Chapter 7

Individual Capital Assessment
7.1 Application

7.1.3A 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 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 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 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 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 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 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 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 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 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 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.

7.1.11 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.
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.

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.

*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

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

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 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 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 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 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 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 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 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  

7.1.27  
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  
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  
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  
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  
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  
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  
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 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 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 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 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 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 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 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 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.

7.1.43 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 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 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 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 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 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 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** 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** 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** 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** 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** 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** 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.
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).

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.

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.