INTERIM PRUDENTIAL SOURCEBOOKS (MISCELLANEOUS AMENDMENTS) INSTRUMENT 2006

Powers exercised

A. The Financial Services Authority makes this instrument in the exercise of the following powers and related provisions in the Financial Services and Markets Act 2000 ("the Act"):

(1) section 138 (General rule-making power);
(2) section 156 (General supplementary powers); and
(3) section 157(1) (Guidance).

B. The rule-making powers listed above are specified for the purpose of section 153(2) (Rule-making instruments) of the Act.

Commencement

C. This instrument comes into force on 6 June 2006.

Amendments to the Handbook

D. The modules of the FSA's Handbook of rules and guidance listed in column (1) below are amended in accordance with the Annexes to this instrument listed in column (2).

(1)	(2)
Interim Prudential sourcebook for Banks (IPRU(BANK))	Annex A
Interim Prudential sourcebook for Building Societies (IPRU(BSOC))	Annex B
Interim Prudential sourcebook for Investment Businesses (IPRU(INV))	Annex C
Supervision manual (SUP)	Annex D

Citation

E. This instrument may be cited as the Interim Prudential Sourcebooks (Miscellaneous Amendments) Instrument 2006.

By order of the Board
25 May 2006

Annex A

Amendments to Interim Prudential sourcebook for Banks

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend Volume 1, CA (Definition of Capital) as follows:

4 ELEMENTS OF A BANK'S CAPITAL BASE

…

4.3 Tier 2 - supplementary capital

5 Tier 2 (or supplementary) capital consists of:

(a) Reserves arising from the revaluation of tangible fixed assets and fixed asset investments, including any net unrealised gains for the fair valuation of equities held in the available-for-sale financial assets category<u> and any unrealised gains on investment property</u>.

…

5 TIER 1 CAPITAL

…

5.2 Reserves

6 *Reserves* are accumulated profits retained by the bank after the payment of all dividends and tax, and other reserves created by appropriations of share premia and other surpluses.

a) Dividends should be deducted from reserves as soon as they are declared.

(a) For the purposes of calculating prudential capital a bank should:

(i) deduct unrealised gains or, where applicable, add back in unrealised losses, on cash flow hedges of financial instruments measured at cost or amortised cost;

(ii) deduct unrealised gains or, where applicable, add back in unrealised losses, on debt instruments held in the available-for-sale financial assets category;

(iii) deduct unrealised gains or, where applicable, add back in unrealised losses, which are not attributable to changes in a benchmark interest rate, arising when a bank, upon initial recognition, designates its financial liabilities as at fair value through profit or loss;

<u>(iv) deduct unrealised gains on investment property;</u>

…

6 UPPER TIER 2 CAPITAL

This section provides detail on the constituent elements of Upper Tier 2 capital.

6.1 Reserves arising from the revaluation of tangible fixed assets and fixed asset investments

1 *Reserves arising from the revaluation of tangible fixed assets*, or fixed asset investments, are reserves created when such assets are revalued to bring them in line with replacement costs. This category also includes any unrealised gains arising on revaluing investment property which is ineligible for inclusion in Tier 1 capital. These reserves are eligible for inclusion in Upper Tier 2 capital.

a) *Fixed assets* are assets such as land, buildings, plant, equipment and other assets acquired for carrying on the business of a company.

b) Where *negative goodwill* is required to be identified under the adopted accounting framework it will be included in reserves. *Negative goodwill* arises when a company/ portfolio is purchased below the value of its assets. The difference is called negative goodwill.

c) For the definition of *goodwill* see the section on deductions from capital.

d) Unrealised gains may arise on revaluing investment property, where applicable.

…

Amend Volume 1, BC (Credit risk in the banking book) as follows:

3 RISK WEIGHTING FRAMEWORK: ON BALANCE SHEET

…

3.2 Counterparty weights

…

3.2.2 Zero weighting

4 The following types of asset may attract a zero weighting:

…

(g) certificates of tax deposit; ~~and~~

(h) items in suspense where they represent position risk; <u>and</u>

<u>(i) a *defined benefit asset*.</u>

Amend Volume 2, VA (Valuation) as follows:

2 GENERAL POLICY ON VALUATION

…

4 Unless a different practice has been agreed in writing with the FSA, non - CAD bank should value both its trading and its banking books on an *accruals* basis rather than on a cash basis; and a CAD bank should value its trading book on a *mark-to-market* basis and its banking book on an *accruals* basis.

...

<u>f) For risk-weighting purposes a bank should deduct unrealised gains or, where applicable, add back in unrealised losses on debt instruments held in the available-for-sale financial assets category.</u>

…

Annex B

Amendments to Interim Prudential sourcebook for Building Societies

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend Volume 1 (Prudential Standards), Chapter 1 Solvency, as follows:

1.8 DEDUCTIONS

…

1.8.4 G

…

(4) a "defined benefit asset" is the excess of the value of the assets in a defined benefit occupational pension scheme over the present value of the scheme liabilities, to the extent that a society, as employer, should recognise that excess as ~~a liability~~ an asset in its balance sheet.

Amend Volume 1 (Prudential Standards), Chapter 1 Solvency, Annex 1A as follows:

CALCULATION OF "OWN FUNDS"

G

1A.1 Tier 1 Capital

1A.1.1 Reserves as disclosed in the latest year end balance sheet;

plus

cumulative interim profits for the year to date which have been verified by the society's external auditors (see Annex 1E); or

less

cumulative losses (if any) for the year to date and any unrealised gains on investment property reported in retained earnings (these should be reported as part of the revaluation reserve (see 1A.4)).

…

1A.4 Revaluation Reserves

1A.4.1 Societies may include revaluation reserves arising out of the differences between book values and the current market value of property fixed assets<u> and unrealised gains on investment property </u>but only if:

….

Amend Volume 1 (Prudential Standards), Chapter 1 Solvency, Annex 1B as follows:

RISK ASSET WEIGHTS

G

1B.1 General

1B.1.1 Risk weights should be applied net of any specific or individual provision. Items subject to deduction from Own Funds should be zero weighted <u>(this includes unrealised gains or losses held in the available-for-sale financial assets category (see 1A.1.5(2) and any defined benefit asset)</u>. Assets held by a subsidiary undertaking are weighted on the same basis as if held by the parent society.

Amend Volume 1 (Prudential Standards), Chapter 10 Securitisation to insert a new paragraph 10.3.4AG after 10.3.4G as follows:

<u>10.3.4AG</u> <u>The adoption of International Accounting Standards by some societies changes the accounting treatment of securitised assets for those societies from 1 January 2005. The Building Societies Act 1986 (Modification of the Lending Limit and Funding Limit Calculations) Order 2004 (S.I. 2004/3200) amends the Building Societies Act 1986 so that securitised assets and related liabilities may continue to be excluded from nature limit calculations, regardless of how they are included in the accounts of a society. Therefore societies which use International Accounting Standards to prepare their accounts will not be disadvantaged in relation to the nature limits.</u>

Annex C

Amendments to Interim Prudential sourcebook for Investment Businesses

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend IPRU(INV) Chapter 3 (Financial resources for Securities and Futures Firms which are not Investment Firms) as follows:

Insert a new rule 3-62(8)R after 3-62(7)G as follows:

3-62(8) R	Where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 3-75 (Liquidity adjustment) as follows:

3-75	Liquidity adjustment
…	
	Intangible assets
3-75(2) R	The liquidity adjustment for intangible assets is nil (these must be deducted from capital to arrive at *tangible net worth* under 3-62). Intangible assets do not include a deferred acquisition cost asset.
…	
	Other assets
3-75(13)R	The liquidity adjustment for assets other than those specifically stated above is the balance sheet value of the asset concerned. Other assets do not include a *defined benefit asset* or a deferred acquisition cost asset.

Amend IPRU(INV) Chapter 5 (Financial Resources) as follows:

Amend IPRU(INV) Table 5.2.2(1) (Calculation of own funds and liquid capital) as follows:

TABLE 5.2.2(1) CALCULATION OF OWN FUNDS AND LIQUID CAPITAL
…
PART II DETAILED REQUIREMENTS
…

2A Audited reserves

For the calculation of *own funds* and *liquid capital* the following adjustments apply to the audited reserves figure:

(a) 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;

(b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*;

(c) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year.

Note
A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *FSA* 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*.

(d) a *firm* must not include any unrealised gains from investment property.

Note
Unrealised gains from investment property should be reported as part of revaluation reserves.

(e) where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

3 Intangible assets

(Item 6)

Intangible assets comprise:…

(a) …

(b) …

(c) …

	<u>Intangible assets do not include a deferred acquisition cost asset.</u>
…	
10 Illiquid assets	Illiquid assets comprise:…
(Item 16)	(a) …
	…
	(i) …
	<u>Illiquid assets do not include a *defined benefit asset* or a deferred acquisition cost asset.</u>

Amend IPRU(INV) Table 5.2.3(5)(e) (Other assets requirement) as follows:

TABLE 5.2.3(5)(e) OTHER ASSETS REQUIREMENT … PART II RISK FACTORS … <u>Defined benefit asset NIL</u> <u>Deferred acquisition cost asset NIL</u> All other assets …

Amend IPRU(INV) Chapter 7 (UCITS Management Companies), Table belonging to rule 7.2.1R(1) as follows:

7.3 METHOD OF CALCULATION OF FINANCIAL RESOURCES

7.3.1R This table belongs to *rule* 7.2.1R(1)

PART II DETAILED REQUIREMENTS …

2A Audited reserves	For the calculation of financial resources, the following adjustments apply to the audited reserves figure: (a) 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; (b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*; (c) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year. Note A *firm* should keep a record of and be ready to explain to its supervisory contacts in the *FSA* 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*. (d) a *firm* must not include any unrealised gains from investment property. Note Unrealised gains from investment property should be reported as part of revaluation reserves. (e) where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.
3 Intangible assets (Item 6)	Intangible assets comprise:… (a) … (b) … (c) … Intangible assets do not include a deferred acquisition cost asset.

…

10 Illiquid assets (Item 14)	Illiquid assets comprise:…
	(a) …
	…
	(i) …
	Illiquid assets do not include a *defined benefit asset* or a deferred acquisition cost asset.

…

Amend IPRU(INV) Chapter 10 (Financial Resources for Securities and Futures Firms which are Investment Firms) as follows:

Amend IPRU(INV) 10-61R (Initial capital) as follows:

10-61(3A) R When calculating *initial capital*, a *firm* may include its audited retained earnings only after making the following adjustments:

(a) 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;

(b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*~~.~~;

(c) a *firm* must not include any unrealised gains from investment property (these should be reported as part of revaluation reserves);

(d) where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Externally-verified interim net profits or current account

10-61(4A) R When calculating *initial capital*, a *firm* may include its partners' current accounts figure only after making the following adjustments:

(a) 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;

(b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset;*

(c) where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

…

Intangible assets

10-61(5) R A *firm* must deduct from *initial capital*, when calculating *original own funds*, the full balance sheet value of intangible assets including goodwill, capitalised development costs, licences, exchange seats held as part of its trading requirement, trademark and similar rights etc. Intangible assets do not include a deferred acquisition cost asset.

Amend IPRU(INV) 10-65(11)R (Liquidity adjustment on illiquid assets: Other assets) as follows:

Other assets

10-65(11) The liquidity adjustment for assets other than those specifically stated above where the asset is not due to be repaid within 90 days, is either 8% multiplied by the appropriate counterparty weight ,or 100% of the balance sheet value, except that there is no liquidity adjustment for amounts due which are secured by *acceptable collateral*. Other assets do not include a *defined benefit asset* or a deferred acquisition cost asset.

Amend IPRU(INV) Chapter 13 (Calculation of own funds) as follows:

Amend IPRU(INV) 13.3.2AR as follows:

13.3.2A R For the purpose of calculating a *Category A firm's own funds*, the following adjustments apply to audited reserves or, (for non-corporate entities), current accounts figures.

(1) a *Category 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;

(2) a *Category A firm* must derecognise any *defined benefit asset*;

(3) a *Category A firm* may substitute for a *defined benefit liability* its *deficit reduction amount.* The election must be applied consistently in respect of any one financial year;

(4) a *Category A firm* must deduct any unrealised gains on investment property and include these within revaluation reserves;

(5) where applicable, a *Category A firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but excluding from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 13.4.1R (Financial Resources Test 1A - Adjusted net current assets) as follows:

13.4.1 R A *Category A firm* must adjust its *net current assets* as follows:

exclude assets which cannot be realised or recovered within twelve months;

exclude amounts receivable from *connected persons* to the extent that they are not *properly secured*, except amounts that are *deposits* referred to at item (11) in Part I of table 13.5.4(1) or at item (11) in Part I of table 13.5.4(2);

value *investments* at current *market value*, using the *bid price* for a *net long position* in an investment and the *offer price* for a *net short position* in an investment~~.~~;

where applicable, deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 13.5.4R (Calculation of financial resources to meet tests 1, 1A or 2) as follows:

13.5.4 R A *Category A firm* must be able to calculate its financial resources at any time on the basis of the balance sheet it could draw up at that time. For this purpose:

a *Category A1 firm* …

a *Category A2* or *A3 firm*,…

~~(3)~~ the assets and liabilities in the balance sheet are also subject to the following adjustments:

(a) a *firm* must deduct any unrealised gains, or where applicable, back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;

(b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*;

(c) a *firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year~~.~~;

(d) where applicable, a *firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 13.10.2AR as follows:

13.10.2A R For the purpose of calculating a *Category B firm's own funds*, the following adjustments apply to audited retained profits or, (for non-corporate entities), current accounts figures.

(1) a *Category B 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;

(2) a *Category B firm* must derecognise any *defined benefit asset*;

(3) a *Category B firm* may substitute for a *defined benefit liability* its *deficit reduction amount.* The election must be applied consistently in respect of any one financial year.

(4) a *Category B firm* must deduct any unrealised gains on investment property and include these within revaluation reserves;

(5) where applicable, a *Category B firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 13.11.2R (Financial Resources Test 1A - Adjusted net current assets) as follows:

13.11.2 R A *Category B firm* must adjust its *net current assets* as follows:

exclude assets which cannot be realised or recovered within twelve months;

exclude amounts receivable from *connected persons* to the extent that they are not *properly secured*, except amounts that are *deposits* referred to in item (11) of table 13.12.3(1) or item (11) in table 13.12.3(2);

value *investments* at current *market value*, using the *bid price* for a *net long position* in an investment and the *offer price* for a *net short position* in an investment~~.~~;

where applicable, deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Amend IPRU(INV) 13.12.3R(3) (Calculation of financial resources to meet tests 1, 1A or 2) as follows

13.12.3 R (1) …

(2) …

(3) the assets and liabilities in the balance sheet are also subject to the following adjustments:

(a) a *Category B 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;

(b) in respect of a *defined benefit occupational pension scheme*, a *Category B firm* must derecognise any *defined benefit asset*;

(c) a *Category B firm* may substitute for a *defined benefit liability* the *firm's deficit reduction amount*. The election must be applied consistently in respect of any one financial year~~.~~;

(d) where applicable, a *Category B firm* must deduct any asset in respect of deferred acquisition costs and add back in any liability in respect of deferred income (but exclude from the deduction or addition any asset or liability which will give rise to future cash flows), together with any associated deferred tax.

Annex D

Amendments to the Supervision manual

In this Annex, underlining indicates new text and striking through indicates deleted text.

Amend SUP 16 Annex 2G form BSD3 as follows:

LIABILITIES

CORE CAPITAL – TIER 1

…

A500 Reserves

…

A500.2 Disclosed prior years reserves (excluding item A580), disclosed current year's positive movement on reserves and negative movements on reserves

Report the disclosed, undistributed balance on profit and loss account attributable to previous years (ie revenue reserves), reserves arising from exchange rate translation differences and other reserves (eg capital redemption reserves and capital gifts). Do not report reserves arising from the revaluation of fixed assets or the unrealised gains on investment property); such reserves and unrealised gains should be shown under item A580.

…

SUPPLEMENTARY TIER 2

A580 Fixed asset revaluation reserves

Report reserves relating to the revaluation of fixed assets and unrealised gains on investment property.

…

Amend SUP 16 Annex 4G form MFS1 as follows:

…

SECTION B: BALANCE SHEET: Liabilities

…

B3 CAPITAL

B3.1 Reserves should include general and any 'special' reserves but not revaluation reserves or any unrealised gains on investment property (which should be included at B3.3).

Amend SUP 16 Annex 4G form QFS1 as follows:

SECTION D: CAPITAL AVAILABLE: Own Funds

…

TIER I CAPITAL

D1.1 Reserves at start of year

Reserves exclude revaluation reserves which are to be shown at D2.1 and any unrealised gains on investment property.

…