
Practice Guideline 6A

Target Capital (Life, General and Health Insurance)

1 April 2022

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1. Introduction

1.1. Application

This Practice Guideline applies to any Member developing or reviewing target capital policies for general, life or health insurance companies.

While this Practice Guideline does not specifically apply to Members providing advice to Authorised Deposit-taking Institutions (ADIs), some of the content may be of relevance to such institutions.

1.2. About this Practice Guideline

This Practice Guideline:

- (a) has been prepared in accordance with the Institute's Policy for Developing Professional Practice Documents; and
- (b) is to be applied in the context of the Code.

This Practice Guideline is not mandatory. Even so, if this Practice Guideline covers the Services a Member provides, then the Member should consider explaining any significant departure from this Practice Guideline to the Principal, and record that explanation.

Work performed by a Member under this PG is designated to be an Applicable Service. As such the Member's attention is drawn to the requirements of PG 1 (General Actuarial Practice).

1.3. Other relevant documents

This Practice Guideline must be applied in the context of the relevant legislation, regulation and accounting standards. If there is a conflict in wording, then the legislation, regulation and accounting standards take precedence over this Practice Guideline.

In this context, legislation, regulation and accounting standards include laws, regulations, prudential standards, subordinate standards, rules issued by government authorities and standards issued by professional bodies which have the force of law. Also included are relevant modifications or substitutions of these. Similarly, a reference to a Professional Standard or Practice Guideline includes any modification or replacement of that Professional Standard or Practice Guideline.

Apart from the Code or a Professional Standard, from legislation or from regulatory standards, no other document, advice or consultation can be taken to modify or interpret the requirements of this Practice Guideline.

This Practice Guideline does not constitute legal advice. Any interpretation or commentary within this Practice Guideline regarding specific legislative or regulatory requirements reflects the expectations of the Institute but does not guarantee compliance under applicable legislation or regulations. Accordingly, Members should seek clarification from the relevant

regulator and/or seek legal advice in the event they are unsure or require specific guidance regarding their legal or regulatory obligations.

1.4. Relationship to PG 1

Compliance with PG 1 is a pre-requisite to compliance with this PG. References in PG 1 to “the applicable PPD” or “all applicable PPDs” should be interpreted as applying equally to this PG 6A, as appropriate.

1.5. Commencement date

This Practice Guideline is effective for relevant Services provided on or after 1 April 2022.

1.6. Definitions and interpretation

Capitalised terms used in this Practice Guideline have the same meaning as set out in the Code.

1.7. Objective

This Practice Guideline provides guidance to Members in developing target capital policies for general, life and health insurance companies. Target capital is a key component of the insurer’s Internal Capital Adequacy Assessment Process (ICAAP). Specific documentation is required under Australian regulatory standards in respect of the ICAAP, such as the ICAAP Summary Statement and ICAAP Report. There is also related documentation required such as a Risk Appetite Statement (RAS), Risk Management Strategy (RMS) and Recovery Plan. This Practice Guideline does not cover all the requirements in respect of the ICAAP, RAS, RMS and Recovery Plan. It is focused on developing target capital policies.

Capital management should be undertaken with due consideration of the size, complexity and nature of the insurer. While common considerations are outlined in this Practice Guideline, it cannot cover all outcomes and Members should apply judgement in determining the appropriateness of this Practice Guideline for their specific purposes.

This Practice Guideline was prepared by the Cross-Practice Target Capital Working Group (TCWG) of the Actuaries Institute and builds on the Target Capital Information Note previously issued by the TCWG of the Actuaries Institute in 2016.

This Practice Guideline also reflects the approach in Section 2.5 Own Risk and Solvency Assessment of the International Standard of Actuarial Practice 6 (ISAP 6) issued by the International Actuarial Association in December 2018.

1.8. Scope

This Practice Guideline covers the following key areas of practice within development and execution of target capital policies:

- Section 2: Establishing a target capital framework
- Section 3: Quantifying target capital

- Section 4: Using target capital as a management tool

2. Establishing a target capital framework

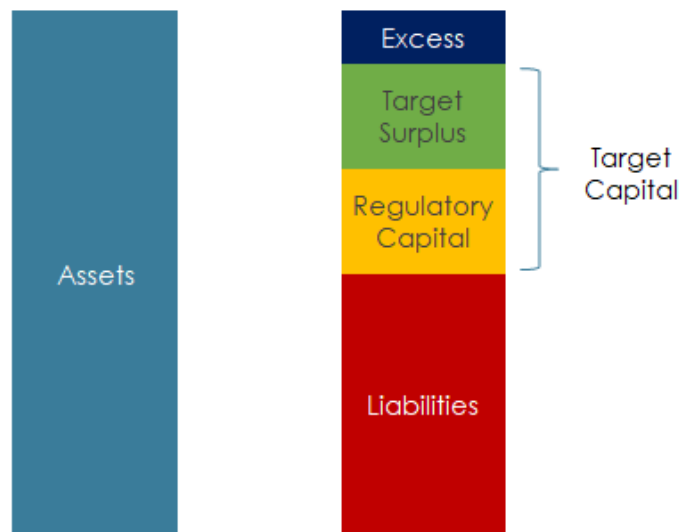
2.1. Definition of target capital

Target capital is the amount of capital that an insurance company seeks to hold to ensure it can achieve its objectives given its risk appetite. These objectives may include meeting regulatory capital requirements, maintaining a minimum credit rating, and/or funding the future capital needs of the business.

For regulated entities, the minimum level of capital which must be held is often prescribed by the relevant regulatory authority. It may therefore often be useful to measure target capital with reference to the level of capital above these regulatory minimums. Within target capital, the component above the Regulatory Capital is referred to as the Target Surplus.

Target capital concepts are illustrated in Figure 1 below.

Figure 1: Target Surplus and Target Capital



An insurance company may also require “working capital”, being an amount of capital needed to fund expected uses of capital (e.g. new business strain net of release of capital from existing business) over the forecast period. From a definition perspective, working capital can be defined as a component of target surplus or as a separate item and may include an allowance for future dividends.

2.2. Regulatory Considerations

This Practice Guideline focuses on Australian regulatory requirements as the predominant legislation for the Members of the Actuaries Institute. Members should consider the relevant regulatory framework when applying their practice to entities with operations outside of Australia.

2.2.1. Minimum Capital Requirements

The Australian Prudential Regulation Authority (APRA) prescribes the minimum level of regulatory capital a regulated insurer must hold, referred to as the Prudential Capital Requirement (PCR). The PCR is defined for general insurers in Prudential Standard GPS 110, for life insurers in Prudential Standard LPS 110 and for health insurers in Prudential Standard HPS 110. The quantification and quality of an insurer's capital base for regulatory purposes is similarly defined in GPS 112 and LPS 112. It is expected that a similar standard will be introduced for health insurers in the near future.

2.2.2. Responsibility for capital management

APRA notes that it is the responsibility of the Board to ensure that the insurer "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" (GPS110, LPS110). HPS110 prescribes similar responsibilities for the Board of health insurers. The Board of a regulated insurer is ultimately responsible for setting the capital and risk management policies of the company, including an insurer's target capital policy, which forms part of the regulated insurer's ICAAP.

2.2.3. Regulatory requirements

APRA requires each insurer to develop a strategy for ensuring adequate capital is maintained over time. This includes plans for how target levels of capital are to be met and the means available for sourcing additional capital, where required, including establishing an action plan to manage any emerging capital deficiency over time. The insurer's capital level may at times fall below its target, with the ICAAP usually covering the company's potential responses to this.

For life insurers, it is necessary to consider target capital needs both at the statutory fund level (or benefit fund level in the case of friendly societies) and at the insurer level.

For health insurers, the capital requirements are assessed only at the Health Benefits Fund (HBF) level, although in a 2019 discussion paper¹ APRA signalled intentions to regulate health insurers at both the HBF and at the insurer level.

Prudential Practice Guide CPG 110 (Internal Capital Adequacy Assessment Process and Supervisory Review) provides further details of APRA's expectations regarding target capital.

2.3. Approach to setting target capital

The following represents a high-level framework for setting the level of target capital:

¹ Titled Discussion paper: Private Health Insurance Capital Standards Review, 3 December 2019

- (a) Establish the insurer's appetite for risk. This will typically be contained in a Board approved risk appetite statement. Target capital should be consistent with the Board's risk appetite.
- (b) Select the universe of risks that will be used in assessing target capital. These risks are typically defined within the risk framework.
- (c) Define the basis for measuring target capital (e.g. regulatory, economic, rating agency capital or other measures). Target capital will be set and monitored on this basis.
- (d) Quantify the level of target capital, including allowances for any non-modelled risk categories and with consideration given to the quality of underlying capital.
- (e) Validate the level of target capital, including discussion with key stakeholders to embed the use of target capital within the business.
- (f) Establish a regular review period for target capital, as well as triggers for an 'out of cycle' review.

It is good practice to involve key stakeholders in relevant steps throughout the target capital setting process.

Consideration should be given to the business plan and reasonably foreseeable changes in the external environment.

2.4. Establishing the insurer's appetite for risk

The target capital level is established to achieve the insurer's objectives to a degree of certainty consistent with the risk appetite. Establishing the risk appetite is an essential first step in determining the target capital level.

The insurer's appetite for risk is normally defined in the Risk Appetite Statement. As an example, an insurer's appetite might be expressed as follows:

"The Company targets capital such that prior to an event occurring there is less than a 2.5% chance of breaching the regulatory minimum capital over one year"

Typically, there are three components within an expression of risk appetite:

1. Risk metric

Common key risk metrics for target capital purposes include probability of breaching regulatory capital requirements or other strategic objectives (e.g. maintaining a minimum credit rating).

2. Level of security

The level of security defines the minimum tolerance for the risk metric and is typically expressed as a probability, for example, 'a 0.5% probability of insolvency over one year'.

It reflects the desired level of confidence that the company will meet the relevant risk metric over the selected time horizon.

Several factors will influence the Board's desired level of security, which will typically weigh the costs of holding capital against the importance of meeting the particular risk metric. There may be different levels of security at an entity level compared to a Group level.

Higher levels of security will typically be traded-off against lower levels of return on equity.

3. Time horizon

The time horizon defines the period over which the level of security will be measured.

In determining the time horizon, consideration should be given to the nature of the risk metric and the underlying strategic objectives. Time horizons should be aligned to the pattern of risk emergence, for example, longer horizons for superimposed inflation. Alternatively, a risk metric based on policyholder outcomes may be based on a time horizon aligning to the run-off of all outstanding liabilities.

2.5. Selection of risks in assessing the target capital

As target capital is deployed against specific risks of the insurer, it is useful to establish the universe of risks which are to be considered when assessing target capital. The key risks an insurer is exposed to are often summarised or categorised within the risk profile of an insurer's risk management framework.

Consideration should be given to which risks are included in the setting of target capital and how they will be reflected, with the goal of ensuring the target capital analysis covers the material risks faced by the insurer. The Member should note that capital is not equally effective against all risks. For example, it has limited impact on managing reputation and liquidity risk. Where a risk is not explicitly modelled, but is relevant for target capital, a separate allowance may be made.

2.6. Basis for measuring target capital

Target capital can be measured in several different ways. The insurer should define which basis is being used in measuring and setting target capital. An insurer may use more than one basis.

The selected basis should reflect the circumstances and purpose for which the target capital measure will be used and the corporate structure (e.g. Level 1/Level 2/Level 3 based on APRA definitions).

Examples of bases for measuring target capital are:

- Regulatory capital, where target capital is measured relative to prudential capital requirements. Under the current prudential standards, regulatory capital for life and general insurers is further classified into Common Equity Tier I, Additional Tier I or Tier 2 capital, which designates the quality of capital. When setting target capital to meet regulatory objectives, the overall level of capital for each of these grades may be considered. Regulatory capital is a commonly used measure due to the importance of meeting regulatory requirements.
- Rating agency view of capital i.e. shareholders, analysts, distributors and customers may expect a certain minimum credit rating, which translates into holding a certain amount of target capital.
- Economic capital, which may allow for additional risks not explicitly covered in the regulatory capital (such as strategic risks or cyber risk), or risks quantified to a higher probability of sufficiency relative to regulatory capital.
- Other Board approved measure(s) such as accounting net assets.

2.7. Quantifying target capital

Once the basis for measuring target capital has been determined, the next step is to quantify the target capital amount. The techniques and approach are elaborated on in [Section 3](#).

2.8. Validating Target Capital

Validation of target capital is an essential step to provide an assessment of whether target capital is achieving the desired outcomes. Stress testing, reverse stress testing and scenario analysis are the primary techniques used to validate target capital, which test whether the target capital is sufficient for the risks it is expected to cover.

The target capital validation methods are discussed in more detail in [Section 3.5](#).

2.9. Stakeholder Involvement in Setting Target Capital

It is important to involve other key stakeholders throughout the target capital setting process to provide validation of the methods and any underlying assumptions used:

1. **Board and Chief Executive Officer (CEO)** - as the ultimate owner of the insurer's ICAAP and capital management, the Board and CEO will provide final approval of target capital and the approach(es) used. It is essential to ensure that the process of setting target capital is well communicated to the Board and CEO, and that relevant analysis and validation is understood. The Board and CEO may be involved in the selection, development and review of stress tests/scenarios in setting and validating target capital levels.
2. **Chief Financial Officer (CFO)** - the CFO is often highly involved in capital management, and will often be able to quantify the impact of remedial

management actions or other mitigants which can be deployed (e.g. expense savings), including their time to effectiveness and capital benefit.

3. **Chief Risk Officer (CRO)** – the CRO can provide insight into the types, severity and risks the insurer is exposed to in further detail than the risk appetite statement, as well as providing input on emerging risks.
4. **Other subject matter experts** - risk, legal, business unit leads, and other subject matter experts may be useful in understanding the 'real world' implications of a risk or scenario outcome including interactions or dependencies which may not be appropriately reflected in the selected modelling approach.

Engagement with these key stakeholders may have the added benefit of embedding target capital within the business and enhancing its usefulness as a management tool.

2.10. Review of the target capital levels

Target capital should be reviewed periodically to ensure that it continues to be relevant. Major changes to the financial position or risk profile of the insurer may materially alter the fundamentals underlying the target capital calculation. This may be a potential trigger for the recalculation of target capital. Examples of major changes are:

- Changes to the risk appetite of the insurer
- Changes to the risk profile of the insurer, including:
 - Run-off or acquisition of a material portfolio
 - Changes to reinsurance arrangements
 - Changes in the operating environment that have a material impact (e.g. regulatory or legislative change, major events such as a pandemic or financial crisis)
 - Strategic changes
 - Merger/acquisitions
- Changes to management actions embedded within the target capital level due to changes in their feasibility, the operating environment or time horizon over which the actions can be implemented.

3. Quantifying target capital

3.1. Introduction

Once the basis upon which target capital will be calculated has been determined, the next step is to quantify the target capital amount. The approach is typically commensurate with the size and complexity of the business.

3.2. Modelling approaches

The aim of the modelling is to calculate the target capital reflective of selected risks, allowing for correlations between risks. There are numerous ways to do so with various levels of complexity. A range of modelling approaches is set out below.

- **Deterministic stressing of individual risks.** Under this approach, the company's balance sheet is shocked for the selected risks based on specified stresses at the required level of security of target capital. Diversification between risks can either be allowed for explicitly, for example via a correlation matrix, or implicitly through a calibration of the stresses at the required level. An example of this approach is the recalibration of the regulatory capital requirement framework to the target capital level of security.
- **Stochastic modelling:** Stochastic approaches involve the use of random probability distributions to simulate risk outcomes. This can range from simple models such as assuming the claims ratio follows a pre-defined statistical distribution to more complicated simulations of joint distributions.
- **Scenario analysis:** Scenario analysis involves combining risks. An example of this is combining insurance, lapse and market risk stresses to form a single scenario which is then used to determine target capital. This is typically performed deterministically, although stochastic approaches are possible.

The chosen target capital modelling approach may be used at intervals throughout the year. In between these intervals, simplified approaches may be used, such as expressing the target capital as a percentage of appropriate drivers.

3.2.1. Advantages and disadvantages of deterministic and stochastic approaches

Deterministic approaches are typically easier to explain, particularly to non-technical audiences. Disadvantages of deterministic approaches are that they can be more subjective and may not capture all the interactions between risks. This can lead to target capital amounts that are highly dependent on the selected stresses or scenarios.

Stochastic models can be more statistically robust and provide the ability to produce a probability distribution of capital outcomes that enable the formulation of confidence limits around capital levels. However, these approaches are more data and time intensive and require stochastic assumptions which may be uncertain and harder to explain. The Member should note that the use of stochastic models without adequate data may lead to spurious accuracy.

3.3. Management actions

The execution of management actions can materially improve the capitalisation of an insurer by improving the capital position or reducing regulatory capital requirements. Quantifying their impact is important as they may justify a lower level of target capital.

3.3.1. The degree to which management actions should be incorporated

The following are three areas of consideration when assessing the degree to which management actions can be incorporated into the quantification of target capital:

1. **Control:** The degree to which the insurer can freely execute the management action given any practical limitations in the scenario under consideration. Limitations may include the fungibility of capital between subsidiaries or between and within funds.
2. **Timing:** The time taken to feasibly identify the issue, approve and execute the action and for the action to provide capital benefits.
3. **Capital benefit:** The impact of the management actions on the capital position under stressed situations. The realistic effectiveness of the action relative to expectations should be considered, given historical performance and the risk of sub-optimal decisions during a stressed scenario. This may include consideration of costs or interdependencies in executing the action which may limit its benefits.

These considerations allow the Member to determine the extent to which management actions impact the quantification of target capital. At the extremes, there may be management actions that are excluded because the capital benefit is unreliable or not timely, or those that can be readily included because they are within the insurer's control and can be implemented easily. Examples of the former include raising capital or selling subsidiaries/portfolios in a stressed scenario. An example of the latter may include reductions in planned dividends.

Quantifying the impact of management actions that fall between these extremes will require judgement, such as allowing for a reduced benefit of the management actions. Examples include changes to the reinsurance arrangements, pricing, investment mix, policy terms and conditions/product changes or underwriting frameworks

Finally, the effectiveness of management actions which support the target capital level should be validated on an ongoing basis, and the target capital updated accordingly.

3.3.2. Double counting of management actions

Management actions may be permitted to reduce the target capital. When allowing for management actions, care should be taken to consider the feasibility of management actions that may have already been allowed for in the regulatory capital calculations.

Furthermore, when performing scenario testing, management actions can be incorporated to the extent to which they have not already been allowed for in the target capital.

3.4. Other Modelling Considerations

Modelling for target capital purposes often occurs at relatively extreme outcomes, which necessitate several additional modelling considerations. The Member should consider the following additional considerations in developing the modelling approach (to the extent relevant):

- **Corporate structure:** For life and health insurers, target capital is held and maintained at the statutory fund level in addition to the company in aggregate. It may be appropriate to allow for diversification between the statutory and shareholder funds, noting potential legislative constraints. Similar considerations also apply to the determination of diversification benefits of target capital within a Level 2 general insurer or between the health benefits fund of a health insurer and the health insurer itself. Considerations may also apply to the allocation of capital to Level 3 group insurers (noting references to levels 2 and 3 are as defined by APRA).
- **Pro-cyclical and counter-cyclical:** After a stress event, the insurer's exposure to risks may change. Some risks may decrease due to a lower exposure base (e.g. asset risk). Other risks, such as operational risk, may increase significantly following a stress event. Risk margins used in the calculation of regulatory capital or economic capital requirements may also change depending on the nature of the shock.
- **Assumptions under extreme scenarios:** Appropriateness of modelling assumptions under extreme scenarios (e.g. correlation assumptions).
- **Model limitations:** To the extent that risks are not materially captured within the selected modelling approach, the target capital amount may be adjusted.

3.5. Validation of Target Capital

Several assumptions and limitations will underlie any target capital model (i.e. model risk). Hence, irrespective of the modelling approach used to determine target capital, it is important that some form of plausible but severe stress testing, scenario testing and/or reverse stress testing is conducted to validate target capital. Note that these methodologies, as discussed in Section 3.2, may also be used to quantify the target capital itself.

3.5.1. Stress Testing

Stress testing involves the changing of single parameters to assess the impact of that parameter on the capital position and therefore whether the target capital amount is able to withstand such a stress. Where the target capital incorporates management actions, stress testing can also assist in assessing the appropriateness of the stated management actions in the context of the chosen stress.

3.5.2. Scenario testing

Scenario testing normally involves a narrative outlining the nature of the event, its severity and timing. Scenarios are often set with reference to the company's risk assessment, historic experience, and past internal and regulatory stress tests. The narrative can help the Board and senior management to understand the scenario and to assess whether it is within risk

appetite by looking at whether the target capital amount is able to withstand the scenario. Modelling a wide range of plausible scenarios is preferable to relying too heavily on a single scenario.

Scenario modelling is complex and involves modelling key business variables under scenario specific assumptions over future time periods. The assumptions should incorporate the key risk drivers for the event (e.g. economic, demographic, behavioural, weather related) and be internally consistent. Assumption setting is a complex process that often requires judgement and/or input from experts. Sensitivity testing of scenario assumptions can be useful where differing opinions exist.

As discussed in Section 3.3, the scenarios should consider potential mitigating management actions, their implementation issues, the timing of their deployment and their effectiveness under the scenario. This can help inform the management actions and capital triggers (see Section 4.2) in the company's ICAAP.

Operational impacts should also be considered. For example, consideration should be given to whether the systems and processes work during a stressed event and whether there are any key dependencies (e.g. key person risk). These risks may not be well captured in a model.

3.5.3. Reverse Stress Testing

Reverse stress testing of target capital involves the design of a scenario or individual stresses specifically designed to breach the target capital level, i.e. "What type of scenario or stresses must happen before the regulatory capital requirements are breached?" By considering the likelihood of the scenario or the individual stress, the Member can validate whether the target capital level is providing the desired level of security.

4. Using target capital as a management tool

4.1. Target Operating Range

A company may decide to have a single target capital amount or a range, which is known as the target operating range. A target operating range may provide flexibility in capital management, allowing the insurer to operate through short-term volatility and seasonal variations in capitalisation. Provided that capitalisation is within and expected to remain within the target operating range, no management action would typically be required to restore capital to the target level.

The bounds for the target operating range should align to the risk appetite and risk profile of the insurer. The upper bound may represent a point beyond which the Board desires the return of excess capital to shareholders to preserve a desired return on capital. The lower bound of the range may be set to a particular return period, for example, a 'no more than x% probability of ruin over an annual time horizon'.

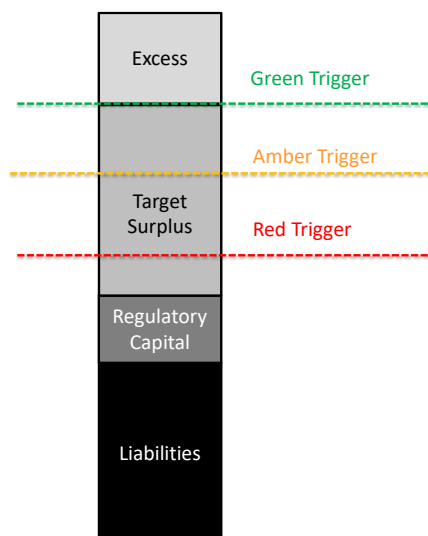
4.2. Capital Triggers

Capital triggers are key levels of capitalisation, which, if breached, require action by management to restore capital to target levels. Often, several cascading capital triggers will be defined, with escalating responses required as capitalisation decreases, for example:

- Exceeding or at target level: "Monitor" / "Green"
- Slightly below target level: "Prepare" / "Amber"
- Well below target level: "Act" / "Red"

Figure 2 below demonstrates the setting of capital triggers relative to key capital levels.

Figure 2: Example Capital Triggers



Capital triggers should act as an early warning system, providing management with sufficient time to plan and execute actions to restore the capital position. Roles and responsibilities surrounding trigger responses should be defined so that actions are effectively implemented. These roles and responsibilities should be documented, for example within an ICAAP Summary Statement, Recovery Plan or equivalent capital management plan. LPS 110, GPS110, HPS110 and CPG 110 provide further details of APRA's requirements and expectations regarding trigger levels.

Additionally, example trigger responses may include the following:

- Increased monitoring of the capital position, with more frequent and detailed monitoring the lower the capital position is compared to target capital
- Increased reporting, with higher escalation the lower the capital position is compared to target capital, including to the Board and the regulator
- Investigating drivers of capital depletion and the formulation of a detailed action plan for capital remediation. This plan may include options such as:
 - Raising additional capital
 - Reduction of dividends (if dividends are allowed for in the capital projections)
 - Restructuring the capital base
 - Exiting a line of business
 - Purchasing additional reinsurance/conduct risk transfers
 - De-risking the asset portfolio relative to defined liabilities

In times of stress, these actions may be more costly, or less effective, than under normal conditions.

4.3. Responding to capital depletion

The actual capital may fall below target due to company specific factors or a stressed scenario impacting the industry (e.g. the COVID-19 pandemic). In the event of the actual capital level falling below the target, the points below may provide a useful checklist for Members in considering target capital, noting that this list is not exhaustive.

4.3.1. Changes in risk profile

Members should consider the drivers of capital depletion, including any structural changes in the current and future operating environment to determine whether the risk profile of the company has changed. Should it be deemed that the risk profile has materially changed, Members should consider if the assumptions used in capital calculations and projections remain appropriate. Any areas of uncertainty in the regulatory and target capital calculations such as the valuation of assets and liabilities may also be reassessed.

If the risk environment changes materially, it is possible that target capital and triggers may need to be revisited to remain consistent with the risk appetite. In particular, the Member should consider whether the level of target capital should be pro-cyclical (increase in a stressed environment), counter-cyclical or stay the same.

4.3.2. Current capital position and capital forecasts (including scenario testing)

During a stressed event, up to date estimates of the current capital position, quality of capital and forecast capital position become more important. Capital projections can provide insight into the required timing of management actions, with forecasts of when capital may breach key thresholds. Whether actions are undertaken may depend on if the depletion is permanent or temporary and if temporary, when the capital position is expected to increase back to target levels.

In addition, the Member may consider the forecast capital position under scenarios that are more tailored to the event. In determining the scenarios, the key areas of uncertainty in assumptions should be considered and communicated. Note that tailored scenarios do not necessarily require new projections as previous scenarios in different combinations or severity levels may be leveraged. This approach is particularly useful if there is time pressure and rapidly moving stressed events and such an approach is appropriate. During these stressed events, tailored scenario testing may assist in showing a range of possible capital outcomes indicating a range of views from pessimistic to optimistic. Tailored scenario testing may also demonstrate the horizon over which the management actions will assist in bringing the capital position back to target capital levels.

Tailored scenario testing is also useful in re-evaluating the following:

- The appropriateness of trigger points in the ICAAP, risk metrics, frequency of reporting
- The company's capital position and credit rating
- Identifying impacts on counterparty exposures (e.g. reinsurance exposures relative to regulatory limits) and whether actions need to be undertaken to mitigate this
- The suitability of recovery plans as defined by APRA

4.3.3. Actions available to restore capital

Members may re-assess available management actions, considering the magnitude of capital relief, availability and execution time during the stress event. This ensures the selected management actions are most effective given the drivers of capital depletion and the operating environment.

Members should note the unavailability of some management actions post-execution (e.g. sale of assets), which may have implications for target capital levels or capital triggers.

In the event of an industry wide stress, the Board may consider whether it is appropriate to temporarily tolerate breaches of target capital, or whether immediate action may be required to restore target capital. The Board may also reconsider the time horizon in which the business recovers its target capital. Ultimately, these decisions should reflect a company's risk

appetite in terms of policyholder security, access to capital and/or available management actions during a stress event.

4.3.4. Increased monitoring and reporting

Increasing the frequency of monitoring and reporting may help to ensure that information relied upon is the most up-to-date and accurate, particularly at key execution stages.

4.3.5. Regulatory considerations

In an industry wide stressed situation, it is likely that the regulator will also act. Examples include the regulator specifying scenarios to run, requiring companies to take pre-emptive action before the situation and seeking regular reporting on capital positions from companies.

Members advising companies should be aware of these additional regulatory requirements, the ability of the company to respond to them and communicate any required material uplift in capability.

4.3.6. Communication strategy

In responding to a capital depletion, a communication strategy should be developed (or followed if an appropriate communication strategy exists), covering who needs to be informed, when, how and by whom. This should cover both internal communication channels (e.g. Board and executive management) as well as key external stakeholders such as regulators, key partners or related entities. The Member may not necessarily be responsible for the communication strategy.

4.4. Allocating target capital through the company

Target capital can be used throughout the company to ensure that risks are appropriately reflected in management decisions. Common applications for target capital within a business unit or product lines include risk adjusted performance measurement (such as return on capital and economic value added), and pricing activities or contracts on a 'cost of capital' basis.

When allocating target capital through the company, the following considerations may apply:

- Is the appetite for risk and the risk profiles the same? Vastly different views on risk may justify different target capital bases.
- Is there a clear and consistent basis for allocating target capital? An example of a clear and consistent basis may be using some sort of profit value driver which can be identified for each business unit or product.
- Should target capital be applied on a "stand-alone" basis or should the diversification benefits from being part of a larger group be passed down to each business unit or product line?

- If the stand-alone basis is applied, then the sum of the allocated target capital will exceed target capital for the insurer. This could lead to inefficient capital decisions being taken across the insurer.
- On the other hand, if diversification benefits are passed down, a consistent approach will need to be undertaken for the allocation of this diversification, and a business unit's or product line's capital allocation may be overly responsive to decisions made in other areas of the company.
- How does the range and effectiveness of management actions differ across the company? If specific management actions are embedded in the setting of the group level target capital, their specific impact will have to be identified to ensure the benefits are allocated to the specific business unit or products.

There are many different approaches to allocating target capital and a detailed discussion of these approaches is outside the scope of this Practice Guideline.

4.5. Limitations of Target Capital

While identifying a target capital level is important, key benefits arise from the framework used to monitor changes, understanding the drivers of change, and being in a position to respond in a timely manner to deteriorating experience.

It is important that the limitations of target capital are well understood. In particular:

- Actual capital does not have to meet or exceed target capital at all times. Target capital reflects a given risk appetite, probability and time horizon. A key use of target capital is serving as an early warning for when different actions can be taken to manage the capital position and position the insurer to withstand threats.
- Holding a target capital level does not remove the risk of breaching regulatory capital requirements or some other agreed benchmark. Even if target capital is held, there remains a risk of breaching minimum requirements.
- The quantification of target capital relies on models of risk. It does not aim to protect against all risks, especially risks that cannot be reflected in a standard statistical model, or risks for which holding capital have limited mitigating effects (e.g. liquidity risk). Models are limited and it is necessary to apply appropriate validation of target capital levels.
- Using a higher confidence level in quantifying target capital does not necessarily mean a stronger risk management framework. These measures need to be combined with a realistic and effective action plan.
- The capital management framework (including target capital) should be viewed as being a value adding tool to manage the business and not purely a compliance exercise.
- The value of target capital will be dependent also on the ability of Members to communicate the benefits and limitations of target capital to the Board, Senior Management and other key stakeholders.

End of Practice Guideline