Life Insurance (prudential standard) determination No. 2 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. 2 of 2024 (the instrument), which revokes *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* made under *Life Insurance (prudential standard) determination No. 9 of 2023* and determines a new *Prudential Standard LPS 117 Capital Adequacy: Asset Concentration Risk Charge* (LPS 117).

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 117 is a legally binding prudential standard. It is part of a group of prudential standards relating to the capital that a private health insurer must hold as a buffer against unexpected losses.

LPS 117 remakes the previous version of the prudential standard with minor amendments.

Asset concentration risk is the risk of a life company's concentration in particular assets resulting in adverse movements in the life company's capital base. The Asset Concentration Risk Charge (ACRC) is the minimum amount of capital required to be held against asset concentration risks. LPS 117 sets out asset exposure limits, and currently does not have a specific ACRC limit category for bank bonds or Negotiable Certificates of Deposit. APRA addressed this in a 2002 letter to industry.

LPS 117 remakes the previous version of the prudential standard with minor amendments. The minor update integrates the 2002 letter into the prudential framework, which will clarify the asset exposure limit for bank bonds and Negotiable Certificates of Deposit.

2. Purpose and Operation

The purpose of the instrument is to revoke the previous LPS 117 and replace it with a new version. The new LPS 117 makes clear the asset exposure limit for bank bonds and Negotiable Certificates of Deposit.

LPS 117 requires life companies to maintain adequate capital against the asset concentration risks associated with their activities, and forms part of a set of prudential standards that deal with the measurement of the capital adequacy of a life company.

The key requirements of LPS 117 are set out in Attachment A to this Explanatory Statement.

3. Consultation

On 4 April 2024, APRA consulted[1] on a set of minor updates to the prudential framework, including changes to LPS 117. APRA has previously consulted on the provisions in LPS 117 that were unchanged.

APRA did not receive any submissions for LPS 117 from life companies during the consultation.

4. Scope of administrative powers

Exercise of discretion by APRA

LPS 117 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). In nearly all cases,[2] the decision is preceded by a full consultation with the insurer to raise any concerns it may have in relation to the decision.

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1 See https://www.apra.gov.au/prudential-framework-minor-updates-0

2 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.

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 117 gives APRA the discretion to adjust or exclude a provision of the prudential standard (paragraph 48). 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; and
- Prudential Standards determined by APRA under subsection 230A(1) of the Act;

These documents may be freely obtained on the Federal Register of Legislation at www.legislation.gov.au.

6. Impact Analysis (IA)

The Office of Impact Analysis has confirmed that an IA is not required as the remaking of LPS 117 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 117

1. Asset Concentration Risk Charge (ACRC)

The ACRC is the amount by which the values of individual asset and credit exposures (or groups of related exposures) exceed certain limits. Paragraphs 10-27 sets out the method for calculating the ACRC.

2. Netting of reinsurance exposures

Paragraphs 28-30 relate to assets and liabilities arising from arrangements with a reinsurer which may be taken as a single net exposure, subject to a legally enforceable right of offset in certain circumstances.

3. Collateral

A fund that holds certain types of collateral against an asset to reduce risk may apply for a different approach to determining the ACRC for that asset. Paragraphs 32-39 sets out the requirements that apply for certain collateral to be eligible.

4. Guarantee

Paragraphs 40-42 sets out the requirements for guarantees to be used to treat the underlying asset as an exposure to the guarantor.

5. Specialist reinsurers

Paragraphs 46-47 outline certain asset concentration limits for specialist reinsurers.

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. 2 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 117 Capital Adequacy: Asset Concentration Risk Charge* made under *Life Insurance (prudential standard) determination No. 9 of 2023* and replace it with another version.

LPS 117 is designed to ensure life companies maintain adequate capital against the asset concentration risks associated with their 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.