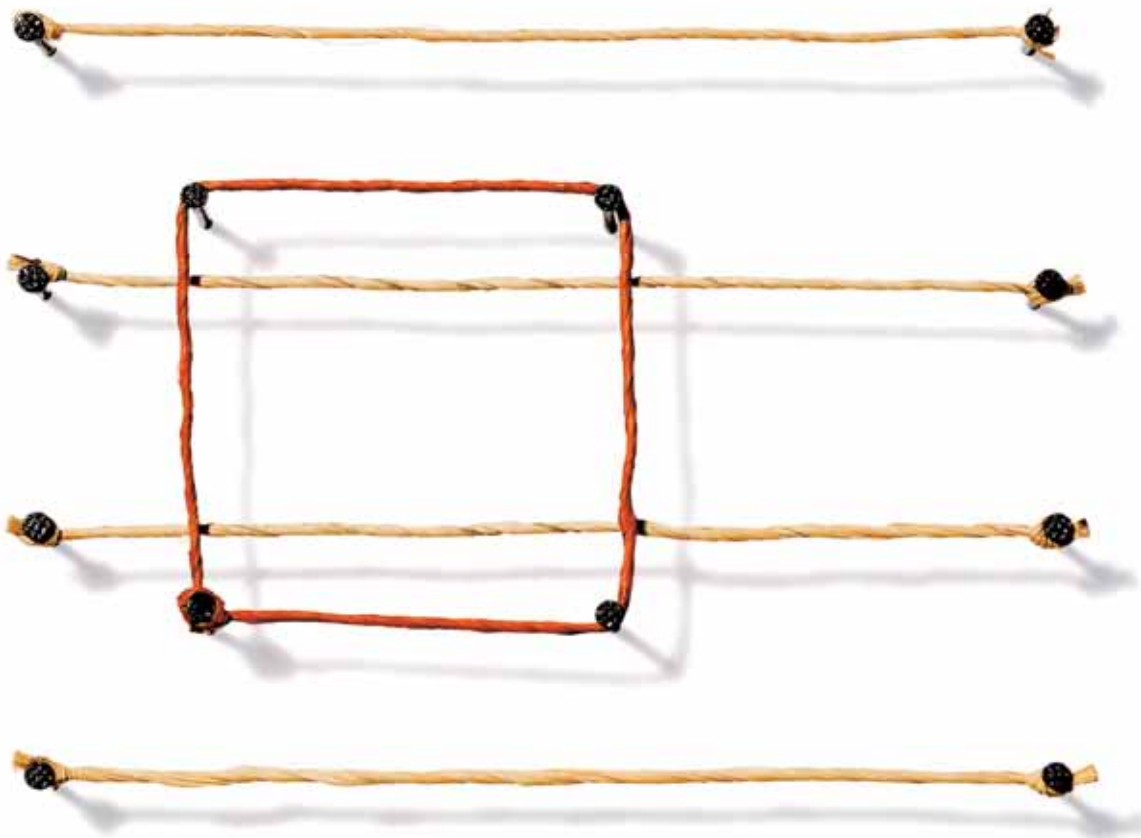




Frequently Asked Questions

Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge

April 2012




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Collateral, guarantees and letters of credit

The following frequently asked questions (FAQs) provide further information to assist general insurers and Level 2 insurance groups (GIs) in the interpretation of *Prudential Standard GPS 114 Capital Adequacy: Investment Risk Capital Charge* (GPS 114). In particular, these FAQs provide guidance around the use of collateral, guarantees and letters of credit (LOCs) in respect of reinsurance recoverables from non-APRA-authorised reinsurers. GIs are encouraged to contact APRA where they have questions regarding the interpretation of GPS 114.

As part of the life and general insurance capital review (LAGIC) project, APRA will issue a Prudential Practice Guide (PPG) on GPS 114 in the second half of 2012. APRA is considering including material on collateral, guarantees and LOCs in that PPG that is consistent with this FAQ. APRA is also considering whether any revisions need to be made to GPS 114 itself. Consistent with APRA practice on consulting with industry on changes to prudential standards, APRA will consult with all GIs on any proposals to amend the requirements relating to collateral, guarantees and LOCs.

Questions and answers

Collateral – GPS 114 paragraphs 23 and 24

1. *How can GIs ensure that the collateral provides effective security against liabilities arising under the relevant reinsurance contract?*

For the purposes of paragraph 23(b), the collateral must **'provide effective security against liabilities arising under the reinsurance contract'**. The collateral must provide effective security not only when the non-APRA-authorised reinsurer is solvent, but also when it is insolvent.

If the collateral is not able to be drawn upon by the GI in the event of an insolvency of the non-APRA-authorised reinsurer (e.g. because of competing demands on the collateral from other creditors of the non-APRA-authorised reinsurer), it will not provide effective security and fails to meet paragraph 23(b).

Effective security against insolvency of the reinsurer

Paragraph 23(c) specifically requires that the collateral **'is not available for distribution to creditors of the reinsurer other than the insurer in the event of insolvency of the reinsurer'**. This means that the other creditors of the reinsurer should not be able to access the collateral required as security to meet all outstanding liabilities due to the GI under the relevant reinsurance contracts until the liabilities have been discharged in full. In particular, the rights of the non-APRA-authorised reinsurer to the collateral must be subordinate to the rights of the GI until all liabilities under the relevant reinsurance contracts have been discharged.

APRA expects that appropriate legal and supporting operational arrangements be put in place to achieve this:

- In respect of assets held under trust (paragraph 23(a)(i)), APRA will only recognise the collateral if the assets are held by the trustee for the sole benefit of the GI. The trust deed should include a term that provides that the non-APRA-authorised reinsurer will not have access to the assets required to meet outstanding liabilities due to the GI under the relevant reinsurance contracts until all the relevant liabilities of the GI have been discharged. In addition, the trustee should not be a related body corporate of either the GI or the non-APRA-authorised reinsurer.

- In respect of amounts held on deposit by the GI (paragraph 23(b)(ii)), there should be a formal agreement executed by the GI and the non-APRA-authorised reinsurer which governs this arrangement. APRA expects that there be satisfactory segregation of collateral funds within the insurer's investments, such as by way of either a separate bank account or a sub-account with a custodian in respect of the relevant investment holdings. This arrangement should ensure that the investments held as collateral are readily identifiable and are distinguishable from the other funds of the GI in the event of the insolvency of the GI. This is important as reinsurance recoveries receivable when an insurer is in liquidation are required to be paid directly to relevant policyholders under s.562A of the *Corporations Act 2001*. Additionally, the funds should only be repayable to the non-APRA-authorised reinsurer where they are in excess of the outstanding liabilities due to the GI under the relevant reinsurance contracts.¹

APRA expects general insurers to obtain legal advice in relation to the above matters, so that the GI and APRA can be satisfied that the collateral meets the requirements of paragraphs 23(b) and (c).

Effective security against winding up of the insurer

APRA considers that effective security around collateral arrangements needs to involve arrangements that secure the collateral for its intended purpose in the event of the insolvency of the GI.

As collateral is intended to be drawn upon when a payment from a reinsurer cannot otherwise be made, the collateral must perform a similar function in a winding up of the GI and the reinsurer at the same time. Where a winding up of the GI commences, s.562A of the *Corporations Act 2001* ensures that any amount received by the GI under a contract of reinsurance must be held for the benefit of policyholders. Collateral must also work in the same way. This means that collateral held by a GI must be held for the purpose of making payments to policyholders to discharge liabilities under the contracts of insurance. To ensure this occurs, the collateral must not be available to meet the claims of:

- creditors of the reinsurer other than the GI (until such time as the liabilities due to the GI under the underlying contracts of reinsurance have been discharged); and
- creditors of the GI other than the GI's policyholders (the collateral must be held for the exclusive benefit of relevant policyholders until such time as the liabilities due to the GI under the underlying contracts of reinsurance have been discharged).

APRA considers appropriate legal protection against this risk can be achieved through a Deed Poll. This would need to establish that collateral funds are held for the benefit of policyholders, quarantined from the other funds of the insurer, and reserved to pay losses under the relevant reinsurance contracts as and when they fall due. If this additional Deed Poll were not in place, the collateral funds would not have the same protections as the reinsurance recoverables they are securing.

¹ This is because collateral for the purposes of GPS 114 is only recognised in respect of amounts owing as reinsurance recoverables, so any excess above such amounts can be repaid to the reinsurer. It is expected that a GI's Appointed Actuary would opine on whether there are amounts in excess of reinsurance recoverables.

2. *What other forms of collateral may APRA approve and recognise under paragraph 23(a)(iv)?*

APRA may approve and recognise any form of collateral that satisfies the requirements of paragraphs 23 (b) and (c). For example, certain forms of 'funds withheld' accounts may be acceptable, but only if the GI is satisfied, after obtaining expert advice, that the collateral will not be available to creditors of the non-APRA-authorised reinsurer other than the GI in the event of the insolvency of the reinsurer.

For example, APRA considers that certain 'funds withheld' arrangements may mean the non-APRA-authorised reinsurer retains a registrable interest in the collateral. Where this occurs, it is important that the GI be granted a registrable charge over that interest to ensure that the collateral is retained to discharge policy liabilities in any winding up of the reinsurer. Without adequate security, the GI may find that the collateral is available to other creditors and this will defeat the purpose of the collateral.

In these instances, the GI must also register the mortgage or charge to protect the interests of its policyholders.

Consistent with the principles in Question 1, where, under such a 'funds withheld' arrangement, a GI proposes to hold collateral in the form of securities purchased from amounts held in a 'funds withheld' account, the securities must be either held separately from the other investments of the GI or be identifiable in the books and records of the GI as being securities held for the benefit of meeting policy liabilities reinsured under the relevant contracts of reinsurance.

In respect of other forms of collateral under paragraph 23 (a)(iv), APRA will only recognise the collateral if the holding of the assets and dealings in the assets are fully detailed in formal agreements. As APRA approval is necessary under this paragraph, GIs should seek APRA's views on the adequacy of such arrangements before the arrangements are executed.

Guarantees and LOCs – GPS 114 paragraph 25

3. *What is expected to be included in a guarantee or LOC?*

The guarantee or LOC must ensure that it meets all the criteria in paragraph 25. APRA also expects that the guarantee or LOC include:

- a pro forma sight draft (or other pro forma payment demand) and that any reference to a demand for payment in the LOC refers to the attached pro forma; and
- the sight draft description of the payment event to correspond with the LOC or guarantee description of the payment event.

4. *Is it acceptable for the parent of the GI or its NOHC to be nominated as the beneficiary of the guarantee or LOC?*

No, the beneficiary of the guarantee or LOC must be the APRA-authorised GI which is intended to benefit from the reinsurance.

5. *Is it appropriate for payments by the issuer under the guarantee or LOC to be made to the GI outside of Australia or directly to a foreign insurer's head office?*

No, the guarantor or issuer of the LOC is obliged to pay the GI in Australia and the sight draft must be presented to a branch or office of the ADI in Australia nominated in the LOC or guarantee.

APRA expects this to be explicitly stated in the guarantee or LOC and clearly reflected in the sight draft.

6. *Is it acceptable for the GI to be required to prove that the reinsurer is in breach of its obligations under the reinsurance contracts before payment is made on the guarantee or the LOC?*

No, the guarantee or LOC must be unconditional. In order to avoid delays in payment by the issuer, the guarantee or LOC should state that the issuer will not conduct any inquiry into the sight draft other than for the purpose of ascertaining whether it is in the required form. However, the demand for payment may be required to state both the existence and nature of the breach by the reinsurer of its obligations under the relevant reinsurance contracts.

7. *What is expected by the requirement in GPS 114 for guarantees and LOCs to be irrevocable?*

An eligible guarantee or LOC must not provide for the guarantor or issuer of the LOC to cancel its undertaking before the expiry date. In addition, to ensure the credit support is available to the GI when required, APRA expects that any right for the GI (beneficiary) to cancel the instrument before its expiry be subject to prior consultation with APRA.

8. *How should the guarantee or LOC be specifically linked to performance of the reinsurance contract(s) under which the reinsurance recoverables arise, as required by GPS 114?*

It should be clear in the guarantee or LOC that the credit support is confined to the reinsurance arrangements specified in the guarantee or LOC. This requires clear and unambiguous identification of the relevant reinsurance contracts in the guarantee or LOC. Where appropriate, the reinsurance contract numbers and dates to which the guarantee or LOC relates should be included in the guarantee or LOC to avoid any ambiguity.

Approval requirements

9. *Is APRA's formal approval required for collateral, guarantees and LOCs under GPS 114?*

Other than those arrangements referenced under paragraph 23(a)(iv), formal APRA approval of the arrangements set out in GPS 114 paragraphs 23(a)(i) to (iii) is not required. However, seeking APRA's views on the adequacy of arrangements in GPS 114 paragraphs 23(a)(i) to (iii) before the arrangements are executed will be in the interest of any GI considering these options, to ensure the GI is not excluded from capital relief when APRA reviews such arrangements as part of ongoing supervisory processes.

The following supporting information will assist APRA's consideration in regard to collateral proposals:

- documentation that establishes and governs the collateral arrangement (including the details of the reinsurance arrangements for which the collateral is to be provided and the methods used to monitor and adjust the amounts due under the reinsurance contracts for which the collateral is to act as security);
- the arrangements over the collateral (to safeguard the collateral from other creditors in the event of the insolvency of the non-APRA-authorised reinsurer);
- legal advice received by the GI on the proposed form of collateral (including whether the GI will have exclusive access to the collateral notwithstanding an insolvency of the reinsurer and whether the collateral will be held exclusively for the benefit of the GI's policyholders in the event of the insolvency of the GI); and

- any other information which the GI believes is relevant to satisfying APRA that the collateral proposal complies with paragraphs 23 and 26. This may include processes to be used by the GI to monitor the collateral arrangement (e.g. keeping track of the value of the collateral and adjustments in the amount of the liabilities which are secured by the collateral arrangement).

For proposals around guarantees or LOCs, draft documentation establishing the arrangement should be provided to APRA.

Reporting requirements

10. How does a GI calculate and report the capital treatment of any eligible collateral, LOCs and/or guarantees?

The lodgement of eligible collateral, or the operation of acceptable LOC or guarantee arrangements, reduces the investment risk charge for the relevant reinsurance recoverables from the counterparty grade of the reinsurer to that of the collateral, the issuer of the LOC or the guarantee provider.

Irrespective of whether eligible collateral is on- or off-balance sheet for accounting purposes, it should be reported in Part A of *Reporting Form GRF 130.3 Off Balance Sheet Business – Credit Support Received*. This form calculates a credit for the difference between the risk charges of the reinsurance recoverable and the risk charges of the collateral.

Where collateral is recorded on the balance sheet, the current design of *Reporting Form GRF 300.0 Statement of Financial Position* is such that the collateral assets will attract an investment risk charge and therefore be effectively risk charged twice. Accordingly, until the forms are revised during 2012 as part of the LAGIC project, the GI should record a deduction for the amount of the investment risk charge on collateral assets in item 11 'Total variation in capital charges as approved by APRA' on *Reporting Form GRF 110.0 Minimum Capital Requirement*.

Guarantees and LOCs should be reported in Part B of *Reporting Form GRF 130.3 Off Balance Sheet Business – Credit Support Received*. This form calculates a credit for the difference between the risk charges of the reinsurance recoverable and the risk charges of the guarantee and/or LOC.



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