Chapter 1

Application

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1.1 Application

1.1.1 G There is no overall application statement for *GENPRU*. Each chapter or section has its own application statement.

1.1.2 G Broadly speaking however, *GENPRU* applies (except as provided in GENPRU 1.1.2-AAG) to:

(1) [deleted]

(2) [deleted]

(3) [deleted]

(4) a *BIPRU firm*; and

(5) groups containing such *firms*.

1.1.2-AA G GENPRU 3 (Cross sector groups) applies to:

(1) an *IFPRU investment firm*;

(2) an *insurer* that is a "UK Solvency II firm" as defined in the PRA Rulebook: Glossary; and

(3) a *group* containing both the *firms* in (1) and (2).

1.1.2-A G

1.1.2-B G *GENPRU* applies to a *collective portfolio management investment firm* that is a *BIPRU firm* in parallel with IPRU-INV -link- 11 (see IPRU-INV -link-11.6).

1.1.2A G A firm should refer to GEN 2.2.13A R (cross-references in the Handbook) and GEN 2.2.23 R to GEN 2.2.25 G (cutover: application of provisions made by both the *FCA* and the *PRA*) when applying the rules and guidance in *GENPRU*.

1.1.2B G As the *FCA* does not have the power to impose prudential rules and guidance on *PRA-authorised persons*, references to *PRA-authorised persons* or *PRA rules* that are included in *FCA GENPRU* provisions will not be relevant in the *FCA*'s application of that provision, unless otherwise stated.

Scope

1.1.3 R *GENPRU* applies to a *firm* in relation to the whole of its business, except where a particular provision provides for a narrower scope.

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1.2 Adequacy of financial resources

Application

1.2.1 R This section applies to a *BIPRU firm*.

(3) [deleted]

1.2.1A R [deleted]

1.2.2 R [deleted]

1.2.2A R [deleted]

1.2.3 R [deleted]

1.2.3A G

1.2.4 R [deleted]

1.2.5 R [deleted]

1.2.7 G The *guidance* in this section is drafted with respect to a *firm* to which this section and the other provisions of *GENPRU* and *BIPRU* (except BIPRU 12) referred to in this section apply in full.

1.2.8 G [deleted]

1.2.9 G [deleted]

1.2.11 G The adequacy of a *firm*'s financial resources needs to be assessed in relation to all the activities of the *firm* and the risks to which they give rise and so this section applies to a *firm* in relation to the whole of its business.

1.2.11A G In the case of a *collective portfolio management investment firm*, GENPRU 1.2.11 G means that this section also applies to its activities in relation to the management of *AIFs* and/or *UCITS*.

Purpose

1.2.12 G Adequate financial resources and adequate systems and controls are necessary for the effective management of prudential risks. This section therefore has requirements relating to both of these topics.

1.2.13 G This section amplifies *Principle* 4, under which a *firm* must maintain adequate financial resources. It is concerned with the adequacy of the financial resources that a *firm* needs to hold in order to be able to meet its liabilities as they fall due. These resources include both capital and liquidity resources.

1.2.14 G In the case of a *BIPRU firm* this section implements the third paragraph of article 95(2) of the *EU CRR* applying Article 34 of the *Capital Adequacy Directive* so far as that Article applies Article 123 of the *Banking Consolidation Directive*.

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1.2.15 G This section also has *rules* requiring a *firm* to identify and assess risks to its being able to meet its liabilities as they fall due, how it intends to deal with those risks, and the amount and nature of financial resources that the *firm* considers necessary. ■ GENPRU 1.2.60 R provides that a *firm* should document that assessment. The *FCA* will review that assessment as part of its own assessment of the adequacy of a *firm*'s capital under its *supervisory review and evaluation process* (*SREP*). When forming a view of any *individual capital guidance* to be given to the *firm*, the *appropriate regulator* will also review the regulator's risk assessment and any other issues arising from day-to-day supervision.

1.2.16 G This section also has *rules* requiring a *firm* to carry out appropriate stress tests and scenario analyses for the risks it has previously identified and to establish the amount of financial resources needed in each of the circumstances and events considered in carrying out the stress tests and scenario analyses. In the case of a *BIPRU firm*, the *FCA* will consider as part of its *SREP* whether the *BIPRU firm* should hold a *capital planning buffer* and, in such a case, the amount and quality of that buffer. The *capital planning buffer* is an amount separate, though related to, the *individual capital guidance*, insofar as its purpose is to ensure that a *BIPRU firm* is able to continue to meet the *overall financial adequacy rule* throughout the relevant capital planning period in the face of adverse circumstances, after allowing for realistic management actions. Therefore, when forming its view on a *BIPRU firm's capital planning buffer*, the *FCA* will take into account the assessment made in relation to the *firm*'s *ICG*.

1.2.17 G The basic requirements in this section are drafted to apply to a *firm* on a solo basis. This section then goes on to describe when its requirements do and do not apply on a solo basis and on a consolidated basis (see ■ GENPRU 1.2.45 R to ■ GENPRU 1.2.47 R and ■ GENPRU 1.2.57 R to ■ GENPRU 1.2.58 R). It also sets out some details about how the solo requirements are adjusted when they are applied on a consolidated basis (see ■ GENPRU 1.2.48 R to ■ GENPRU 1.2.56 G and ■ GENPRU 1.2.29 G).

Outline of other related provisions

1.2.18 G ■ GENPRU 2.1 sets out the minimum *capital resources requirements* for a *firm*. ■ GENPRU 2.2 sets out how *capital resources* are defined and measured for the purpose of meeting the requirements of ■ GENPRU 2.1.

1.2.19 G

(1) ■ BIPRU 2.2 (Internal capital adequacy standards) sets out detailed *guidance* on how a *firm* should carry out the assessment referred to in ■ GENPRU 1.2.15 G. The more thorough, objective, and prudent a *firm's* assessment is, and can be demonstrated as being, the more reliance the *FCA* will be able to place on the results of that assessment.

(2) ■ BIPRU 2.2 also has information on how the *FCA* will review and respond to the assessments referred to in ■ GENPRU 1.2.15G and ■ GENPRU 1.2.16 G. In particular they deal with the giving of *individual capital guidance* to a *firm*, which is *guidance* about the amount and quality of capital resources that the *FCA* thinks a

firm should hold at all times under the *overall financial adequacy rule* as it applies on a solo level and a consolidated level. BIPRU 2.2. also deals with the giving of a *capital planning buffer* to a *BIPRU firm* on a solo level and a consolidated level.

1.2.20 G *SYSC* sets out general *rules* and *guidance* on the establishment and maintenance of systems and controls.

1.2.21 G [deleted]

1.2.21A G

(1) BIPRU 12 sets out material on systems and controls that apply specifically to *liquidity risk* in relation to a *BIPRU firm*.

(2) GENPRU 2.2 (Adequacy of financial resources) requires certain *BIPRU firms* to deduct illiquid assets when calculating their *capital resources*.

1.2.22 G BIPRU 2.3 contains *rules* and *guidance* on interest rate risk in the *non-trading book*. That material elaborates on the general obligation in the *overall Pillar 2 rule*.

1.2.23 G For a *BIPRU firm* using a *VaR model* BIPRU 7.10.72 R (Risk management standards: Stress testing) sets out certain stress tests that the *firm* should carry out.

1.2.24 G

1.2.25 G For a *BIPRU firm* using the *IRB approach* BIPRU 4.3.39 R to BIPRU 4.3.40 R set out a recession credit rating migration stress test that the *firm* should carry out. Further *rules* and *guidance* on such stress tests are set out in BIPRU 2.2 (Internal capital adequacy standards).

Requirement to have adequate financial resources

1.2.26 R A *firm* must at all times maintain overall financial resources, including *capital resources* and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due.

1.2.26A G BIPRU 12 contains *rules* and *guidance* in relation to the adequacy of a *BIPRU firm*'s liquidity resources. Consistent with GENPRU 1.2.2A R, in assessing the adequacy of its liquidity resources, a *BIPRU firm* should do so by reference to the *overall liquidity adequacy rule*, rather than the *overall financial adequacy rule*.

1.2.27 G The liabilities referred to in the *overall financial adequacy rule* include a *firm's* contingent and prospective liabilities. They exclude liabilities that might arise from transactions that a *firm* has not entered into and which it could avoid, for example, by taking realistic management actions such as ceasing to transact new business after a suitable period of time has elapsed. They include liabilities or costs that arise both in scenarios where the *firm* is a going concern and those where the *firm* ceases to be a going concern. Theyalso include claims that could be made against a *firm*, which ought to be paid in accordance with fair treatment of *customers*, even if such claims could not be legally enforced.

1.2.28 G A *firm* should therefore make its assessment of adequate financial resources on realistic valuation bases for assets and liabilities taking into account the actual amounts and timing of cash flows under realistic adverse projections.

1.2.29 G Risks may be addressed through holding capital to absorb losses that unexpectedly materialise. The ability to pay liabilities as they fall due also requires liquidity. Therefore, in assessing the adequacy of a *firm's* financial resources, both capital and liquidity needs should be considered. A *firm* should also consider the quality of its financial resources such as the loss-absorbency of different types of capital and the time required to liquidate different types of asset.

Systems, strategies, processes and reviews

1.2.30 R A *firm* must have in place sound, effective and complete processes, strategies and systems:

(1) to assess and maintain on an ongoing basis the amounts, types and distribution of financial resources, *capital resources* and internal capital that it considers adequate to cover:

  (a) the nature and level of the risks to which it is or might be exposed;

  (b) the risk in the *overall financial adequacy rule*; and

  (c) the risk that the *firm* might not be able to meet its *CRR* in the future; and

(2) that enable it to identify and manage the major sources of risks referred to in (1), including the major sources of risk in each of the following categories where they are relevant to the *firm* given the nature and scale of its business:

(a) credit risk;

(b) market risk;

(c) liquidity risk;

(d) operational risk;

(e) insurance risk;

(f) concentration risk;

(g) residual risk;

(h) securitisation risk;

(i) business risk;

(j) interest rate risk (including, in the case of a *BIPRU firm*, interest rate risk in the *non-trading book*);

(k) pension obligation risk; and

(l) group risk.

1.2.31 R

(1) This *rule* defines some of the terms used in the *overall Pillar 2 rule*.

(2) Residual risk means the risk that *credit risk mitigation* techniques used by the *firm* prove less effective than expected.

(3) Securitisation risk includes the risk that the *capital resources* held by a *firm* in respect of assets which it has *securitised* are inadequate having regard to the economic substance of the transaction, including the degree of risk transfer achieved.

(4) Business risk means any risk to a *firm* arising from changes in its business, including the risk that the *firm* may not be able to carry out its business plan and its desired strategy. It also includes risks arising from a *firm's remuneration policy* (see also the *Remuneration Code* which applies to *BIPRU firms* and the detailed application of which is set out in ■ SYSC 19A.1).

(5) Pension obligation risk is the risk to a *firm* caused by its contractual or other liabilities to or with respect to a pension scheme (whether established for its employees or those of a related *company* or otherwise). It also means the risk that the *firm* will make payments or other contribution to or with respect to a pension scheme because of a moral obligation or because the *firm* considers that it needs to do so for some other reason.

1.2.32 G

(1) This paragraph gives *guidance* on some of the terms used in the *overall Pillar 2 rule*.

(2) Insurance risk refers to the inherent uncertainties as to the occurrence, amount and timing of insurance liabilities.

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(3) Interest rate risk in the *non-trading book* is explained in BIPRU 2.3 (Interest rate risk in the non-trading book).

(4) In a narrow sense, business risk is the risk to a *firm* that it suffers losses because its income falls or is volatile relative to its fixed cost base. However, in a broader sense, it is exposure to a wide range of macro-economic, geopolitical, industry, regulatory and other external risks that might deflect a *firm* from its desired strategy and business plan. GENPRU 1.2.73 G provides further *guidance* on business risk.

(5) Further material on pension obligation risk can be found in GENPRU 1.2.79 G – GENPRU 1.2.86 G.

(6) Group risk is the risk that the financial position of a *firm* may be adversely affected by its relationships (financial or non-financial) with other entities in the same *group* or by risks which may affect the financial position of the whole *group*, for example reputational contagion. Further *guidance* on group risk can be found in GENPRU 1.2.87 G to GENPRU 1.2.91 G.

1.2.33 R

(1) This *rule* amplifies some of the obligations in the *overall Pillar 2 rule*.

(3) As part of its obligations in respect of *market risk*, a *BIPRU firm* must consider whether the value adjustments and provisions taken for *positions* and portfolios in the *trading book* enable the *firm* to sell or hedge out its *positions* within a short period without incurring material losses under normal market conditions.

(4) The processes, strategies and systems required by the *overall Pillar 2 rule* must take into account stress tests and scenario analyses that the *firm* is required to carry out under any other provision of the *Handbook*.

1.2.34 G

In the *overall Pillar 2 rule* , internal capital refers to the financial resources of a *firm* which it treats as being held against the risks listed in the *overall Pillar 2 rule*. The obligation in that *rule* to assess the distribution of such capital refers, in relation to a *firm* making an assessment on a solo basis, for example, to the need to take account of circumstances where part of a *firm*'s financial resources are held by a *branch* of that *firm* which are subject to restrictions on its ability to transfer that capital. An assessment of internal capital distribution might also take account of such of a *firm*'s financial resources as may be ring-fenced in the event of its insolvency.

1.2.35 R

The processes, strategies and systems required by the *overall Pillar 2 rule* must be comprehensive and proportionate to the nature, scale and complexity of the *firm*'s activities.

1.2.36 R

As part of its obligations under GENPRU 1.2.30R (1) (Main requirement relating to risk processes, strategies and systems), a *firm* must identify separately the amount of *tier one capital*, *tier two capital*, *tier three capital*, other capital eligible to form part of its *capital resources* and each category of capital (if any) that is not eligible to form part of its *capital resources* which it considers adequate for the purposes described in GENPRU 1.2.30R (1).

1.2.37 R The processes and systems required by the *overall Pillar 2 rule* must:

(1) include an assessment of how the *firm* intends to deal with each of the major sources of risk identified in accordance with GENPRU 1.2.30R (2);

(2) take into account the impact of diversification effects and how such effects are factored into the *firm*'s systems for measuring and managing risks; and

(3) include an assessment of the *firm*-wide impact of the risks identified in accordance with GENPRU 1.2.30R (2), to which end a *firm* must aggregate the risks across its various business lines and units, making appropriate allowance for the correlation between risks.

1.2.38 G Certain risks such as systems and controls weaknesses may not be adequately addressed by, for example, holding additional capital and a more appropriate response would be to rectify the weakness. In such circumstances, the amount of financial resources required to address these risks might be zero. However, a *firm* should consider whether holding additional capital might be an appropriate response until the identified weaknesses are rectified. A *firm*, should, in accordance with GENPRU 1.2.60 R (Documentation of risk assessments), document the approaches taken to manage these risks.

1.2.39 R A *firm* must:

(1) carry out regularly the assessments required by the *overall Pillar 2 rule*; and

(2) carry out regularly assessments of the processes, strategies and systems required by the *overall Pillar 2 rule* to ensure that they remain compliant with GENPRU 1.2.35 R.

1.2.40 G A *firm* should carry out assessments of the sort described in the *overall Pillar 2 rule* and GENPRU 1.2.39 R at least annually, or more frequently if changes in the business, strategy, nature or scale of its activities or operational environment suggest that the current level of financial resources is no longer adequate. The appropriateness of the internal process, and the degree of involvement of senior management in the process, will be taken into account by the *FCA* when reviewing a *firm*'s assessment as part of the *FCA's* own assessment of the adequacy of a *firm*'s financial resources. The processes and systems should ensure that the assessment of the adequacy of a *firm*'s financial resources is reported to its senior management as often as is necessary.

Stress and scenario tests

1.2.42 R (1) As part of its obligation under the *overall Pillar 2 rule*, a *firm* must, for the major sources of risk identified in accordance with GENPRU 1.2.30R (2), carry out stress tests and scenario analyses that are appropriate to the nature, scale and complexity of those major sources of risk and to the nature, scale and complexity of the *firm*'s business.

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(a) [deleted]

(b) [deleted]

(i) [deleted]

(ii) [deleted]

(iii) [deleted]

(iv) [deleted]

(2) In carrying out the stress tests and scenario analyses in (1), a *firm* must identify an appropriate range of adverse circumstances of varying nature, severity and duration relevant to its business and risk profile and consider the exposure of the *firm* to those circumstances, including:

(a) circumstances and events occurring over a protracted period of time;

(b) sudden and severe events, such as market shocks or other similar events; and

(c) some combination of the circumstances and events described in (a) and (b), which may include a sudden and severe market event followed by an economic recession.

(3) In carrying out the stress tests and scenario analyses in (1), the *firm* must estimate the financial resources that it would need in order to continue to meet the *overall financial adequacy rule* and the *CRR* in the adverse circumstances being considered.

(4) In carrying out the stress tests and scenario analyses in (1), the *firm* must assess how risks aggregate across business lines or units, any material non-linear or contingent risks and how risk correlations may increase in stressed conditions.

(5) As part of its obligation under the *overall Pillar 2 rule*, a *BIPRU firm* must also incorporate and take into account any stress tests and scenario analyses that it is required to carry out under *BIPRU*. In particular, a *BIPRU firm* with an *IRB permission* must incorporate and take into account the stress test required to be carried out under BIPRU 4.3.40 R (2).

1.2.42A G In order to comply with the *general stress and scenario testing rule*, a *firm* should undertake a broad range of stress tests which reflect a variety of perspectives, including sensitivity analysis, scenario analysis and stress testing on an individual portfolio as well as a *firm*-wide level.

1.2.42B G A *BIPRU firm* with an *IRB permission* which has any material credit *exposures* excluded from its *IRB* models should also include these *exposures* in its stress and scenario testing to meet its obligations under the *general stress and scenario testing rule*. A *BIPRU firm* without an *IRB permission*, should conduct analyses to assess risks to the credit quality of its counterparties, including any protection sellers, considering both on and off-balance sheet exposures.

1.2.42D G In carrying out the stress tests and scenario analyses required by GENPRU 1.2.42R (1), a *firm* should also consider any impact of the adverse circumstances on its *capital resources*. In particular, a *firm* should consider the *capital resources gearing rules* where its *tier one capital* is eroded by the event.

1.2.42E G A *firm* should assign adequate resources, including IT systems, to stress testing and scenario analysis, taking into account the stress testing techniques employed, so as to be able to accommodate different and changing stress tests at an appropriate level of granularity.

1.2.42F G GENPRU 1.2.63 G to GENPRU 1.2.78 G provide additional *guidance* on stress testing and scenario analyses. In particular, GENPRU 1.2.73A G provides specific *guidance* on capital planning.

1.2.43 G Stress tests and scenario analyses should be carried out at least annually. A *firm* should, however, consider whether the nature of the major sources of risks identified by it in accordance with GENPRU 1.2.30R (2) (Main requirement relating to risk processes, strategies and systems) and their possible impact on its financial resources suggest that such tests and analyses should be carried out more frequently. For instance, a sudden change in the economic outlook may prompt a *firm* to revise the parameters of some of its stress tests and scenario analyses. Similarly, if a *firm* has recently become exposed to a particular sectoral concentration, it may wish to add some stress tests and scenario analyses in order to reflect that concentration.

Application of this section on a solo and consolidated basis: General

1.2.44 G

(1) GENPRU 1.2.45 R – GENPRU 1.2.56 G explain when the *ICAAP rules* apply on a solo basis and when they apply on a consolidated basis. This material also explains how the *ICAAP rules* are adjusted to apply on a consolidated basis.

(2) GENPRU 1.2.57 R – GENPRU 1.2.59 R provide that the *overall financial adequacy rule* always applies on a solo basis. They also explain when and how it applies on a consolidated basis.

Application of this section on a solo and consolidated basis: Processes and tests

1.2.46 R The *ICAAP rules* do not apply on a solo basis to a *BIPRU firm* to which the *ICAAP rules*:

(1) apply on a consolidated basis under BIPRU 8.2.1 R (Basic consolidation *rule* for a *UK consolidation group*); or

(2) apply on a sub-consolidated basis under BIPRU 8.3.1 R (Basic consolidation *rule* for a non-*EEA*).

1.2.47 R The *ICAAP rules* apply on a solo basis:

(1) [deleted]

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(2) to a *BIPRU firm* to which those *rules* do not apply on a consolidated or sub-consolidated basis as referred to in GENPRU 1.2.46 R (including a *BIPRU investment firm* with an *investment firm consolidation waiver*).

(3) [deleted]

1.2.47A R

1.2.48 R The requirements of the *ICAAP rules* as they apply on a consolidated basis must be carried out on the basis of the consolidated position of:

(1) [deleted]

(2) (if BIPRU 8.2.1 R (Basic consolidation *rule* for a *UK consolidation group*) applies) the *UK consolidation group* of which the *firm* is a member; and

(3) (if BIPRU 8.3.1 R (Basic consolidation *rule* for a non-*EEA sub-group*) applies) the non-*EEA sub-group* of which the *firm* is a member.

1.2.49 R (1) In accordance with the general principles in GENPRU 1.2.48 R and BIPRU 8 (Group risk – consolidation), for the purpose of the *ICAAP rules* as they apply on a consolidated basis:

(a) the *firm* must ensure that the relevant group as defined in (2) have the processes, strategies and systems required by the *overall Pillar 2 rule*;

(b) the risks to which the *overall Pillar 2 rule* and the *general stress and scenario testing rule* refer are those risks as they apply to each member of the relevant group;

(c) the reference in the *overall Pillar 2 rule* to amounts and types of financial resources, *capital resources* and internal capital (referred to in this *rule* as resources) must be read as being to the amounts and types that the *firm* considers should be held by the members of the relevant group as defined in (2);

(d) other references to resources must be read as being to resources of the members of the relevant group as defined in (2);

(e) references to the *CRR* are to the consolidated capital requirements applicable to the relevant group under BIPRU 8 (Group risk - consolidation) ;

(f) the reference in the *overall Pillar 2 rule* to the distribution of resources must be read as including a reference to the distribution between members of the relevant group as defined in (2); and

(g) the reference in the *overall Pillar 2 rule* to the *overall financial adequacy rule* must be read as being to that *rule* as adjusted under GENPRU 1.2.59 R (Application of the *overall financial adequacy rule* on a consolidated basis).

(2) For the purpose of this *rule* the relevant group is the group referred to in GENPRU 1.2.48 R and the members of that group are those *undertakings* that are included in the scope of consolidation with respect to the *UK consolidation group* or, as the case may be, non-*EEA sub-group* in question.

1.2.50 G GENPRU 1.2.49 R means that non-financial members of the *firm*'s group are excluded from the *group* assessment. Notwithstanding the scope of GENPRU 1.2.49 R, a *firm* should nevertheless take account of risks arising from the activities of those excluded members in its overall assessment of risk.

1.2.51 R

(1) This *rule* relates to the assessment of the amounts, types and distribution of financial resources, *capital resources* and internal capital (referred to in this *rule* as "resources") under the *overall Pillar 2 rule* as applied on a consolidated basis and to the assessment of diversification effects as referred to in GENPRU 1.2.37R (2) as applied on a consolidated basis.

(2) A *firm* must be able to explain how it has aggregated the risks referred to in the *overall Pillar 2 rule* and the resources required by each member of the relevant group as referred to in GENPRU 1.2.49R (2) and how it has taken into account any diversification benefits with respect to the group in question.

(3) In particular, to the extent that the transferability of resources affects the assessment in (2), a *firm* must be able to explain how it has satisfied itself that resources are transferable between members of the group in question in the stressed cases and the scenarios referred to in the *general stress and scenario testing rule*.

1.2.52 R

(1) A *firm* must allocate the total amount of financial resources, *capital resources* and internal capital identified as necessary under the *overall Pillar 2 rule* (as applied on a consolidated basis) between different parts of the relevant group (as defined in GENPRU 1.2.49 R). GENPRU 1.2.36 R (Identifying different tiers of capital) does not apply to this allocation.

(2) The *firm* must carry out the allocation in (1) in a way that adequately reflects the nature, level and distribution of the risks to which the group is subject and the effect of any diversification benefits.

1.2.53 R A *firm* must also allocate the total amount of financial resources, *capital resources* and internal capital (referred to in this *rule* as "resources") identified as necessary under the *overall Pillar 2 rule* as applied on a consolidated basis between each *firm* which is a member of the relevant group (as defined in GENPRU 1.2.49 R) on the following basis:

(1) the amount allocated to each *firm* must be decided on the basis of the principles in GENPRU 1.2.52R (2); and

(2) if the process in (1) were carried out for each group member, the total so allocated would equal the total amount of resources identified as necessary under the *overall Pillar 2 rule* as applied on a consolidated basis.

1.2.54 G A *firm* to which the *ICAAP rules* apply on a consolidated basis need not prepare a consolidated basis assessment if such an assessment has been prepared by another member of its *group*. Where that is the case, a *firm* may adopt such an assessment as its own. A *firm* nevertheless remains responsible for the assessment.

1.2.55 G The purpose of GENPRU 1.2.51 R – GENPRU 1.2.53 R is to enable the *FCA* to assess the extent, if any, to which a *firm's* assessment, calculated on a consolidated basis, is lower than it would be if each separate legal entity were to assess the amount of capital it would require to mitigate its risks (to the same level of confidence) were it not part of a group subject to consolidated supervision under BIPRU 8 (Group risk - consolidation) . The reason the *FCA* wishes to make this assessment is so that individual capital *guidance* which it gives is fair and comparable as between different *firms* and groups. Group diversification benefits which a *firm* might assert exist can be a material consideration in a capital adequacy assessment. Understanding the methods used to aggregate the different risks (for example, the correlation assumptions) is crucial to a proper evaluation of such benefits.

1.2.56 G Whereas a single legal entity can generally use its capital to absorb losses wherever they arise, there are often practical and legal restrictions on the ability of a group to do so. For instance:

(1) capital which is held by overseas regulated *firms* may not be capable of being remitted to a *firm* in the *UK* which has suffered a loss;

(2) a *firm* which is insolvent or likely to become so may be obliged to look to the interests of its creditors first before transferring capital to other group *companies*; and

(3) a parent *company* may have to balance the interests of its shareholders against the protection of the creditors of a *subsidiary undertaking* which is or might become insolvent and may, rationally, conclude that a *subsidiary undertaking* should be allowed to fail rather than provide capital to support it.

Application of this section on a solo and consolidated basis: Adequacy of resources

1.2.57 R The *overall financial adequacy rule* applies to a *firm* on a solo basis whether or not it also applies to the *firm* on a consolidated basis.

1.2.58 R The *overall financial adequacy rule* applies to a *firm* on a consolidated basis if the *ICAAP rules* apply to it on a consolidated basis.

1.2.59 R

(1) When the *overall financial adequacy rule* applies on a consolidated basis, the *firm* must ensure that at all times its group maintains overall financial resources, including capital resources and liquidity resources, which are adequate, both as to amount and quality, to ensure that there is no significant risk that the liabilities of any members of its group cannot be met as they fall due.

(2) The group referred to in (1) is the relevant group as defined in GENPRU 1.2.49 R.

(3) The members of the group referred to in (1) must be identified in accordance with GENPRU 1.2.49 R.

Documentation of risk assessments

1.2.60 R

A *firm* must make a written record of the assessments required under this section. These assessments include assessments carried out on a consolidated basis and on a solo basis. In particular it must make a written record of:

(1) the major sources of risk identified in accordance with GENPRU 1.2.30R (2) (Main requirement relating to risk processes, strategies and systems);

(2) how it intends to deal with those risks; and

(3) details of the stress tests and scenario analyses carried out, including any assumptions made in relation to scenario design, and the resulting financial resources estimated to be required in accordance with the *general stress and scenario testing rule*.

1.2.61 R

A *firm* must retain the records of its assessments referred to in GENPRU 1.2.60 R for at least three years.

1.2.62 G

Where a *firm* assesses the adequacy of its *CRR* in its particular circumstances in accordance with BIPRU 2.2 (Internal capital adequacy standards) as a basis for deciding what financial resources are adequate, it should include this in the documentation produced in accordance with GENPRU 1.2.60 R.

Additional guidance on stress tests and scenario analyses

1.2.63 G

The *general stress and scenario testing rule* requires a *firm* to carry out stress tests and scenario analyses as part of its obligations under the *overall Pillar 2 rule*. Both stress tests and scenario analyses are undertaken by a *firm* to further a better understanding of the vulnerabilities that it faces under adverse conditions. They are based on the analysis of the impact of a range of events of varying nature, severity and duration. These events can be financial, operational or legal or relate to any other risk that might have an economic impact on the *firm*.

1.2.64 G

Stress testing typically refers to shifting the values of individual parameters that affect the financial position of a *firm* and determining the effect on the *firm*'s financial position.

1.2.65 G Scenario analysis typically refers to a wider range of parameters being varied at the same time. Scenario analyses often examine the impact of adverse events on the *firm*'s financial position, for example, simultaneous movements in a number of risk categories affecting all of a *firm*'s business operations, such as business volumes, investment values and interest rate movements.

1.2.66 G There are three broad purposes of stress testing and scenario analysis. Firstly, it can be used as a means of quantifying how much capital might be absorbed if an adverse event or events occurred. As such it represents a simple 'what if' approach to estimating exposure to risks. This might be a proportionate approach to risk management for an unsophisticated business. Secondly, it can be used to provide a check on the outputs and accuracy of risk models; particularly, in identifying non-linear effects when aggregating risks. Thirdly, it can be used to explore the sensitivities in longer term business plans and how capital needs might change over time.

1.2.67 G [deleted]

1.2.68 G Subject to ■ GENPRU 1.2.76 G, the purpose of stress tests and scenario analyses under the *general stress and scenario testing rule* is to test the adequacy of overall financial resources. Scenarios need only be identified, and their impact assessed, in so far as this facilitates that purpose. In particular, the nature, depth and detail of the analysis depend, in part, upon the *firm*'s capital strength and the robustness of its risk prevention and risk mitigation measures.

1.2.69 G Both stress testing and scenario analyses are forward-looking analysis techniques, which seek to anticipate possible losses that might occur if an identified risk crystallises. In applying them, a *firm* should decide how far forward to look. This should depend upon:

(1) how quickly it would be able to identify events or changes in circumstances that might lead to a risk crystallising resulting in a loss; and

(2) after it has identified the event or circumstance, how quickly and effectively it could act to prevent or mitigate any loss resulting from the risk crystallising and to reduce exposure to any further adverse event or change in circumstance.

1.2.70 G Where a firm is exposed to *market risk*, the time horizon over which stress tests and scenario analyses should be carried out will depend on, among other things, the maturity and liquidity of the *positions* stressed. For example, for the *market risk* arising from the holding of investments, this will depend upon:

(1) the extent to which there is a regular, open and transparent market in those assets, which would allow fluctuations in the value of the investment to be more readily and quickly identified; and

(2) the extent to which the market in those assets is sufficiently liquid (and would remain liquid in the changed circumstances contemplated in the stress test or scenario analysis) to allow the *firm*, if needed, to

sell, hedge or otherwise mitigate the risks relating to its holding so as to prevent or reduce exposure to future price fluctuations. In devising stress tests and scenario analyses for *market risk*, a *BIPRU firm* should also take into account BIPRU 7.1.17 R to BIPRU 7.1.20 G.

1.2.71 G In identifying scenarios, and assessing their impact, a *firm* should take into account, where material, how changes in circumstances might impact upon:

(1) the nature, scale and mix of its future activities; and

(2) the behaviour of *counterparties*, and of the *firm* itself, including the exercise of choices (for example, options embedded in financial instruments or *contracts of insurance*).

1.2.72 G In determining whether it would have adequate financial resources in the event of each identified realistic adverse scenario, a *firm* should:

(1) only include financial resources that could reasonably be relied upon as being available in the circumstances of the identified scenario; and

(2) take account of any legal or other restriction on the use of financial resources.

1.2.73 G (1) [deleted]

(1A) [deleted]

(2) [deleted]

(3) [deleted]

(4) [deleted]

(5) [deleted]

Capital planning

1.2.73A G (1) In identifying an appropriate range of adverse circumstances and events in accordance with GENPRU 1.2.42R (2):

(a) a *firm* will need to consider the cycles it is most exposed to and whether these are general economic cycles or specific to particular markets, sectors or industries;

(b) for the purposes of GENPRU 1.2.42R (2)(a), the amplitude and duration of the relevant cycle should include a severe downturn scenario based on forward looking hypothetical events, calibrated against the most adverse movements in individual risk drivers experienced over a long historical period;

(c) the adverse scenarios considered should in general be acyclical and, accordingly, the scenario should not become more severe during a downturn and less severe during an upturn. However, the *FCA* does expect scenarios to be updated with relevant new economic data on a pragmatic basis to ensure that the scenario continues to be relevant; and

(d) the adverse scenarios considered should reflect a *firm's* risk tolerance of the adverse conditions through which it expects to remain a going concern.

(2) In making the estimate required by ■ GENPRU 1.2.42R (3), a *firm* should project both its *capital resources* and its required *capital resources* over a time horizon of 3 to 5 years, taking account of its business plan and the impact of relevant adverse scenarios. In making the estimate, the *firm* should consider both the *capital resources* required to meet its *CRR* and the *capital resources* needed to meet the *overall financial adequacy rule*. The *firm* should make these projections in a manner consistent with its risk management processes and systems as set out in ■ GENPRU 1.2.37 R.

(3) In projecting its financial position over the relevant time horizon, the *firm* should:

(a) reflect how its business plan would "flex" in response to the adverse events being considered, taking into account factors such as changing consumer demand and changes to new business assumptions;

(b) consider the potential impact on its stress testing of dynamic feedback effects and second order effects of the major sources of risk identified in accordance with ■ GENPRU 1.2.30R (2);

(c) estimate the effects on the *firm's* financial position of the adverse event without adjusting for management actions;

(d) separately, identify any realistic management actions that the *firm* could and would take to mitigate the adverse effects of the stress scenario; and

(e) estimate the effects of the stress scenario on the *firm's* financial position after taking account of realistic management actions.

(4) A *firm* should identify any realistic management actions intended to maintain or restore its capital adequacy. These could include ceasing to transact new business after a suitable period has elapsed, balance sheet shrinkage, restricting distribution of profits or raising additional capital. A *firm* should reflect management actions in its projections only where it could and would take such actions, taking account of factors such as market conditions in the stress scenario and any effects upon the *firm's* reputation with its counterparties and investors. The combined effect on capital and retained earnings should be estimated. In order to assess whether prospective management actions in a stress scenario would be realistic and to determine which actions the *firm* would and could take, the *firm* should take into account any preconditions that might affect the value of management actions as risk mitigants and analyse the difference between the estimates in (3)(c) and (3)(e) in sufficient detail to understand the implications of taking different management actions at different times, particularly where they represent a significant divergence from the *firm's* business plan.

(5) The *firm* should document its stress testing and scenario analysis policies and procedures, as well as the results of its tests in accordance with ■ GENPRU 1.2.60 R. These records should be included within the *firm's ICAAP* submission document.

(6) The *FCA* will review the *firm's* records referred to in (5) as part of its *SREP*. The purpose of examining these is to enable the *FCA* to judge whether a *firm* will be able to continue to meet its *CRR* and the *overall financial adequacy rule* throughout the projection period.

(7) If, after taking account of realistic management actions, a *firm's* stress testing management plan shows that the *firm's* projected *capital resources* are less than those required to continue to meet its *CRR* or less than those needed to continue to meet the *overall financial adequacy rule* over the projection period, the *FCA* may require the *firm* to set out additional countervailing measures and off-setting actions to reduce such difference or to restore the *firm's* capital adequacy after the stress event.

(8) The *firm's* senior management or *governing body* should be actively involved and engaged in all relevant stages of the *firm's* stress testing and scenario analysis programme. This would include establishing an appropriate stress testing programme, reviewing the programme's implementation (including the design of scenarios) and challenging, approving and actioning the results of the stress tests.

(9) [deleted]

1.2.73B G The *FCA* may formulate macroeconomic and financial market scenarios which a *firm* may use as an additional input to its *ICAAP* submission. In addition, the *FCA* may also ask a *firm* to apply specific scenarios directly in its *ICAAP* submission.

1.2.73C G [deleted]

1.2.74 G A *firm* may consider scenarios in which expected future profits will provide capital reserves against future risks. However, it would only be appropriate to take into account profits that can be foreseen with a reasonable degree of certainty as arising before the risk against which they are being held could possibly arise. In estimating future reserves, a *firm* should deduct future dividend payment estimates from projections of future profits.

1.2.75 G

(1) [deleted]

(2) Stress and scenario analyses should, in the first instance, be aligned with the risk appetite of the *firm*, as well as the nature, scale and complexity of its business and of the risks that it bears. The calibration of the stress and scenario analyses should be reconciled to a clear statement setting out the premise upon which the *firm's* internal capital assessment under the *overall Pillar 2 rule* is based.

(3) [deleted]

(4) In identifying adverse circumstances and events in accordance with GENPRU 1.2.42R (2), a *firm* should consider the results of any reverse stress testing conducted in accordance with SYSC 20. Reverse stress testing may be expected to provide useful information about the *firm's* vulnerabilities and variations around the most likely ruin scenarios for the purpose of meeting the *firm's* obligations under

GENPRU 1.2.42 R. In addition, such a comparison may help a *firm* to assess the sensitivity of its financial position to different stress calibrations.

1.2.76 G A *firm* should use the results of its stress testing and scenario analysis not only to assess capital needs, but also to decide if measures should be put in place to minimise the adverse effect on the *firm* if the risk covered by the stress or scenario test actually materialises. Such measures might be a contingency plan or might be more concrete risk mitigation steps.

1.2.77 G Additional *guidance* on stress tests and scenario analyses for the assessment of *capital resources* is available in BIPRU 2.2 (Internal capital adequacy standards).

1.2.78 G [deleted]

1.2.78A G BIPRU 12 sets out the main *Handbook* provisions in relation to *liquidity risk* for a *BIPRU firm*.

Pension obligation risk

1.2.79 G GENPRU 1.2.80 G to GENPRU 1.2.86 G contain *guidance* on the assessment required by GENPRU 1.2.30R (2)(k) for a *firm* exposed to pension obligation risk as defined in GENPRU 1.2.31R (5).

1.2.80 G The pension scheme itself (i.e. the scheme's assets and liabilities) is not the focus of the risk assessment but rather the *firm*'s obligations towards the pension scheme . A *firm* should include in its estimate of financial resources both its expected obligations to the pension scheme and any increase in obligations that may arise in a stress scenario.

1.2.81 G If a *firm* has a current funding obligation in excess of normal contributions or there is a risk that such a funding obligation will arise then, when calculating available capital resources, it should reverse out any accounting deficit and replace this in its capital adequacy assessment with its best estimate, calculated in discussion with the scheme's actuaries or trustees, of the cash that will need to be paid into the scheme in addition to normal contributions over the foreseeable future. This may differ from the approach taken in assessing pension scheme risks for the purposes of calculating resources to meet the *CRR*, where a *firm* may not need to consider funding obligations beyond the next five years.

1.2.82 G A *firm* should also assess the risks that may increase its current funding obligations towards the pension scheme and that might lead to the *firm* not being able to pay its other liabilities as they fall due.

1.2.83 G A *firm* may wish to consider the following scenarios:

(1) one in which the *firm* gets into difficulties with an effect on its ability to fund the pension scheme; and

(2) one in which the pension scheme position deteriorates (for example, because investment returns fall below expected returns or because of increases in life expectancy) with an effect on the *firm*'s funding obligations; taking into account the management actions the *firm* could and would take.

1.2.83A G A *firm* is expected to determine where the scope of any stress test impacts upon its pension obligation risk and estimate how the relevant measure of pension obligation risk will change in the scenario in question. For example, in carrying out stress tests under GENPRU 1.2.42 R a *firm* must consider how a stress scenario, such as an economic recession, would impact on the *firm*'s current obligations towards its pension scheme and any potential increase in those obligations. Risks such as interest rate risk or reduced investment returns may have a direct impact on a *firm*'s financial position as well as an indirect impact resulting from an increase in the *firm*'s pension scheme obligations. Both effects should be taken into account in a *firm*'s estimate of financial resources under GENPRU 1.2.30 R.

1.2.84 G Scenarios in which a *firm*'s employees suffer a loss or members of a pension scheme suffer a loss do not necessarily affect the *firm*'s ability to pay its liabilities as they fall due.

1.2.85 G A *firm* should consider issues such as:

(1) the extent to which trustees of the pension scheme or a pension regulator (such as the one created under the Pensions Act 2004) can compel a certain level of contributions or a one-off payment in adverse financial situations or in order to meet the minimum legal

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requirements under the scheme's trust deed and rules or under the applicable laws relating to the pension scheme;

(2) whether the valuation bases used to set pension scheme contribution rates are consistent with the *firm*'s current business plans and anticipated changes in the workforce; and

(3) which valuation basis is appropriate given the expected investment return on scheme assets and actions the *firm* can take if those returns do not materialise.

1.2.86 G A *firm* should carry out analyses only to a degree of sophistication and complexity which is commensurate with the materiality of its pension risks.

Group risk (BIPRU firm only)

1.2.87 G GENPRU 1.2.88G to GENPRU 1.2.91G contain additional *guidance* on the assessment required by GENPRU 1.2.30R (2)(l) (Group risk).

1.2.88 G A *firm* should include in the written record referred to in GENPRU 1.2.60 R a description of the broad business strategy of the *UK consolidation group* or the *non-EEA sub-group* of which it is a member, the group's view of its principal risks and its approach to measuring, managing and controlling the risks. This description should include the role of stress testing, scenario analysis and contingency planning in managing risk at the solo and consolidated level.

1.2.89 G A *firm* should satisfy itself that the systems (including IT) of the *UK consolidation group* or the *non-EEA sub-group* of which it is a member are sufficiently sound to support the effective management and, where applicable, the quantification of the risks that could affect the *UK consolidation group* or the *non-EEA sub-group*, as the case may be.

1.2.90 G In performing stress tests and scenario analyses, a *firm* should take into account the risk that its *group* may have to bring back on to its consolidated balance sheet the assets and liabilities of off-balance sheet entities as a result of reputational contagion, notwithstanding the appearance of legal risk transfer.

1.2.91 G A *firm* should carry out stress tests and scenario analyses to a degree of sophistication which is commensurate with the complexity of its group and the nature of its *group* risk.

1.3 Valuation

Application

1.3.1 R

(1) [deleted]

(2) This section of the *Handbook* applies to a *BIPRU firm*.

(3) [deleted]

1.3.1A R

Purpose

1.3.2 G This section sets out, for the purposes of *GENPRU* and *BIPRU*, *rules* and *guidance* as to how a *firm* should recognise and value assets, liabilities, *exposures*, equity and income statement items.

1.3.3 G

(1) In the case of a *BIPRU firm*, this section implements Articles 64(4) and 64(5) of the *Banking Consolidation Directive* (Own funds) and Article 33 and Part B of Annex VII of the *Capital Adequacy Directive*.

(2) [deleted]

General requirements: Accounting principles to be applied

1.3.4 R Subject to GENPRU 1.3.9 R to GENPRU 1.3.10 R and GENPRU 1.3.36 R, except where a *rule* in *GENPRU*, *BIPRU* or *INSPRU* provides for a different method of recognition or valuation, whenever a *rule* in *GENPRU* or *BIPRU* refers to an asset, liability, *exposure*, equity or income statement item, a *firm* must, for the purpose of that *rule*, recognise the asset, liability, *exposure*, equity or income statement item and measure its value in accordance with whichever of the following are applicable:

(1) [deleted]

(2) Financial Reporting Standards issued by the Financial Reporting Council;

(3) Statements of Recommended Practice, issued by industry or sectoral bodies recognised for this purpose by the Financial Reporting Council;

(4) [deleted]

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(5) *international accounting standards*;

(6) the Companies Act 1985; and

(7) the Companies Act 2006;

as applicable to the *firm* for the purpose of its external financial reporting (or as would be applicable if the *firm* was a company with its head office in the *United Kingdom*).

1.3.5 G Except where a *rule* in *GENPRU* or *BIPRU* makes a different provision, GENPRU 1.3.4 R applies whenever a *rule* in *GENPRU* or *BIPRU* refers to the value or amount of an asset, liability, *exposure*, equity or income statement item, including:

(1) whether, and when, to recognise or de-recognise an asset or liability;

(2) the amount at which to value an asset, liability, *exposure*, equity or income statement item; and

(3) which description to place on an asset, liability, *exposure*, equity or income statement item.

1.3.6 G In particular, unless an exception applies, GENPRU 1.3.4 R should be applied for the purposes of *GENPRU* or *BIPRU* to determine how to account for:

(1) netting of amounts due to or from the *firm*;

(2) the securitisation of assets and liabilities (see also GENPRU 1.3.7 G);

(3) leased tangible assets;

(4) assets transferred or received under a sale and repurchase or *stock lending* transaction; and

(5) assets transferred or received by way of initial or variation margin under a *derivative* or similar transaction.

General requirements: Adjustments to accounting values

1.3.9 R For the purposes of *GENPRU* or *BIPRU*, except where a *rule* in *GENPRU* or *BIPRU* provides for a different method of recognition or valuation:

(1) when a *firm*, upon initial recognition, designates its liabilities as at fair value through profit or loss, it must always adjust any value calculated in accordance with GENPRU 1.3.4 R by subtracting any unrealised gains or adding back in any unrealised losses which are not attributable to changes in a benchmark interest rate;

(2) in respect of a *defined benefit occupational pension scheme*:

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

(b) a *firm* may substitute for a *defined benefit liability* the *firm's* *deficit reduction amount*.

1.3.10 R An election made under GENPRU 1.3.9R (2) must be applied consistently for the purposes of *GENPRU* or *BIPRU* in respect of any one financial year.

1.3.11 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*.

1.3.12 G The provisions of GENPRU 1.3.9 R to GENPRU 1.3.10 R and GENPRU 1.3.36 R apply only to the extent that the items referred to in those paragraphs would otherwise be recognised under the accounting requirements applicable to the *firm*. Some of those requirements may only be relevant to a *firm* subject to *international accounting standards*.

General requirements: Methods of valuation and systems and controls

1.3.13 R (1) Except to the extent that *GENPRU* or *BIPRU* provide for another method of valuation, GENPRU 1.3.14 R to GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification or Valuation adjustments) apply:

(a) for the purposes set out in GENPRU 1.3.41 R;

(b) for the purposes set out in GENPRU 1.3.39 R; and

(c) to any balance sheet position measured at market value or fair value.

(2) A *firm* must establish and maintain systems and controls sufficient to provide prudent and reliable valuation estimates.

(3) Systems and controls under (2) must include at least the following elements:

(a) documented policies and procedures for the process of valuation, including clearly defined responsibilities of the various areas involved in the determination of the valuation, sources of market information and review of their appropriateness, frequency of independent valuation, timing of closing prices, procedures for adjusting valuations, month-end and ad-hoc verification procedures, and, in the case of a *BIPRU firm*, guidelines for the use of unobservable inputs reflecting the *firm's* assumptions of what market participants would use in pricing the *position*; and

(b) reporting lines for the department accountable for the valuation process that are:

(i) clear and independent of the front office; and

(ii) ultimately to a main board executive director.

General requirements: Marking to market

1.3.14 R Wherever possible, a *firm* must use mark to market in order to measure the value of the investments and positions to which this *rule* applies under GENPRU 1.3.13 R and GENPRU 1.3.38 R to GENPRU 1.3.41 R. Marking to market is valuation (on at least a daily basis in the case of the *trading book* positions of a *BIPRU firm*) at readily available close out prices from independent sources.

1.3.15 R For the purposes of GENPRU 1.3.14 R, examples of readily available close out prices include exchange prices, screen prices, or quotes from several independent reputable brokers.

1.3.16 R

(1) When marking to market, a *firm* must use the more prudent side of bid/offer unless the *firm* is a significant market maker in a particular position type and it can close out at the mid-market price.

(2) When calculating the current *exposure* value of a credit risk *exposure* for *counterparty credit risk* purposes:

(a) a *firm* must use the more prudent side of bid/offer or the mid-market price and the *firm* must be consistent in the basis it chooses; and

(b) where the difference between the more prudent side of bid/offer and the mid-market price is material, the *firm* must consider making adjustments.

General requirements: Marking to model

1.3.17 R Where marking to market is not possible, a *firm* must (in the case of a *BIPRU firm*, conservatively)use mark to model in order to measure the value of the investments and positions to which this *rule* applies under GENPRU 1.3.13 R and GENPRU 1.3.38 R to GENPRU 1.3.41 R. Marking to model is any valuation which has to be benchmarked, extrapolated or otherwise calculated from a market input. GENPRU 1.3.18 R to GENPRU 1.3.25 R apply when marking to model.

1.3.18 R When the model used is developed by the *firm*, that model must be:

(1) based on appropriate assumptions which have been assessed and challenged by suitably qualified parties independent of the development process;

(2) independently tested, including validation of the mathematics, assumptions, and software implementation; and

(3) (in the case of a *BIPRU firm*) developed or approved independently of the front office.

1.3.19 R A *firm* must ensure that its senior management are aware of the positions which are subject to mark to model and understand the materiality of the uncertainty this creates in the reporting of the performance of the business of the *firm* and the risks to which it is subject.

1.3.20 R A *firm* must source market inputs in line with market prices so far as possible and assess the appropriateness of the market inputs for the position being valued and the parameters of the model on a frequent basis.

1.3.21 R A *firm* must use generally accepted valuation methodologies for particular products where these are available.

1.3.22 R A *firm* must establish formal change control procedures, hold a secure copy of the model, and periodically use that model to check valuations.

1.3.23 R A *firm* must ensure that its risk management functions are aware of the weaknesses of the models used and how best to reflect those in the valuation output.

1.3.24 R A *firm* must periodically review the model to determine the accuracy of its performance.

1.3.25 R Examples of periodical review are assessing the continued appropriateness of the assumptions, analysis of profit and loss versus risk factors and comparison of actual close out values to model outputs.

General requirements: Independent price verification

1.3.26 R In addition to marking to market or marking to model, a *firm* must perform independent price verification. This is the process by which market prices or model inputs are regularly verified for accuracy and independence.

1.3.27 G For independent price verification, where independent pricing sources are not available or pricing sources are more subjective (for example, only one available broker quote), prudent measures such as valuation adjustments may be appropriate.

1.3.28 R In the case of the *trading book* positions of a *BIPRU firm*, while daily marking to market may be performed by dealers, verification of market prices and model inputs must be performed by a unit independent of the dealing room, at least monthly (or, depending on the nature of the market/ trading activity, more frequently).

General requirements: Valuation adjustments

1.3.29 R The recognition of any gains or losses arising from valuations subject to ■ GENPRU 1.3.13 R and ■ GENPRU 1.3.38 R to ■ GENPRU 1.3.41 R must be recognised for the purpose of calculating *capital resources* in accordance with ■ GENPRU 1.3.14 R to ■ GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification or Valuation adjustments). However if *GENPRU* or *BIPRU* provide for another treatment of such gains or losses, that other treatment must be applied.

1.3.30 R A *firm* must establish and maintain procedures for considering valuation adjustments. These procedures must be compliant with the requirements set out in ■ GENPRU 1.3.33 R.

1.3.31 R A *firm* using third-party valuations, or marking to model, must consider whether valuation adjustments are necessary.

1.3.32 R A *firm* must consider the need for making adjustments for less liquid positions and, on an ongoing basis, review their continued appropriateness in accordance with the requirements set out in ■ GENPRU 1.3.33 R. Less liquid positions could arise from both market events and institution-related situations e.g. concentration positions and/or stale positions.

1.3.33 R

(1) This paragraph sets out the requirements referred to in ■ GENPRU 1.3.30 R and ■ GENPRU 1.3.32 R.

(2) A *firm* must consider the following adjustments: unearned credit spreads, close-out costs, operational risks, early termination, investing and funding costs, future administrative costs and, where appropriate, model risk.

(3) (a) In the case of a *BIPRU firm*, a *firm* must establish and maintain procedures for calculating adjustments to the current valuation of less liquid positions. Those adjustments must, where necessary, be in addition to any changes to the value of the position required for financial reporting purposes and must be designed to reflect the illiquidity of the position.

(b) A *firm* must consider several factors when determining whether a valuation adjustment is necessary for less liquid positions. These factors include the amount of time it would take to hedge out the position/risks within the position; the average and volatility of bid/offer spreads; the availability of market quotes (number and identity of market makers); the average and volatility of trading volumes; market concentrations; the ageing of positions; the extent to which valuation relies on marking to model and the impact of other model risks.

(4) With regard to complex products including, but not limited to, *securitisation exposures* and nth-to-default credit derivatives, a *BIPRU firm* must explicitly consider the need for valuation adjustments for model risk arising from using a valuation which may be incorrect or the risk from using unobservable calibration parameters in the valuation model.

1.3.34 R If the result of making adjustments under GENPRU 1.3.29 R to GENPRU 1.3.33 R is a valuation which differs from the fair value determined in accordance with GENPRU 1.3.4 R, a *firm* must reconcile the two valuations.

1.3.35 G Reconciliation differences under GENPRU 1.3.34 R should not be reflected in the valuations under GENPRU 1.3 but should be disclosed to the *FCA* in prudential returns. *Firms* which are subject to the reporting requirement under SUP 16.16 should disclose those reconciliation differences in the Prudent Valuation Return which they are required to submit to the *FCA* under SUP 16.16.4 R.

1.3.35A G

Specific requirements: BIPRU firms

1.3.36 R Adjustments to accounting values

(1) For the purposes of *GENPRU* and *BIPRU*, the adjustments in (2) and (3) apply to values calculated pursuant to GENPRU 1.3.4 R in addition to those required by GENPRU 1.3.9 R to GENPRU 1.3.10 R.

(2) A *BIPRU firm* must not recognise either:

(a) the fair value reserves related to gains or losses on cash flow hedges of financial instruments measured at amortised cost; or

(b) any unrealised gains or losses on debt instruments held, or formerly held, in the available-for-sale category.

(3) A *BIPRU 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.

(4) The items referred to in (2) and (3) must be excluded from *capital resources*.

1.3.37 G Provisions for equity instruments held in the available-for-sale category can be found in GENPRU 2.2.185 R.

Trading book and other fair-valued positions, and revaluations

1.3.38 R to GENPRU 1.3.40 R apply only to a *BIPRU firm*.

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1.3.39 R Both *trading book* positions and other fair-valued positionsare subject to prudent valuation rules as specified in GENPRU 1.3.14 R to GENPRU 1.3.34 R (Marking to market, Marking to model, Independent price verification,Valuation adjustments or, in the case of an insurer or a UK ISPV, valuation adjustments or reserves). In accordance with those *rules*, a *firm* must ensure that the value applied to each of its *trading book* positionsand other fair-valued positions appropriately reflects the current market value. This value must contain an appropriate degree of certainty having regard to the dynamic nature of *trading book* positions, the demands of prudential soundness and the mode of operation and purpose of capital requirements in respect of *trading book* positions and other fair-valued positions.

1.3.40 R *Trading book* positions must be re-valued at least daily.

1.4 Actions for damages

General insurance business: Community co-insurance operations -

1.4.1 R A contravention of the *rules* in GENPRU does not give rise to a right of action by a *private person* under section 138D of the *Act* (and each of those *rules* is specified under section 138D(3) of the *Act* as a provision giving rise to no such right of action).