Chapter 7

Prudential requirements and professional indemnity insurance

7

7.3 Calculation of prudential resources

Eligible prudential resources

7.3.1 R

(1) A *firm* must calculate its prudential resources only from the items which are eligible to contribute to a *firm's* prudential resources as set out in the table in CMCOB 7.3.2R.

(2) In arriving at its calculation of its prudential resources, a *firm* must deduct certain items as set out in the table in CMCOB 7.3.3R.

7.3.2 R

Table: Items which are eligible to contribute to the prudential resources of a firm

	Item	Additional explanation
1	*Share* capital	This must be fully paid and may include: (1) ordinary *share* capital; or (2) preference *share* capital (excluding preference *shares* redeemable by shareholders within two years).
2	Capital other than *share* capital (for example, the capital of a *sole trader*, *partnership* or *limited liability partnership*)	The capital of a *sole trader* is the net balance on the *firm's* capital account and current account. The capital of a *partnership* is the capital made up of the *partners'*: (1) capital account, that is the account: (a) into which capital contributed by the *partners* is paid; and (b) from which, under the terms of the *partnership* agreement, an amount representing capital may be withdrawn by a *partner* only if: (i) the *person* ceases to be a *partner* and an equal amount is transferred to another such account by the *person's* former *partners* or any *person* replacing that *person* as their *partner*; or (ii) the *person* ceases to be a partner and an equal amount is transferred to another such account by the *person's* former partners or any *person* replacing that *person* as their partner; or (iii) the *partnership* is otherwise dissolved or wound up; and

Item		Additional explanation
		(2) current accounts according to the most recent financial statement. For the purpose of the calculation of capital resources in respect of a *defined benefit occupational pension scheme*: (3) a *firm* must derecognise any *defined benefit asset*; (4) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*, provided that the election is applied consistently in respect of any one financial year.
3	Reserves (Note 1)	These are, subject to Note 1, the audited accumulated profits retained by the *firm* (after deduction of tax, dividends and proprietors' or *partners'* drawings) and other reserves created by appropriations of share premiums and similar realised appropriations. Reserves also include gifts of capital, for example, from a *parent undertaking*. For the purposes of calculating capital resources, a *firm* must make the following adjustments to its reserves, where appropriate: (1) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on debt instruments held, or formerly held, in the available-for-sale financial assets category; (2) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost; (3) in respect of a *defined benefit occupational scheme*: (a) a *firm* must derecognise any *defined benefit asset*; (b) a *firm* may substitute for a *defined benefit liability* the *firm's reduction amount*, provided that the election is applied consistently in respect of any one financial year.
4	Interim net profits (Note 1)	If a *firm* seeks to include interim net profits in the calculation of its capital resources, the profits have, subject to Note 1, to be verified by the *firm's* external auditor, net of tax, anticipated dividends or proprietors' drawings and other appropriations.
5	Revaluation reserves	Revaluation reserves such as reserves arising from the revaluation of land and buildings, including any net unrealised gains for the fair valuation of equities held in the available-for-sale financial assets category.
6	Subordinated loans/ debt	Subordinated loans/debt must be included in capital on the basis of the provisions in this chapter that apply to subordinated loans/debts.
Note:		
1	Reserves must be audited and interim net profits, general and collective provisions must be verified by the *firm's* external auditor unless the firm is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemption from audit) or, where applicable,	

Item	Additional explanation
	Part 16 of the Companies Act 2006 (section 477 (Small companies; Conditions for exemption from audit)) relating to the audit of accounts.

7.3.3 R Table: Items which must be deducted in arriving at prudential resources

1	*Investments* in own *shares*
2	*Investments* in *subsidiaries* (Note 1)
3	Intangible assets (Note 2)
4	Interim net losses (Note 3)
5	Excess of drawings over profits for a *sole trader* or a *partnership* (Note 3)
Notes:	
1	*Investments* in *subsidiaries* are valued at the full balance sheet value.
2	Intangible assets are the full balance sheet value of goodwill, capitalised development costs, brand names, trademarks and similar rights and licences.
3	The interim net losses in row 4, and the excess of drawings in row 5, are in relation to the period following the date as at which the prudential resources are being computed.

Subordinated loans/debt

7.3.4 R A subordinated loan/debt must not form part of the prudential resources of the *firm* unless it meets the following conditions:

(1) it has an original maturity of:

(a) at least five years; or

(b) it is subject to five years' notice of repayment;

(2) the claims of the subordinated creditors must rank behind those of all unsubordinated creditors;

(3) the only events of default must be non-payment of any interest or principal under the debt agreement or the winding-up of the *firm*;

(4) the remedies available to the subordinated creditor in the event of non-payment or other default in respect of the subordinated loan/debt must be limited to petitioning for the winding-up of the *firm* or proving the debt and claiming in the liquidation of the *firm*;

(5) the subordinated loan/debt must not become due and payable before its stated final maturity date, except on an event of default complying with (3);

(6) the agreement and the debt are governed by the law of England and Wales, or of Scotland or of Northern Ireland;

(7) to the fullest extent permitted under the rules of the relevant jurisdiction, creditors must waive their right to set off amounts they

owe the *firm* against subordinated amounts owed to them by the *firm*;

(8) the terms of the subordinated loan/debt must be set out in a written agreement that contains terms which provide for the conditions set out in this *rule*; and

(9) the loan/debt must be unsecured and fully paid up.

7.3.5 R When calculating its prudential resources, the *firm* must exclude any amount by which the aggregate amount of its subordinated loans/debts exceeds the amount calculated as follows:

a – b

where:

a = the sum of Items 1-5 in the Table of items, which are eligible to contribute to a *firm's* capital resources (see CMCOB 7.3.2R)

b = the sum of Items 1-5 in the Table of items, which must be deducted in arriving at a *firm's* capital resources (see CMCOB 7.3.3R)

7.3.6 G CMCOB 7.3.5R can be illustrated by the examples set out below:

(1)	Share capital	£20,000
	Reserves	£30,000
	Subordinated loans/debts	£10,000
	Intangible assets	£10,000
	As subordinated loans/debts (£10,000) are less than the total of share capital + reserves - intangible assets (£40,000) the *firm* need not exclude any of its subordinated loans/debts pursuant to CMCOB 7.3.4R when calculating its prudential resources. Therefore the *firm's* total prudential resources will be £50,000.	
(2)	Share capital	£20,000
	Reserves	£30,000
	Subordinated loans/debts	£60,000
	Intangible assets	£10,000
	As subordinated loans/debts (£60,000) exceed the total of share capital + reserves - intangible assets (£40,000) by £20,000, the *firm* should exclude £20,000 of its subordinated loans/debts pursuant to CMCOB 7.3.5R when calculating its prudential resources. Therefore the *firm's* total prudential resources will be £80,000.	