

Chapter 4

Capital resources

4.4 Calculation of capital resources

The calculation of a firm's capital resources

4.4.1

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- (1) A *firm* must calculate its capital resources only from the items which are eligible to contribute to a *firm's* capital resources from which it must deduct certain items (see ■ MIPRU 4.4.4 R).
- (2) If the *firm* is subject to the Prudential sourcebook for MiFID Investment Firms (*MIFIDPRU*) or the Interim Prudential sourcebook for investment businesses (*IPRU(INV)*), the capital resources are the higher of:
 - (a) the amount calculated under (1); and
 - (b) the financial resources calculated under those sourcebooks.

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

| | Item | Additional explanation |
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| 1. | Share capital | This must be fully paid and may include: <ol style="list-style-type: none"> (1) ordinary <i>share</i> capital; or (2) preference <i>share</i> capital (excluding preference <i>shares</i> redeemable by shareholders within two years). |
| 2. | Capital other than <i>share</i> capital (for example, the capital of a <i>sole trader</i> , <i>partnership</i> or <i>limited liability partnership</i>) | The capital of a <i>sole trader</i> is the net balance on the <i>firm's</i> capital account and current account. The capital of a <i>partnership</i> is the capital made up of the <i>partners'</i> : <ol style="list-style-type: none"> (1) capital account, that is the account: <ol style="list-style-type: none"> (a) into which capital contributed by the <i>partners</i> is paid; and (b) from which, under the terms of the <i>partnership</i> agreement, an amount representing capital may be withdrawn by a <i>partner</i> only if: <ol style="list-style-type: none"> (i) he ceases to be a <i>partner</i> and an equal amount is transferred to another such account by his |

| Item | Additional explanation |
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| | <p>former <i>partners</i> or any <i>person</i> replacing him as their <i>partner</i>; or</p> <p>(ii) the <i>partnership</i> is otherwise dissolved or wound up; and</p> <p>(2) current accounts according to the most recent financial statement.</p> <p>For the purpose of the calculation of capital resources, in respect of a <i>defined benefit occupational pension scheme</i>:</p> <p>(1) a <i>firm</i> must derecognise any <i>defined benefit asset</i>;</p> <p>(2) a <i>firm</i> may substitute for a <i>defined benefit liability</i> the <i>firm's deficit reduction amount</i>, provided that the election is applied consistently in respect of any one financial year.</p> |
| <p>3. Reserves (Note 1)</p> | <p>These are, subject to Note 1, the audited accumulated profits retained by the <i>firm</i> (after deduction of tax, dividends and proprietors' or <i>partners'</i> drawings) and other reserves created by appropriations of share premiums and similar realised appropriations. Reserves also include gifts of capital, for example, from a <i>parent undertaking</i>.</p> <p>For the purposes of calculating capital resources, a <i>firm</i> must make the following adjustments to its reserves, where appropriate:</p> <p>(1) a <i>firm</i> 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;</p> <p>(2) a <i>firm</i> 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;</p> <p>(3) in respect of a <i>defined benefit occupational pension scheme</i>:</p> <p>(a) a <i>firm</i> must derecognise any <i>defined benefit asset</i>;</p> <p>(b) a <i>firm</i> may substitute for a <i>defined benefit liability</i> the <i>firm's deficit reduction amount</i>, provided that the election is applied consistently in respect of any one financial year.</p> |
| <p>4. Interim net profits (Note 1)</p> | <p>If a <i>firm</i> 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 <i>firm's</i> external auditor, net of tax, anticipated dividends or proprietors' drawings and other appropriations.</p> |
| <p>5. Revaluation reserves</p> | |

| Item | Additional explanation |
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| 6. General/ collective provisions (Note 1) | These are provisions that a <i>firm</i> carrying on <i>home financing</i> or <i>home finance administration</i> holds against potential losses that have not yet been identified but which experience indicates are present in the <i>firm's</i> portfolio of assets. Such provisions must be freely available to meet these unidentified losses wherever they arise. Subject to Note 1, general/collective provisions must be verified by external auditors and disclosed in the <i>firm's</i> annual report and accounts. |
| 7. Subordinated loans | Subordinated loans must be included in capital on the basis of the provisions in this chapter that apply to subordinated loans. |
| Note: | |
| 1 | Reserves must be audited and interim net profits, general and collective provisions must be verified by the <i>firm's</i> external auditor unless the <i>firm</i> is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemptions from audit)) or, where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions for exemption from audit)) relating to the audit of accounts. |

4.4.3 G A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *appropriate regulator* the reasons for any difference between the *deficit reduction amount* and any commitment the *firm* has made in any public document to provide funding in respect of a *defined benefit occupational pension scheme*.

4.4.4 R Table: Items which must be deducted from capital resources

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| 1 | <i>Investments</i> in own shares |
| 2 | Intangible assets (Note 1) |
| 3 | Interim net losses (Note 2) |
| 4 | Excess of drawings over profits for a <i>sole trader</i> or a <i>partnership</i> (Note 2) |
| Notes | Notes 1. Intangible assets are the full balance sheet value of goodwill (but not until 14 January 2008 - see transitional provision 1), capitalised development costs, brand names, trademarks and similar rights and licences. 2. The interim net losses in row 3, and the excess of drawings in row 4, are in relation to the period following the date as at which the capital resources are being computed. |

Personal assets

4.4.5 R In relation to a *sole trader's firm* or a *firm* which is a *partnership*, the *sole trader* or a *partner* in the *firm* may use personal assets to meet the general solvency requirement and the general capital resource requirement, to the

extent necessary to make up any shortfall in meeting those requirements, unless:

- (1) those assets are needed to meet other liabilities arising from:
 - (a) personal activities; or
 - (b) another business activity not regulated by the *appropriate regulator*; or
- (2) the *firm* holds *client money* or other *client assets*.

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A *sole trader* or a *partner* may use any personal assets, including property, to meet the capital requirements of this chapter, but only to the extent necessary to make up a shortfall.

Subordinated loans

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A subordinated debt must not form part of the capital resources of the *firm* unless it meets the following conditions:

- (1) (for a *firm* which carries on *insurance distribution activity*, *home finance mediation activity* (or both) but not *home financing* or *home finance administration*) it has an original maturity of:
 - (a) at least two years; or
 - (b) it is subject to two years' notice of repayment;
- (2) (for all other *firms*) it has an original maturity of:
 - (a) at least five years; or
 - (b) it is subject to five years' notice of repayment;
- (3) the claims of the subordinated creditors must rank behind those of all unsubordinated creditors;
- (4) 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*;
- (5) the remedies available to the subordinated creditor in the event of non-payment or other default in respect of the subordinated 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*;
- (6) the subordinated debt must not become due and payable before its stated final maturity date except on an event of default complying with (4);
- (7) the agreement and the debt are governed by the law of England and Wales, or of Scotland or of Northern Ireland;
- (8) 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*;

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- (9) the terms of the subordinated debt must be set out in a written agreement or instrument that contains terms that provide for the conditions set out in this *rule*; and
- (10) the debt must be unsecured and fully paid up.
- (1) This *rule* applies to a *firm* which:
- (a) carries on:
- (i) *insurance distribution activity*; or
- (ii) *home finance mediation activity* (or both); and
- in relation to those activities, holds *client money* or other *client assets*; or
- (b) carries on *home financing* or *home finance administration* connected to *regulated mortgage contracts* (or both) unless as at 26 April 2014 its *Part IV permission* was and continues to remain subject to a restriction preventing it from undertaking new *home financing* or *home finance administration* connected to *regulated mortgage contracts*.
- (2) In calculating its capital resources, the *firm* must exclude any amount by which the aggregate amount of its subordinated loans and its redeemable preference *shares* exceeds the amount calculated as follows:

four times (a - b - c);

where:

| | | |
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| a | = | items 1 to 5 in the Table of items which are eligible to contribute to a <i>firm's</i> capital resources (see MIPRU 4.4.2 R) |
| b | = | the <i>firm's</i> redeemable preference <i>shares</i> ; and |
| c | = | the amount of its intangible assets (but not goodwill until 14 January 2008 - see transitional provision 1). |

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If a *firm* wishes to see an example of a subordinated loan agreement which would meet the required conditions, it should refer to the Forms page.

Reversion providers: additional requirement for instalment reversions

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- (1) If the *reversion provider* agrees under the terms of an *instalment reversion plan* to pay the *reversion occupier* for the *qualifying interest in land* over a period of time, then the provider must:

- (a) take out and maintain adequate insurance from an *insurance undertaking* authorised in the *UK* or a *person* of equivalent status in:
 - (i) a *Zone A country*; or
 - (ii) the Channel Islands, Gibraltar, Bermuda or the Isle of Man; or
 - (b) enter into a written agreement with a *credit institution*;
- to meet these obligations in the event that the *reversion provider* is unable to do so.

(2) This rule does not apply if:

- (a) the *instalment reversion plan* is linked to an *investment* and it is reasonably anticipated that the amounts due to the *reversion occupier* under the plan will be paid out of the proceeds of the *investment* to the occupier by a *product provider* other than the *reversion provider*; or
- (b) the *reversion provider* acquires its interest in the property in steps proportionate to the instalments paid.

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The additional requirement for *reversion providers* aims to protect the *reversion occupier* against the insolvency of the *reversion provider* where the *reversion occupier* has agreed to receive the price for the part of the *qualifying interest in land* sold in instalments rather than in a lump sum. The requirement does not arise, for example, in relation to reversions linked to annuities as the *reversion occupier* has no credit risk on the *reversion provider*. Also, the requirement does not arise in relation to 'mini-reversions' (or 'staged reversions') as under these plans the *reversion occupier* continues to own the *qualifying interest in land*.

Regulated sale and rent back agreements: additional requirement

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If a *SRB agreement provider* agrees, under the terms of a *regulated sale and rent back agreement*, to account to the *SRB agreement seller* for any monetary sum, whether after a qualifying period, over a period of time, on the occurrence of a contingent event or otherwise, the provider must:

- (1) take out and maintain adequate insurance from an *insurance undertaking* authorised in the *EEA* or a *person* of equivalent status in:
 - (a) a *Zone A country*; or
 - (b) the Channel Islands, Gibraltar, Bermuda, or the Isle of Man; or
- (2) enter into a written agreement with a *credit institution*;

to meet these obligations in the event that the *SRB agreement provider* is unable to do so.

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An example of where this additional requirement would apply would be a term of a *regulated sale and rent back agreement* under which the *SRB agreement seller* was to receive from the *SRB agreement provider* a refund of an agreed percentage of the discount on the sale price of the property to which the agreement relates after an agreed qualifying period.