



Key Contact

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“... Certain capital requirements are required to be met with a specific tier of capital...”

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AN INTRODUCTION TO GENPRU AND BIPRU

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Overview

Prudential requirements for investment firms is one of the more complex areas of the FSA rules. GENPRU and BIPRU are lengthy sourcebooks and it can sometimes be quite hard to establish which rules are applicable to your firm and the practical implications.

GENPRU Overview

The General Prudential Sourcebook (“GENPRU”) covers the overall requirement to have capital resources in excess of the firm’s capital resources requirement and sets out what constitutes capital resources and how different firms should calculate their capital resources requirement.

Capital Resources Requirement

The method for calculating the firm’s capital resources requirement will depend on whether it is categorised as a Limited Licence, Limited Activity or Full Scope firm. The requirement will be the higher of a base capital requirement (either €50k, €125k or €730k) and a variable requirement which will include one or more of the following:

- Fixed Overheads Requirement (“FOR”);
- Operational Risk Capital Requirement (“ORCR”);
- Credit Risk Capital Requirement (“CRCR”); and
- Market Risk Capital Requirement (“MRCR”).

For example the capital requirement for a BIPRU 50K Limited Licence Firm is the higher of €50,000, **or** Market Risk + Credit Risk, **or** the Fixed Overheads Requirement.

Fixed Overheads Requirement

The Fixed Overheads Requirement is equal to one quarter of the firm’s total annual expenditure shown in its last audited report and accounts. There are certain items which can be excluded from the calculation of total expenditure (eg staff bonuses that are not guaranteed).

Capital Resources

Capital Resources is comprised of three tiers. Tier 1 capital includes items such as share capital, tier 2 includes items such as long term subordinated loans and tier 3 includes items such as short term subordinated loans. There are strict limits on the amount of both tier 2 and tier 3 capital which can be included in the calculation of capital resources and these link back ultimately to the level of tier 1 capital in place.

Certain capital requirements are required to be met with a specific tier of capital (eg the credit risk capital component, counterparty risk capital component, ORCR and base requirement must be met by capital which falls within tier 1 and/or tier 2).

BIPRU Overview

The Prudential Sourcebook for Banks, Building Societies and Investment Firms (“BIPRU”) sets down the detailed rules on ICAAPs, consolidation and all the risk requirements (other than the Fixed Overheads Requirement which is in GENPRU). The main rules applicable to the risk requirements are summarised below.

Credit Risk Capital Requirement



The most relevant of the components for the majority of investment firms is the credit risk capital component. This requires firms to take a haircut on exposures in their non-trading book. The component is calculated as 8% of the risk weighted exposure amount. The risk weighting of an exposure will depend on a number of variables (eg the credit rating of the exposure).

The other two components only apply if the firm has a trading book (ie it is dealing as principal).

Large Exposure Rules

Large Exposures is an area where firms often breach the rules. The rules set out the limits on the size of non-trading book exposures to a counterparty or group of connected counterparties. These must not exceed 25% of the firm's capital. A breach of this rule must be notified to FSA. Fund management firms will often be in danger of breaching this rule as their management fees are only paid infrequently and will show as a large debtor on their balance sheet.

Operational Risk Capital Requirement (“ORCR”)

The ORCR will only be applicable to full scope firms. Most such firms will use the simplest approach which is the Basic Indicator Approach. Under this approach the requirement is calculated as 15% of the three year average sum of a firm's net income (including interest income). The three year average is based on the figures included in the last three sets of annual accounts.

Market Risk Capital Requirement (“MRCR”)

The MRCR is calculated on all trading book positions and certain positions which are held in the non-trading book. MRCR is comprised of different types of position risk requirement (“PRR”) and the type of PRR depends on the instrument held. The most common form of PRR for firms which do not have a trading book is foreign currency PRR and this calculated as 8% of the open currency position (eg if the firm holds cash in a dollar bank account it will need to take an 8% hit on this position).

Summary

We have covered here at a high level some of the key rules within both GENPRU and BIPRU. However not all of these will be relevant to all firms, and other rules may also be applicable. Please get in touch with your usual Bovill contact if you would like further guidance on the rules applicable to your firm.

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