted policy liabilities is specified in Attachment F.

#### *3. Capital base of a statutory fund or general fund*

The capital base requirements for statutory funds are specified in paragraphs 51-54. The requirements for general funds are specified in paragraphs 55-57.

#### *4. Minimum requirements regarding size and composition of a capital base*

Paragraphs 15, 53, and 56-57 set out the minimum requirements regarding size and composition of a capital base for a life company, statutory fund and general fund respectively.

## **ATTACHMENT B**

### **Statement of Compatibility with Human Rights**

Prepared in accordance with Part 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011*

#### **Life Insurance (prudential standard) determination No. 1 of 2024**

This Legislative Instrument is compatible with the human rights and freedoms recognised or declared in the international instruments listed in section 3 of the *Human Rights (Parliamentary Scrutiny) Act 2011* (HRPS Act).

#### **Overview of the Legislative Instrument**

The purpose of the Legislative Instrument is to revoke *Prudential Standard LPS 112 Capital Adequacy: Measurement of Capital* made under *Life Insurance (prudential standard) determination No. 7 of 2023* and replace it with another version.

LPS 112 is designed to ensure life companies remain financially resilient by maintaining sufficient capital against the risks associated with its activities.

#### **Human rights implications**

APRA has assessed the Legislative Instrument and is of the view that it does not engage any of the applicable rights or freedoms recognised or declared in the international instruments listed in section 3 of the HRPS Act. Accordingly, in APRA's assessment, the Instrument is compatible with human rights.

#### **Conclusion**

This Legislative Instrument is compatible with human rights as it does not raise any human rights issues.