

Chapter 5

Financial resources



5.8 Calculation of own funds and liquid capital

5.8.1

R

A firm must calculate its **own funds** and **liquid capital** as shown below, subject to the detailed requirements set out in ■ IPRU-INV 5.8.2R.

| Financial resources | | | Category | IPRU-INV 5.8.2R paragraph |
|------------------------|--|---|----------|---------------------------|
| Tier 1 | | | | |
| (1) | Paid-up share capital (excluding preference shares) | A | | |
| (1A) | Eligible LLP members' capital | | | |
| (2) | Share premium account | | | |
| (3) | Reserves | | | 2A |
| (4) | Non-cumulative preference shares | | | |
| Less: | (5) Investments in own shares | B | | |
| | (6) Intangible assets | | | |
| | (7) Material current year losses | | | 4 |
| | (8) Material holdings in credit and financial institutions | | | 5 |
| | (8A) Excess LLP members' drawings | | | |
| Tier 1 capital = (A-B) | | C | | |
| Plus: TIER 2 | | | | 1 |
| (9) | Revaluation reserves | D | | |
| (10) | Fixed term cumulative preference share capital | | | |
| (11) | Long-term Qualifying Subordinated Loans | | | 6 |
| (12) | Other cumulative preference share capital and debt capital | | | |

| Financial resources | | Category | IPRU-INV 5.8.2R paragraph |
|----------------------------|---|----------|---------------------------------|
| (13) | Qualifying arrangements | | 7 |
| "Own Funds" = (C+D) | | E | |
| Plus: TIER 3 | | | |
| (14) | Net trading book profits | F | 8 |
| (15) | Short-term Qualifying Subordinated Loans and excess Tier 2 capital | | 1(b); 9 |
| Less: (16) | Illiquid assets | G | 10 |
| Add: (17) | Qualifying Property | | 11 |
| "Liquid Capital" = (E+F+G) | | | |

5.8.2

R

| | | |
|---|-----|---|
| 1 Deductions and Ratios (Items 10, 11 and 15) | (a) | [deleted] |
| | (b) | A <i>firm</i> which is subject to a liquid capital requirement under IPRU-INV 5.4.1R may take into account qualifying subordinated loans in the calculation of liquid capital up to a maximum of 400% of its Tier 1 capital. |
| 2 Non corporate entities | (a) | In the case of <i>partnerships</i> or <i>sole traders</i> , the following terms should be substituted, as appropriate, for items 1 to 4 in Tier 1 capital: <ul style="list-style-type: none"> (i) partners' capital accounts (excluding loan capital); (ii) partners' current accounts (excluding unaudited profits and loan capital); (iii) proprietors' account (or other term used to signify the sole trader's capital but excluding unaudited profits). |
| | (b) | Loans other than qualifying subordinated loans shown within partners' or proprietors' accounts must be classified as Tier 2 capital under item 12. |
| | (c) | For the calculation of own funds , partners' current accounts figures are subject to the following adjustments in respect of a <i>defined benefit occupational pension scheme</i> : <ul style="list-style-type: none"> (i) a <i>firm</i> must derecognise any <i>defined benefit asset</i>; (ii) a <i>firm</i> may substitute for a <i>defined benefit liability</i> the <i>firm's deficit reduction amount</i>. The |

2A Reserves

election must be applied consistently in respect of any one financial year.

Note 1

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

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

- (a) a *firm* must deduct any unrealised gains or, where applicable, add back in any unrealised losses on cash flow hedges of financial instruments measured at cost or amortised cost;
- (b) in respect of a *defined benefit occupational pension scheme*, a *firm* must derecognise any *defined benefit asset*;
- (c) a *firm* may substitute for a *defined benefit liability* the *firm's* deficit reduction amount. The election must be applied consistently in respect of any one financial year.

Note 2

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

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

Note 3

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

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

Note 4

Reserves must be audited unless the *firm* is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemptions from audit)), or where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions for exemption from audit)) relating to the audit of accounts.

| | |
|---|---|
| 3 Intangible assets (Item 6) | <p>Intangible assets comprise:</p> <ul style="list-style-type: none"> (a) formation expenses to the extent that these are treated as an asset in the <i>firm's</i> accounts; (b) goodwill, to the extent that it is treated as an asset in the <i>firm's</i> accounts; and (c) other assets treated as intangibles in the <i>firm's</i> accounts. <p>Intangible assets do not include a deferred acquisition cost asset.</p> |
| 4 Material current year losses (Item 7) | <p>Losses in current year operating figures must be deducted when calculating Tier 1 capital if such losses are material. For this purpose profits and losses must be calculated quarterly or monthly, as appropriate. If this calculation reveals a net loss it shall only be deemed to be material for the purposes of this Table if it exceeds 10 per cent of the <i>firm's</i> Tier 1 capital.</p> |
| 5 Material holdings in credit and financial institutions (Item 8) | <p>Material holdings comprise:</p> <ul style="list-style-type: none"> (a) where the <i>firm</i> holds more than 10 per cent of the equity share capital of the institution, the value of that holding and the amount of any subordinated loans to the institution and the value of holdings in qualifying capital items or qualifying capital instruments issued by the institution; (b) in the case of holdings other than those mentioned in (a) above, the value of holdings of equity share capital in, and the amount of subordinated loans made to, such institutions and the value of holdings in qualifying capital items or qualifying capital instruments issued by such institutions to the extent that the total of such holdings and subordinated loans exceeds 10 per cent of the <i>firm's</i> own funds calculated before the deduction of item 8. |
| 6 Long term qualifying subordinated loans (Item 11) | <p>Loans having the characteristics prescribed by IPRU-INV 5.6.1R may be included in item 11, subject to the limits set out in paragraph (1) above.</p> |
| 7 Qualifying arrangements (Item 13) | <p>A <i>firm</i> may only include qualifying undertakings in its calculation of liquid capital if:</p> |

| | |
|--------------------------------------|---|
| | <div><div>(i)</div><div>it maintains liquid capital equivalent to 6/52 of its annual expenditure in a form other than qualifying undertakings; and</div></div> <div><div>(ii)</div><div>the total amount of all qualifying undertakings plus qualifying subordinated loans does not exceed the limits set out in paragraph (1)(b) above.</div></div> |
| 8 Net trading book profits (Item 14) | <div>Unaudited profits can be included at item 14.</div> <div>This Item must not be included in the <i>liquid capital calculation</i> of a firm whose permitted business includes <i>establishing, operating or winding up a personal pension scheme</i>.</div> <div>Note 5</div> <div>Non-trading book interim profits may only be included in Tier 1 of the calculation if they have been independently verified by the <i>firm's</i> external auditors, unless the <i>firm</i> is exempt from the provisions of Part VII of the Companies Act 1985 (section 249A (Exemptions from audit)), or where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions for exemption from audit)) relating to the audit of accounts.</div> <div>For this purpose, the external auditor should normally undertake at least the following:</div> <div><div>(a)</div><div>satisfy himself that the figures forming the basis of the interim profits have been properly extracted from the underlying accounting records;</div></div> <div><div>(b)</div><div>review the accounting policies used in calculating the interim profits so as to obtain comfort that they are consistent with those normally adopted by the <i>firm</i> in drawing up its annual financial statements;</div></div> <div><div>(c)</div><div>perform analytical review procedures on the results to date, including comparisons of actual performance to date with budget and with the results of prior periods;</div></div> <div><div>(d)</div><div>discuss with management the overall performance and financial position of the <i>firm</i>;</div></div> <div><div>(e)</div><div>obtain adequate comfort that the implications of current and prospective litigation, all known claims and commitments, changes in business activities and provisions for bad and doubtful debts have been properly taken into account in arriving at the interim profits; and</div></div> <div><div>(f)</div><div>follow up problem areas of which the auditors are already aware in the course of auditing the <i>firm's</i> financial statements.</div></div> |

| | |
|--|---|
| | <p>A <i>firm</i> wishing to include interim profits in Tier 1 capital in a financial return should submit to the FCA with the financial return a verification report signed by its external auditor which states whether the interim results are fairly stated, unless the <i>firm</i> is exempt from the provisions of Part VII of the Companies Act 198 (section 249A (Exemptions from audit)), or where applicable, Part 16 of the Companies Act 2006 (section 477 (Small companies: Conditions for exemption from audit)) relating to the audit of accounts.</p> <p>Profits on the sale of capital items or arising from other activities which are not directly related to the investment business of the <i>firm</i> may also be included within the calculation of liquid capital, but (unless the <i>firm</i> is exempt as above) only if they can be separately verified by the <i>firm's</i> auditors. In such a case, such profits can form part of the <i>firm's</i> Tier 1 capital as profits.</p> |
| 9 Short term qualifying subordinated loans (Item 15) | Loans having the characteristics prescribed by IPRU-INV 5.6.3R may be included in item 15 subject to the limits set out in paragraph (1) above. Tier 2 capital which exceeds the ratios prescribed by paragraph (1)(a) and (b) may be included in item 15 subject to paragraph (1) above. |
| 10 Illiquid assets (Item 16) | <p>Illiquid assets comprise:</p> <ul style="list-style-type: none"> (a) tangible fixed assets. <p>Note 6</p> <p>In respect of tangible fixed assets purchased under finance leases the amount to be deducted as an illiquid asset shall be limited to the excess of the asset over the amount of the related liability shown on the balance sheet.</p> <ul style="list-style-type: none"> (b) holdings in, including subordinated loans to, credit or financial institutions which may be included in the own funds of such institutions unless they have been deducted under item 8; (c) any investment in undertakings other than credit institutions and other financial institutions where such investments are not readily realisable; (d) any deficiency in net assets of a subsidiary; (e) deposits not available for repayment within 90 days or less (except for payments in connection with margined futures or options contracts); <p>Note 7</p> <p>Where cash is placed on deposit with a maturity of more than 90 days but is repayable on demand subject to the payment of a penalty, then this is not required to be deducted as an illiquid asset but a deduction is required for the amount of the penalty.</p> |

| | |
|----------------------------------|---|
| | <div><div><div>(f)</div><div>loans, trade and other debtors and accruals not falling due to be repaid within 90 days or which are more than one month overdue by reference to the contractual payment date;</div></div><div><div>(g)</div><div>physical stocks (except where subject to the position risk requirement as set out in IPRU-INV 5.11; and</div></div><div><div>(h)</div><div>prepayments to the extent that the period of prepayment exceeds six weeks in the case of a <i>firm</i> subject to the 6/52 expenditure based requirement or thirteen weeks in the case of a firm subject to the 13/52 expenditure based requirement.</div></div><div><div>(i)</div><div>if not otherwise covered, any holding in eligible capital instruments of an insurance undertaking, insurance holding company, or reinsurance undertaking that is a subsidiary or participation. Eligible capital instruments include ordinary share capital, cumulative preference shares, perpetual securities and long-term subordinated loans that are eligible for insurance undertakings under INSPRU 1.</div></div></div> <div><div>Illiquid assets do not include a defined benefit asset or a deferred acquisition cost asset.</div></div> |
| 11 Qualifying property (Item 17) | <div><div>This item comprises the qualifying amount calculated in accordance with IPRU-INV 5.7.1R.</div></div> |