Chapter 7

Individual Capital Assessment

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7.1 Application

7.1.3A G The *rules* and *guidance* in INSPRU 7.1 are made by the *FCA* solely for the purpose of their application to *dormant account fund operators*.

7.1.3B G References in this chapter to *GENPRU*, *INSPRU*, and connected terms, are to the provisions in force as at 31 December 2015. References in this chapter to the *appropriate regulator* are to the *FCA*.

Purpose

7.1.4 G *Principle* 4 requires a *firm* to maintain adequate financial resources. GENPRU 2 deals specifically with the adequacy of the *capital resources* element of a *firm's* financial resources.

7.1.5 G The adequacy of a *firm's capital resources* needs to be assessed both by the firm and the *appropriate regulator*. In GENPRU 2.1, the *appropriate regulator* sets minimum *capital resources requirements* for firms.

7.1.6 G The *appropriate regulator* also assesses whether the minimum *capital resources requirements* are appropriate by reviewing:

(1) a *firm's* own assessment of its capital needs; and

(2) the processes and systems by which that assessment is made.

7.1.7 G In assessing whether the minimum *capital resources requirements* are appropriate, the *appropriate regulator* is principally concerned with capital resources as calculated in accordance with GENPRU 2.2.17 R. However, in carrying out its own assessment of its capital needs, a *firm* may take into account other capital available to it (see GENPRU 1.2.30 R and GENPRU 1.2.36 R), although it should be able to explain and justify its reliance on these other forms of capital.

7.1.8 G There are two main aims in this section:

(1) to enable *firms* to understand the issues which the *appropriate regulator* would expect to see assessed and the systems and processes which the *appropriate regulator* would expect to see in operation for *ICAs* by *firms* to be regarded as thorough, objective and prudent; and

(2) to enable *firms* to understand the *appropriate regulator*'s approach to assessing whether the minimum *capital resources requirements* of GENPRU 2.1 are appropriate and what action may be taken if the *appropriate regulator* concludes that those requirements are not appropriate to a *firm*'s circumstances.

General approach

7.1.9 G The *rules* in GENPRU 1.2 require a *firm* to identify and assess risks to its being able to meet its liabilities as they fall due, to assess how it intends to deal with those risks and to quantify the financial resources it considers necessary to mitigate those risks. To meet these requirements, a *firm* should consider:

(1) the extent to which capital is an appropriate mitigant for the risks identified; and

(2) assess the amount and quality of capital required.

7.1.9A G This section sets out in greater detail the approach to be taken by a *firm* when carrying out the assessment of capital described in the preceding paragraph. This is the assessment referred to as an *individual capital assessment*. GENPRU 1.2.42 R is a general requirement for a *firm* to carry out stress tests and scenario analyses taking into account an appropriate range of adverse circumstances and events relevant to the *firm*'s business and risk profile and to estimate the financial resources it would need to continue to meet the *overall financial adequacy rule* in the stress scenarios considered. As part of its obligations under GENPRU 1.2.42 R, the *firm* must carry out stress tests and scenario analyses to estimate the financial resources it would need to support its business plans and continue adequately to cover its *CRR* and meet the *overall financial adequacy rule* over a time horizon of 3 to 5 years. This is a separate requirement from that to carry out an *ICA*, and *guidance* on this requirement is provided in GENPRU 1.2.73A G and GENPRU 1.2.73C G. In particular, *firms* should note that there is no requirement that the level of capital required as identified by the *ICA* should be equal to, or exceed, the *CRR*.

7.1.9B G The requirements and *guidance* in this section are drafted so as to apply to a *firm* on a solo basis. As noted in GENPRU 1.2.17 G, however, in some cases the requirements in GENPRU 1.2 apply on a consolidated basis. In these cases, a *firm* should read and apply this section making appropriate adjustments to reflect the application of the GENPRU 1.2 requirements on a consolidated basis.

7.1.10 G A *firm* may choose to carry out its *ICA* in another way than through the use of stress tests and scenario analyses. The method should be proportionate to the size and nature of its business.

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7.1.11 G In accordance with GENPRU 1.2.60 R, these assessments must be documented so that they can be easily reviewed by the *appropriate regulator* as part of the *appropriate regulator's* assessment of the adequacy of the *firm's capital resources*.

7.1.12 G The *appropriate regulator* may ask for the results of these assessments to be provided to it together with a description of the processes by which the assessments have been made, the range of results from each stress test or scenario analysis performed and the main assumptions made. The *appropriate regulator* may also carry out a more detailed examination of the details of the *firm's* processes and calculations.

7.1.13 R Based upon this information and other information available to it, the *appropriate regulator* will consider whether the *capital resources requirement* applicable to the firm is appropriate. Where relevant, the *firm's ECR* will be a key input to the *appropriate regulator's* assessment of the adequacy of the *firm's capital resources*. For *firms* carrying on *general insurance business*, the *ECR* is calculated in accordance with INSPRU 1.1.72C R.

7.1.14 G *Firms* that are required to calculate an *ECR* may wish to note that the *ECR* as calculated is based upon the assumptions that a *firm's* business is well diversified, well managed with assets matching its liabilities and good controls, and stable with no large, unusual, or high risk transactions. *Firms* may find it helpful to assess the extent to which their actual business differs from these assumptions and therefore what adjustments it might be reasonable to make to the *CRR* or *ECR* to arrive at an adequate level of *capital resources*.

Methodology of capital resources assessment

7.1.15 R Where a *firm* is carrying out an assessment in accordance with GENPRU 1.2 of the adequacy of its overall financial resources to cover the risk in the *overall financial adequacy rule*, that is, the risk of its being unable to meet its liabilities as they fall due, the assessment of the adequacy of the *firm's* capital resources must:

(1) reflect the *firm's* assets, liabilities, intra-group arrangements and future plans;

(2) be consistent with the *firm's* management practice, systems and controls;

(3) consider all material risks that may have an impact on the *firm's* ability to meet its liabilities to *policyholders*; and

(4) use a valuation basis that is consistent throughout the assessment.

Representative of the firm's characteristics

7.1.16 G The *ICA* should reflect both the firm's desire to fulfil its business objectives and its responsibility to meet liabilities to *policyholders*. This means that the *ICA* should demonstrate that the *firm* holds sufficient capital to be able to make planned investments and take on new business (within an appropriate planning horizon). It should also ensure that if the *firm* had to close to new business (if it has not already done so), it would be able to meet its existing commitments. The costs of writing new business, the expenses incurred in servicing all liabilities, including liabilities to non-*policyholders*, and the nature of intra-group arrangements and *reinsurance* arrangements should be considered as part of the assessment as well as the costs that would be incurred in the event of closure to new business.

7.1.17 G Where a *firm* has not already closed to new business, the *ICA* should be made on the basis that the *firm* closes to new business after an appropriate period. This period should allow for the time it would take for the *firm* to identify the need for closure and to implement the necessary action.

7.1.18 G Where including new business would increase the capital resources by more than any increase in the capital required, or reduce the capital required by more than any reduction in available capital, new business should be excluded. To the extent that including new business increases the required capital, a *firm* should consider whether it is appropriate to include the additional amount within the *ICA*.

7.1.19 G Any contract that the *firm* is legally obliged to renew should be considered part of the *firm*'s existing liabilities and not treated as new business. Such contractual obligations include multi-year *general insurance contracts* and the exercise of options by long-term *policyholders*.

7.1.20 G For a *firm* to discharge its financial obligations to *policyholders*, it will incur certain expenses, including payments to the *firm*'s own staff, contributions to any pension scheme and fees to outsourcing suppliers or service companies. All of these expenses, and risks associated with these payments, should be considered when carrying out the *ICA*. When considering the appropriate level of expenses in a projection, the *firm* should consider the acceptability of the service provided to *policyholders* and the resources required by the senior management to manage the *firm*.

7.1.21 G Where a *firm*'s liabilities include payments which are subordinated to liabilities to *policyholders*, these payments do not need to be included within the *ICA*. However, the *ICA* should include all payments that must be made to avoid putting *policyholders*' interests at risk, including any payment on which a default might trigger the winding up of the *firm*. For example, if the principal of a loan could be recalled on default of a coupon payment, coupon payments over the lifetime of *policyholder* liabilities should be included in the *ICA*. As a further example, declared dividends should be treated as a liability. However, planned dividends that have not been declared need not be included in the *ICA*.

Consistency with a firm's practice, systems and controls

7.1.25 G The *ICA* should reflect the *firm*'s ability to react to events as they occur. When relying on prospective management actions, *firms* should understand the implications of taking such actions, including the financial effect, and taking into consideration any preconditions that might affect the value of management actions as risk mitigants.

7.1.26 G The *ICA* should assume that a *firm* will continue to manage its business having regard to the *PRA's* and *FCA's* Principles for Businesses. In particular, a *firm* should take into account how the Principles for Businesses may constrain its prospective management actions, for example, the *FCA's Principle* 6 (Treating Customers Fairly).

7.1.26A G

7.1.27 G *Firms* should also consider whether their systems and controls provide sufficient information to permit senior management to identify the crystallisation of risks in a timely manner so as to provide them with the opportunity to respond and allow the *firm* to obtain the full value of the modelled management action. *Firms* should also analyse the wider implications of the management actions, particularly where they represent significant divergence from the business plan and use this information to consider the appropriateness of taking this action.

Considering all material risks

7.1.29 G The *ICA* should give the required level of confidence that the *firm's* liabilities to *policyholders* will be paid. The *ICA* should consider all material risks which may arise before the *policyholder* liabilities are paid (including those risks set out in GENPRU 1.2.30 R).

7.1.30 G *Firms* should not ignore risks simply because they relate to events that occur with an expected likelihood beyond the confidence level. However, the capital required in the face of these tail events may be reduced for the purpose of carrying out the *ICA*. For example, while an A-rated bond may be assumed not to default within the required confidence level, allowance should be made for the devaluation of that bond through a more likely downgrade or change in credit spreads or other method which reflects that this investment includes a default risk to the *firm*.

7.1.31 G Notwithstanding INSPRU 7.1.30 G, risks which have an immaterial effect on the *firm's* financial position or only occur with an extreme probability may be excluded from the *ICA*.

7.1.32 G The number of *claims*, the amount paid and the timing of a *firm's* liabilities may be uncertain. The *ICA* should consider risks which result in a change in the cost of those liabilities.

7.1.33 G The assets that a *firm* holds will include assets to back both the liabilities and any capital requirement. These assets carry risk, both in their own right and to the extent that they do not match the liabilities that they are backing. The risk associated with these assets should be considered over the full term for which the *firm* expects to carry the liabilities.

7.1.34 G Where the *firm* is relying on systems and controls in order to mitigate risks, the *firm* should consider the risk of those systems and controls failing at the confidence level at which the *ICA* is being carried out.

7.1.35 G If a *firm* summarises cash flows over part of the lifetime of the portfolio using a balance sheet but is exposed to risks which emerge after the balance sheet date, then these longer-dated risks may be captured by adjusting the assumptions used in the closing balance sheet.

Valuation basis

7.1.36 G The valuation of the assets and of the liabilities should reflect their economic substance. A realistic valuation basis should be used for assets and liabilities taking into account the actual amounts and timings of cash flows under any projections used in the assessment.

7.1.37 G In carrying out the *ICA*, wherever possible the value of assets should be marked to market. Where marking to market is not possible, the *ICA* should use a method suitable for assessing the underlying economic benefit of holding each asset.

7.1.38 G The methods and assumptions used in valuing the liabilities should contain no explicit margins for risk, nor should the approach be optimistic. The valuation of liabilities should be consistent with the valuation of assets. To the extent the market price includes an implicit allowance for risk, this should be included within the valuation.

7.1.39 G The methodology used to place a value on an asset or a liability following a risk event should be consistent with the methodology used prior to the risk event.

7.1.40 G Approximate valuation methods may be used by the *firm* for minor lines of business or to capture less material types of risk. However, the *firm* should avoid methods which under-estimate the risk in aggregate.

7.1.41 G The *firm* should carry out a broad reconciliation of key parts of any balance sheet used in the *ICA* with the corresponding entry from audited results.

ICA submitted to appropriate regulator: confidence level

7.1.42 R Where the *appropriate regulator* requests a *firm* to submit to it a written record of the *firm*'s assessments of the adequacy of its capital resources carried out in accordance with INSPRU 7.1.15 R, those assessments must include an assessment comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities, whether or not this is the confidence level otherwise used in the *firm*'s own assessments.

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7.1.43 G In considering the value of liabilities for the purpose of INSPRU 7.1.42 R, *firms* should have regard to the guidance in INSPRU 7.1.21 G, INSPRU 7.1.26 G and GENPRU 1.2.27 G to GENPRU 1.2.29 G.

7.1.44 G The *appropriate regulator* requires *firms* to submit a capital assessment calibrated to a common confidence level, as set out in INSPRU 7.1.42 R, to enable the *appropriate regulator* to assess whether the minimum *capital resources requirements* in GENPRU 2.1 are appropriate. This then allows the *appropriate regulator* to give a consistent level of *individual capital guidance* across the industry.

7.1.45 G If a *firm* selects a longer time horizon than one year it may choose to use a lower confidence level than 99.5%. In such a case, the *firm* should be prepared to justify its choice and explain why this confidence interval is appropriate and how it is comparable to a 99.5% confidence level over a one year timeframe. An assessment based on a longer timeframe should also demonstrate that there are sufficient assets to cover liabilities at all future dates. This may be illustrated by future annual balance sheets.

Measurement

7.1.46 G In determining the strength of the *ICA*, a *firm* should consider all risks in aggregate making appropriate allowance for diversification such that the assessment meets the required confidence level overall. The *firm* should be able to describe and explain each of the main diversification benefits allowed for.

7.1.47 G For risks that can be observed to crystallise over a short period of the order of a year, the confidence level may be measured with reference to the probability distribution for the impact of the risks over one year. For example, catastrophic events such as hurricanes can be measured in this way by estimating the ultimate capital cost.

7.1.48 G For risks that are not observable over a short period (such as long-tailed liability business or annuitant mortality), the confidence level may be measured with reference to the probability distribution for the emergence of that risk over the lifetime of the liabilities.

Documenting ICAs submitted to the appropriate regulator

7.1.49 R The written record of a *firm's individual capital assessments* carried out in accordance with INSPRU 7.1.15 R submitted by the *firm* to the *appropriate regulator* must:

(1) in relation to the assessment comparable to a 99.5% confidence level over a one year timeframe that the value of assets exceeds the value of liabilities, document the reasoning and judgements underlying that assessment and, in particular, justify:

(a) the assumptions used;

(b) the appropriateness of the methodology used; and

(c) the results of the assessment; and

(2) identify the major differences between that assessment and any other assessments carried out by the *firm* using a different confidence level.

Appropriate regulator assessment process - all firms

7.1.91 G In assessing the adequacy of a *firm's capital resources*, the *appropriate regulator* draws on more than just a review of the submitted *ICA*. Use is made of wider supervisory knowledge of a *firm* and of wider market developments and practices. When forming a view of any *individual capital guidance* to be given to a *firm*, the review of the *firm's ICA* along with the regulator's risk assessment and any other issues arising from day-to-day supervision will be considered.

7.1.92 G The *appropriate regulator* will take a risk-based and proportionate approach to the review of a *firm's ICA*, focusing on the *firm's* approach to dealing with the key risks it faces. Any *individual capital guidance* given will reflect the judgements reached through the regulator's review process as well as the review of the *firm's ICA*.

7.1.93 G A *firm* should not expect the *appropriate regulator* to accept as adequate any particular model that the *firm* develops or that the results from the model are automatically reflected in any *individual capital guidance* given to the *firm* for the purpose of determining adequate *capital resources*. However, the *appropriate regulator* will take into account the results of any sound and prudent model when giving *individual capital guidance* or considering applications for a waiver under sections 138A and 138B of the *Act* of the *capital resources requirement* in GENPRU 2.1.

7.1.94 G Where the *appropriate regulator* considers that a *firm* will not comply with GENPRU 1.2.26 R (adequate financial resources, including *capital resources*) by holding the *capital resources* required by GENPRU 2.1, the *appropriate regulator* may give the *firm individual capital guidance* advising it of the amount and quality of *capital resources* which the *appropriate regulator* considers it needs to hold in order to meet that *rule*.

7.1.95 G In giving *individual capital guidance*, the *appropriate regulator* seeks a balance between delivering consistent outcomes across the *individual capital guidance* it gives to all *firms* and recognising that such guidance should reflect the individual features of the *firm*. Comparison with the assumptions used by other *firms* will be used to trigger further enquiry. Debate will be sought where good arguments are made for a particular result that differs markedly from those of a *firm's* peers. The *appropriate regulator* also takes account of the quality of the wider risk management around the development of the numbers used in the *ICA*. The aim is to deliver *individual capital guidance* that comes closest to ensuring that there is no significant risk that a *firm* is unable to pay its liabilities as they fall due.

7.1.96 G Following an internal validation process, the *appropriate regulator* will write to the Board of the *firm* being assessed providing both quantitative and qualitative feedback on the results of the *appropriate regulator's* assessment. This letter will notify the *firm* of the *individual capital guidance* considered appropriate. The letter will include reasons for any capital add-ons identified, where applicable.

7.1.97 G If a *firm* considers that the individual capital guidance is inappropriate to its circumstances, then the firm should inform the *appropriate regulator* that it does not intend to follow that *guidance*. Informing the *appropriate regulator* of such an intention would be expected if a *firm* is to comply with *Principle* 11 (Relations with regulators).

7.1.98 G The *appropriate regulator* expects most disagreements about the adequacy of capital will be resolved through further analysis and discussion. The *appropriate regulator* may consider the use of its powers under section 166 of the *Act* (Reports by skilled persons) to assist in such circumstances. If the *appropriate regulator* and the *firm* still do not agree on an adequate level of capital, then the *appropriate regulator* may consider using its powers under section 55J of the *Act* to, on its own initiative, vary a *firm's Part 4A permission* so as to require it to hold capital in accordance with the *appropriate regulator's* view of the capital necessary to comply with ■ GENPRU 1.2.26 R. ■ SUP 7 provides further information about the *appropriate regulator's* powers under section 55J.

7.1.99 G Where a *firm* considers that the *capital resources requirements* of ■ GENPRU 2.1 require the holding of more capital than is needed for the *firm* to comply with ■ GENPRU 1.2.26 R then the firm may apply to the *appropriate regulator* for a *waiver* of the requirements in ■ GENPRU 2.1 under sections 138A and 138B of the *Act*. In addition to the statutory tests under sections 138A and 138B in deciding whether to grant a *waiver* and, if granted, its terms, the *appropriate regulator* will consider the thoroughness, objectivity and prudence of a *firm's ICA* and the extent to which the *guidance* in this section has been followed.