Daiwa
Capital Markets

Daiwa Capital Markets Europe Limited

Pillar 3 disclosures for the year ended 31 March 2011

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1. Overview

1.1. Background

The European Union (EU) Capital Requirements Directive (CRD) implements the Basel capital adequacy framework (Basel II) and applies it to all investment firms, building societies and banks. The CRD was formally adopted by the EU on 14 June 2006 and became effective in the UK on 1 January 2007.

In the UK, the implementation of the CRD required regulated firms to make significant changes to the way they calculate their capital requirements including the application of the concepts of minimum capital requirements (Pillar 1) and supervisory review processes (Pillar 2) in the determination of those requirements. The disclosure requirements of Pillar 3 complement the capital requirements described in Pillar 1 and Pillar 2 and seek to promote greater market discipline and transparency through the disclosure of key information about risk exposures and risk management processes.

Daiwa Capital Markets Europe Limited ("the Firm") adopted the Pillar 1 standardised approach to credit, market and operational risk with effect from 1 January 2008 and were subject to the Pillar 2 and Pillar 3 requirements from that date.

1.2. Structure

The Firm is the wholly owned European subsidiary of Daiwa Securities Capital Markets Co. Ltd. ("the Parent"), which is headquartered and regulated in Japan and is a wholly owned subsidiary of Daiwa Securities Group ("the Ultimate Parent").

The Firm has its head office in London and operates a small branch and representative office network in Europe and the Middle East. At 31 March 2011, the Firm has two wholly owned subsidiary undertakings, Empire Nominees Limited and Daiwa Corporate Advisory Partners Limited.

Empire Nominees Limited's sole purpose is to act as a nominee holder of securities and is not consolidated in the Firm's year-end financial statements on the basis that it is immaterial, in accordance with s229(2) of the Companies Act 1985.

Daiwa Corporate Advisory Partners Limited (formerly Close Brothers Corporate Finance Holdings Limited) provides Corporate Finance, M&A and debt advisory services through a network of operating companies across Europe. For statutory accounting purposes, it is not consolidated in the Firm's year-end financial statements on the basis that it is consolidated at group level by Daiwa Securities Capital Markets Co. Ltd in Tokyo. However, for regulatory purposes the Firm is required to file consolidated returns and has been filing on this basis since September 2009.

1.3. Principal Activities

The Firm's principal activities are to provide investment banking services in Equities, Fixed Income and Derivatives together with Corporate Finance Advisory services, through its subsidiary group DC Advisory Partners.
In November 2010, the firm completed the acquisition of the convertible bond businesses of KBC Financial Products UK Limited as part of a larger deal involving the sale of certain businesses of KBC Bank NV to Daiwa Securities Group.

1.4. Scope

Daiwa Capital Markets Europe Limited is regulated by The Financial Services Authority ("the FSA") in the UK. These Pillar 3 disclosures have been prepared as at 31 March 2011, which is the Firm's accounting reference date and financial year-end.

1.5. Basis of Disclosures

The Pillar 3 disclosures presented here are the consolidated view for the Firm and include both the quantitative and qualitative information in relation to credit risk and market risk, both of which have been prepared on a "standardised approach" basis in accordance with the rules set out in Chapter 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) section of the FSA handbook.

As a result of a capital injection into the Firm in March of 2011, the Firm became a "Tier 1" firm (according to the definition within FSA Policy Statement 10/21 "Implementing the CRD requirements on the disclosure of remuneration: Feedback on CP10/27 and final rules") and is therefore required to provide certain disclosures with regard to remuneration in accordance with Chapter 11 of the FSA's Prudential sourcebook for Banks, Building Societies and Investment Firms ("BIPRU 11"). No comparatives are given as this is the first year of disclosure.
Not all the Pillar 3 disclosure requirements apply to Daiwa Capital Markets Europe Limited. This document has been produced solely for the purposes of providing information on the capital adequacy and risk management of the Firm. Any disclosure requirements that do not apply have not been included.

1.6. Location and Verification

The Pillar 3 disclosures have been approved by the Firm's Asset and Liability Committee, ("ALCO") and the Board of Directors of the Firm and are published on the Firm's website (www.uk.daiwacm.com). Disclosures will be updated on an annual basis and made available on the Firm's website as soon as practicable.

This document has not been subject to audit by the Firm's external auditors.

2. Risk Management Objectives and Policies

2.1. Governance and Structure

The Board of Directors of the Firm (“the Board”) is ultimately responsible for the management of the Firm – including its branch and representative offices in Europe and the Middle East – and for establishing and monitoring the effectiveness of its corporate governance framework. The Board, the membership of which includes two Independent Non-Executive Directors, is also responsible for determining the Firm’s strategic direction and risk appetite.

The Board meets on a monthly basis and more frequently should the need arise. Day to day management responsibilities are delegated to the Firm's Executive Committee, which comprises all the Executive Board Directors and the heads of each business and support area. To fulfil its responsibilities the Board is supported by a number of committees and a diagram of the Firm's committee structure is provided below. The formal committee structure, including terms of reference and membership details, is maintained centrally and any changes to these are approved by either the Executive Committee or the Board, as appropriate.

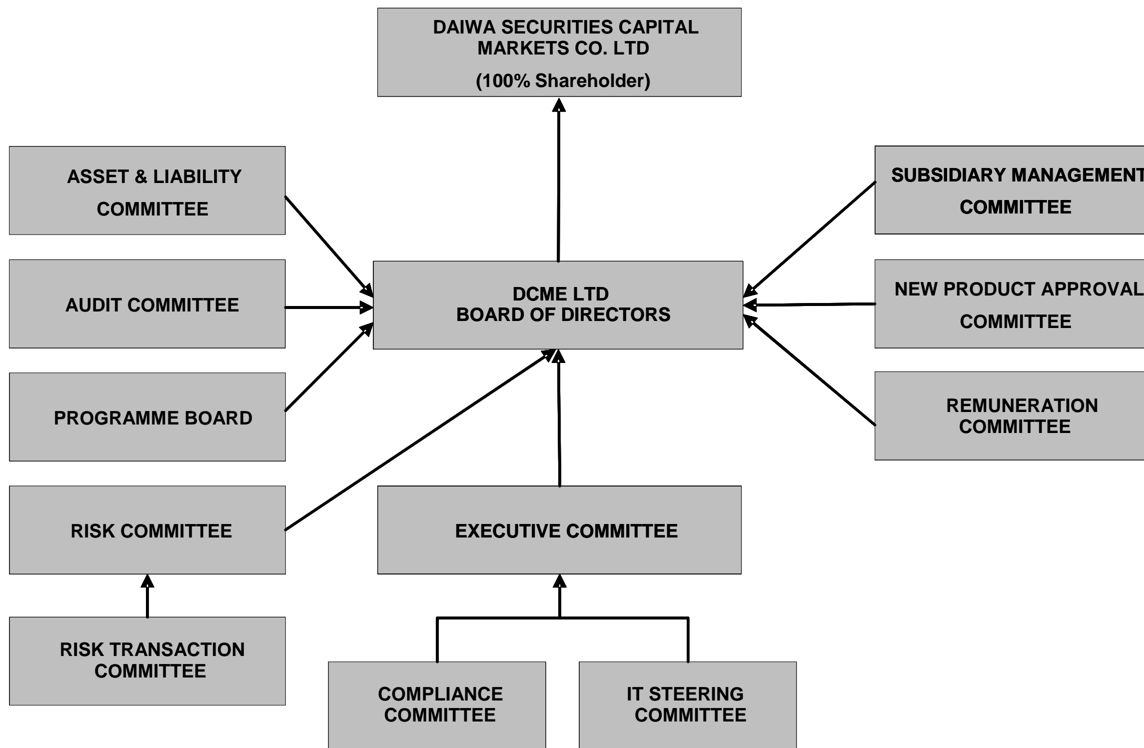

Figure 1

The main roles and responsibilities of the committees shown in the above diagram are as follows:

2.2. Asset and Liability Committee (ALCO)

Operating under the delegated authority from the Board, ALCO’s prime role is to ensure that the Firm’s financial resources are appropriately understood and managed in a manner consistent with its agreed strategy, business plans and risk appetite.

The responsibility of ALCO can be analysed into three main components:

- Capital
- Funding & Liquidity, and
- Balance Sheet Management.

A Control and Valuations Group maintains oversight of the key controls and policies around the valuation of balance sheet positions, including *inter alia* Independent Price Verification Policy and Reserving Policy. It is intended that this Group formally report through ALCO during 2011.

2.3. Audit Committee

Responsible for monitoring and reviewing the adequacy of the Firm's financial, risk management and other internal controls, its accounting policies, the integrity of its financial statements and external reporting responsibilities and its relationship with its external auditors.

2.4. Subsidiary Management Committee

Responsible for approving specific matters pertaining to the ongoing operation and management of the Firm's subsidiaries.

2.5. Remuneration Committee

Responsible for monitoring and reviewing the Firm's remuneration and compensation policies as well as bonus allocations and payments.

2.6. Executive Committee

Provides ongoing oversight of the Firm's key business and operational areas in the context of approved budgets and business plans.

2.7. Risk Committee

The committee is responsible for overseeing the Firm's capital adequacy assessment process and for the promotion of a strong and effective risk management culture throughout the Firm. Key responsibilities include setting policy for market, credit, liquidity and operational risk and oversees the management of those risks within the Firm.

A particular focus is understanding how the firm would perform under various market stresses. A stress testing focus group reports into the Risk Committee and is responsible for agreeing stress testing scenarios, reviewing output from stress tests and confirming the validity of stress testing conditions if limits are breached. This Group also evaluates the capacity of the Firm to absorb losses and identifies steps to reduce risk. It contributes to risk mitigation strategies which are reflected in the risk management policies and limits set by the Firm.

2.8. Risk Transaction Committee

Responsible for assessing proposed transactions from a market, credit and reputational risk perspective and for making recommendations to the Chair of the Committee.

2.9. Compliance Committee

The Compliance Committee provides the Firm's senior management team with periodic updates on a range of regulatory topics including, in particular, the compliance monitoring plan and any key regulatory changes.

2.10. IT Steering Committee

Co-ordinates IT policy and strategy and oversees the adoption and implementation of IT initiatives, projects and developments.

2.11. New Product Approval Committee

The role of the NPA committee is to ensure that there is a clearly defined approval process for the evaluation of new products and businesses from an operational perspective, and that these are only implemented after due consideration of the risks involved and the establishment of an adequate control environment.

2.12. Programme Board

Acts as the governance forum for reviewing, prioritising and agreeing company change initiatives

3. Significant Risks

The most significant types of risks to which the Firm is exposed are discussed below:

3.1. Market Risk

Market risk is defined as the potential adverse change in position values arising from movements in interest rates, credit spreads, stock prices, exchange rates or other market risk factors. Market risk exposures arise from trading book positions held in Fixed Income, Equity and Derivative instruments.

The Risk Committee (RC) is responsible for establishing the Firm's overall risk appetite subject to approval by the Board and for establishing and monitoring the Firm's risk management policies and procedures. Risk is actively managed or hedged by the business within these policies and within the trading book policy statement. The RC fulfils its responsibilities in consultation with the Parent's Risk Management Department with whom it agrees risk limits and guidelines. Regular meetings are also held between Risk Department personnel and desk heads from the front office divisions as part of its active management of the Firm's exposure to risk.

The Market Risk department is responsible for presenting a fair picture of the risk in the Firm's trading book. Market risk exposures are monitored every day to ensure that both individual trader exposure and overall exposure are within the limits agreed between the Firm and its Parent. Internal reports that identify daily trader levels and limit utilisation levels are reviewed and distributed to front office staff and senior management. Any breaches of the pre-agreed limits are reported immediately to the Parent and any extensions agreed upon are ratified where appropriate by the RC.

Market risk is controlled and monitored using a range of risk management tools including VaR, basis point value (BPV) limits, and various changes in credit spreads. A variety of limits are set locally within rules set by the Parent – by instrument rating, issuer, geographic location, and both cumulative and aged holdings. External ratings, where available, are applied to all issuers of debt securities.

Option positions are adjusted into their delta equivalent positions and gamma and vega limits are applied. Concentrated holdings and aged inventory are monitored to check how the balance sheet is being utilised. Interest rate risk is measured and controlled within overall parameters and limits.

All material market risks are monitored on a daily basis.

The VaR methodology the Firm uses is calibrated to a 99% confidence level, one day holding period and a one year observation period. The model used is provided by an external vendor, with risk figures checked regularly for reasonableness by the Market Risk department, using techniques such as backtesting and profit and loss attribution. Additionally, stress testing and scenario analysis techniques are used to assess the impact of extreme but plausible events. The scenarios are discussed and agreed regularly by the stress testing focus group, and signed off by the RC.

The VaR analysis for the year was as follows:

Table 1

	Year to Mar 2011	Year to Mar 2010
	£'000	£'000
Year-end	1,967	643
Average	1,740	413
Maximum	2,840	811
Minimum	588	162

The VaR numbers shown for 2011 incorporate full diversification offsets between businesses. They include a step up as at 22 November 2010 when the ex-KBC convertibles business was consolidated into the Firm. Even prior to this, however, VaR usage was running at a higher level than in 2010, partly due to an expansion in business activity (mainly in Fixed Income) but also a change of methodology to historical simulation VaR. The VaR methodology in 2010 was based on Monte Carlo simulation using a Normal probability distribution. The revision was introduced to ensure a consistency of methodology across Daiwa Group.

3.2. Credit Risk

Credit risk is defined as the potential financial loss arising from a customer or counterparty failing to meet their financial obligations to the Firm as they become due. Credit risk exposures arise from unsettled / outstanding trades in the event of counterparty failure and the deterioration of the credit quality of issuers of debt securities, resulting in a fall in the value of the Firm's holding of assets.

The RC sets credit policy and oversees the control of credit risk. It is supported by the Credit Risk department of the Firm's Risk Management division. Counterparty exposure is managed by rigorous onboarding procedures, counterparty rating, limit setting (notional, credit and settlement, where necessary), exposure monitoring and exception reporting. Appropriate legal agreements are entered into according to product. Risk mitigation is also conducted daily via collateral management activity.

Formal Credit approval is required for all potential counterparties as part of the Firm's account opening process. Credit limits are set at individual counterparty (legal entity) level and for groups of connected counterparties. Credit requirements beyond Risk Management approval authority must be approved by senior management and/or the Credit Risk Management Department of the Parent. The counterparty base is predominantly investment grade banks, financial institutions, fund managers including hedge funds and large corporates. Credit mark-to-market exposure to below investment grade counterparties as at 31st March 2011 was less than 1% of the total.

Credit limits are calculated recognising principal risk, settlement risk and pre-settlement risk factors. Credit risk is monitored and reported upon daily. Trade capture and exposure calculation (including potential future exposure) is automated via overnight batch processing. Credit risk is captured at trade level and reported at legal entity level with exposure calculation methodology recognising within each counterpart the legal capacity to net credit exposures in accordance with any market standard documentation. Exposure to groups of related entities is also captured and monitored.

All client and counterparty credit facilities are reviewed periodically. As a result of these reviews, credit limits may be reduced or cancelled in the event of low / zero activity. Reinstatement of a previously cancelled credit facility requires formal re-approval of the counterparty. The Firm uses an internally developed risk rating system as well as external credit rating assessment institutions (ECAI), where available, to perform counterparty risk classification.

Internal ratings are applied to all counterparties and are a key component in determining the risk appetite and size of limit assigned to each client. The Firm determines internal ratings through a scorecard-based approach using publicly available information and accounts and ensuring overall consistency with external ratings provided by ECAIs. The rating assignment process includes qualitative and quantitative considerations as well as trend analysis and peer comparisons.

Reports to management identify credit portfolio composition, credit exposure and limits granted. The RC is apprised of the Firm's credit risk profile/concentration according to risk rating, geographic location and industry type. The trading book business conducted has not required, and currently does not require, the establishment of credit reserves, but this situation is kept under review.

The use of collateralisation, netting and trading within market standard documentation is employed whenever practicable. The collateral management and margining of counterparty exposure is actively managed on a daily basis and most heavily utilised in the repo and security financing businesses. All exposures are revalued daily using independent price sources. Quality, concentration risk, correlated ('wrong way') risk, illiquidity, pricing risk and haircuts are all considered when determining acceptable collateral. The main types of collateral taken by the Firm are cash, government bonds, supranational bonds and listed equities from primary exchanges globally. Lower quality *incremental* collateral is accepted when warranted by the counterparty quality and with appropriate haircuts but constitutes only a minor element of overall gross exposure.

The basis upon which credit is granted is set out in Firm policy and any breach of limits, policy or procedures is recorded and reported immediately to senior management and reported in detail at the monthly RC. No counterparty losses were suffered during the year.

3.3. Liquidity Risk

Liquidity risk is the risk that the Firm, despite remaining solvent, either does not have sufficient financial resources to meet payment obligations as they fall due or that it can only secure such resources at excessive cost.

The Board approves the Firm's liquidity framework which is reviewed at least annually to ensure its continued relevance.

In considering the Firm's business plans, the Board will review the Firm's projected funding and liquidity position plan over a three year horizon, to ensure that the Firm can continue to have both adequate and appropriate financial resources to meet its requirements.

The Board delegates certain responsibility for operational oversight and management to the Firm's ALCO. This committee is responsible for ongoing development of all components of the liquidity framework including providing feedback to the Board to allow it to discharge its obligations.

ALCO allocates funding limits by business area, always ensuring that such limits can be accommodated within the overall funding capacity of the Firm. The Firm's funding sources comprise capital and reserves, parental support and secured funding from a range of professional counterparts. In addition, the Firm has access to a range of wholesale uncommitted lines. These are accessed periodically as part of the Firm's operational liquidity management process. However, such facilities are not regarded as a core funding source for the business and are not assumed to be available under liquidity stress.

Day to day management of liquidity risk and funding is delegated to Treasury. ALCO agrees the mechanism whereby funding costs are charged to business areas. Treasury operates as a cost centre, with all funding and liquidity costs charged to business units in proportion to their funding usage and the liquidity characteristics of their portfolios.

Treasury also maintain the Firm's liquidity buffer of cash deposits and unencumbered government securities.

The cornerstone of the Firm's quantitative liquidity control is a balance sheet cash flow model, appropriately segmented, firstly on a contractual basis and then with behavioural overlays applied to assess the Firm's position in both normal conditions and under various stress scenarios. Due to their subjective nature, the control processes supporting the behaviour assumptions used are subject to a sequence of executive challenges, including agreement by ALCO and the Board.

Stress test analysis forms the basis by which the Firm defines its liquidity risk appetite. This is currently defined in terms of ensuring the firm remains cash positive for all periods up to the maturity of one year under a severe market wide liquidity stress. Key aspects of the Firm's stress testing include, but are not limited to, the impact of additional margin calls and collateral requirements, the ability to access secured and unsecured funding and the impact on access to payment or settlement systems. Supporting controls address other potential stress vulnerabilities including foreign exchange market access and the failure of funding or credit counterparts.

Were the Firm to conclude from either quantitative or qualitative liquidity/funding controls that there was a potential liquidity issue developing, it would invoke its Board approved contingency funding plans.

3.4. Operational Risk

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. Operational risk policies, which are approved by the RC, are in place for the key risk mitigation and monitoring activities within the Firm.

The Firm manages and monitors its operational risks through a variety of techniques, including internal controls, policies and procedures, risk and control self-assessment ("R&CSA"), key risk indicator monitoring, loss data collection and analysis and the tracking of action points arising from the R&CSA and incident reporting processes. To help protect it from external threats, the Firm maintains comprehensive business continuity plans together with appropriate information security policies and standards. The Firm is also protected from the financial consequences of unplanned events by a combination of insurance policies.

In addition to the above, specialist support functions also provide expertise in areas such as compliance (regulatory / reputation risk), health & safety (people risk), business continuity and office security (external event risk), information security (technology risk), and legal and transaction management (legal risk).

An independent operational risk team within the Risk Management division is responsible for ensuring the effective maintenance of the operational risk framework within which operational risk is managed and for its consistent application across the Firm. Operational Risk Management (ORM) focuses on supporting line management and the business functions with the identification, measurement, monitoring and mitigation of operational risks. On a monthly basis, ORM presents a summary of the Firm's key operational risks, monitoring activities and risk incidents experienced during the month to the RC.

As part of its regular activities, ORM undertakes a rolling schedule of R&CSAs in conjunction with the business areas. For any significant risk identified an action plan is drawn up to mitigate the risk or a key risk indicator is set up to monitor it. A process is also in place to capture, assess and report incidents. This procedure helps to identify where process improvements may be required to reduce the risk of a recurrence. Key risk indicators are also in place and are being gradually introduced across the business in order to monitor the Firm's key risks and to ensure that senior management are aware of any breaches, or potential breaches, to key risk indicator thresholds.

Whilst the Board has ultimate responsibility for the management of operational risk, in practice the responsibility lies with everyone in the Firm.

3.5. Other Risks

It is the Firm's policy to have low open foreign exchange (FX) risk. FX risk in the profit and loss account is managed by Product Control. Limits are in place against which this is reviewed on a weekly basis. A process is in place to ensure that there is no material FX risk at each month-end. This is achieved through an interim FX sell-off at month-end, followed by a final sell-off after the month-end close process.

In addition, any material P&L items arising intra-month are considered on a case-by-case basis by front office with a view of entering into an interim FX transaction if appropriate.

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4. Capital Resources

The table below details the composition of the Firm's consolidated regulatory capital as at 31 March 2011.

Table 2

		Notes	As at 31 March 2011 £'000	As at 31 March 2010 £'000
Tier 1 capital				
	Called up share capital		882,121	207,121
	Profit and loss account and other reserves		45,054	124,979
	Less total deductions from tier 1 capital	1	(76,499)	(57,171)
Total tier 1 capital		**2**	**850,676**	**274,929**
Tier 2 capital				
	Revaluation reserve		3,492	3,520
Total tier 2 capital		**3**	**3,492**	**3,520**
Total capital resources			**854,168**	**278,449**

Notes

1. Deductions comprise: Goodwill on acquisition of Close Brothers Corporate Finance Holdings Limited, and of the convertibles business of KBC Financial Products £75,529k and prudential valuation adjustments £970k
2. Tier 1 capital consists of share capital and reserves, excluding revaluation reserves. The Firm has no innovative Tier 1 instruments.
3. Tier 2 capital consists of reserves representing unrealised gains on available for sale assets.

The Firm's capital resources are primarily Tier 1 capital. At 31 March 2011 and during the year, the Firm complied with all externally imposed capital requirements and all gearing rules in accordance with the rules set out in Chapter 2 of the General Prudential Sourcebook (GENPRU) section of the FSA handbook.

4.1. Capital Adequacy

The Firm defines capital as the resources necessary to cover unexpected losses arising from discretionary risks, being those which it accepts as credit risk and market risk, or non-discretionary risks, being those which arise by virtue of its operations, such as operational risk.

The Firm's Asset and Liability Committee and Risk Committee use capital management principles and related policies define the Internal Capital Adequacy Assessment Process by which the Firm's risk profile is examined to ensure the level of capital:

- remains sufficient to support the Firm's risk profile and outstanding commitments;
- exceeds the Firm's supervisory capital requirement by an agreed margin;
- is capable of withstanding a severe economic downturn or stress scenario;
- remains consistent with the Firm's strategic and operational goals.

The following table shows the Firm's Pillar 1 consolidated capital requirement:

Table 3

	As at 31 March 2011	As at 31 March 2010
	£'000	£'000
Minimum capital requirements		
Trading book		
Interest rate PRR	68,223	24,346
Equity PRR	27,070	1,971
Foreign currency PRR	3,548	836
Market risk requirement	98,842	27,153
Trading book		
Counterparty risk capital component	63,501	23,366
Concentration risk capital component	9,197	4,554
Credit Risk Capital Component	6,627	5,690
Credit risk requirement	79,325	33,610
Operational Risk Capital Requirement – Standardised Approach	30,206	26,461
Total Pillar 1 capital requirement	**208,373**	**87,224**

4.2. Counterparty Credit Risk

The following table shows the counterparty risk capital component and credit risk capital component by exposure class (8% of the risk weighted exposure amounts):

Table 4

As at 31 March 2011	Counterparty Risk Capital Component £'000	Credit Risk Capital Component £'000
Standardised Approach		
Central Governments and Central Banks	290	-
Institutions	35,348	1,455
Corporates	26,313	-
Other Items	1,550	5,172
Total	**63,501**	**6,627**

As at 31 March 2010:	Counterparty Risk Capital Component £'000	Credit Risk Capital Component £'000
Standardised Approach		
Central Governments and Central Banks	-	-
Institutions	20,009	1,475
Corporates	2,405	-
Other Items	952	4,215
Total	**23,366**	**5,690**

The following table details the OTCderivative contracts

Table 5

As at 31 March 2011	Gross Positive Fair Value of contracts £'000	Total Netting Benefits £'000	Netted Current Credit Exposure (A) £'000	Collateral Held * (B) £'000	Net Derivatives Credit Exposure (C) = (A)+(B) £'000
Trading Book	217,296		651,222	235,528	415,693
Total	**217,296**		**651,222**	**235,528**	**415,693**

As at 31 March 2010:	Gross Positive Fair Value of contracts £'000	Total Netting Benefits £'000	Netted Current Credit Exposure (A) £'000	Collateral Held * (B) £'000	Net Derivatives Credit Exposure (C) = (A)+(B) £'000
Trading Book	104,207	-	184,499	40,759	143,740
Total	**104,207**	**-**	**184,499**	**40,759**	**143,740**

The entire exposure value was calculated using the CCR mark to market method.

Credit derivative transactions

As at 31 March 2011, the Firm's portfolio of credit derivatives was split between those hedging a reference asset held by the firm and those not referenced to an asset held by the firm. All credit derivatives are held in the Firm's trading book.

The counterparty base is predominantly investment grade banks.

The following table shows the notional value of the credit derivative transactions as at 31 March 2011:

Table 6

As at 31 March 2011	**Protection Sold**	**Protection Purchased**	**Total**
	£'000	**£'000**	**£'000**
Trading Book - Credit default swaps			
Specifically hedging	-	18,755	18,755
Other	-	64,878	64,878
Total		83,633	83,633

As at 31 March 2010	**Protection Sold**	**Protection Purchased**	**Total**
	£'000	**£'000**	**£'000**
Trading Book - Credit default swaps			
Specifically hedging	-	-	-
Other	3,294	3,294	6,588
Total	**3,294**	**3,294**	**6,588**

4.3. Credit Risk and Dilution Risk

4.3.1. Definition of past due and impaired

A financial asset (loan and receivable) is defined as past due when a counterparty has failed to make a payment when contractually due.

A financial asset (loan and receivable or available for sale investment) is impaired if its recoverable amount is less than its carrying amount on the balance sheet.

At each balance sheet date the Firm assesses whether, as a result of one or more events that occurred after initial recognition, there is objective evidence that a financial asset is impaired. Evidence of impairment may include indications that the counterparty is experiencing significant financial difficulty. If there is objective evidence that an impairment loss on a financial asset has been incurred, the amount of loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective interest rate. The impairment loss is immediately recognised in the profit and loss account.

As at 31 March 2011, the Firm did not have any impaired financial assets and no provision was made.

4.3.2. Analysis of credit risk exposures

The gross credit risk exposure (before credit risk mitigation) and the average for the year ended 31 March 2011 are summarised as follows

Table 7

	Year Ended 31 March 2011 Average Gross Credit Exposures[1]	As at 31 March 2011 Total Gross Credit Exposures	Year Ended 31 March 2010 Average Gross Credit Exposures*	As at 31 March 2010 Total Gross Credit Exposures
	£'000	£'000	£'000	£'000
Sovereigns	76,038	57,831	13,879	22,187
Institutions	20,948,521	23,005,825	15,837,555	19,958,672
Corporates	1,737,135	2,516,704	229,354	243,029
Other	98,385	99,857	54,534	64,570
Total	**22,860,079**	**25,680,217**	**16,135,322**	**20,288,458**

The geographical distribution of these exposures is as follows

Table 8

As at 31 March 2011

	UK	Japan	Europe	North America	Rest of the World	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Sovereigns	46,805		11,026	-	-	57,831
Institutions	13,525,110	3,048,630	2,069,655	2,176,399	2,186,030	23,005,824
Corporates	1,242,378	3,254	662,723	152,285	456,065	2,516,705
Other				-	99,857	99,857
Total	**14,814,293**	**3,051,884**	**2,743,404**	**2,328,684**	**2,741,952**	**25,680,217**

As at 31 March 2010

	UK	Japan	Europe	North America	Rest of the World	Total
	£'000	£'000	£'000	£'000	£'000	£'000
Sovereigns	21,193	972	22	-	-	22,187
Institutions	10,140,261	2,221,760	2,883,287	3,159,427	1,553,937	19,958,672
Corporates	36	11,706	4	231,256	27	243,029
Other	64,030	-	415	-	125	64,570
Total	**10,225,520**	**2,234,438**	**2,883,728**	**3,390,683**	**1,554,089**	**20,288,458**

[1] Average gross credit exposure is based on data from the four previous quarter-ends.

The distribution of exposures by industry and exposure class is as follows
Table 9

As at 31 March 2011

	Sovereigns	Institutions	Corporates	Other	Total
	£'000	£'000	£'000	£'000	£'000
Central Government/Central Banks	57,831	-	-	-	57,831
Banks	-	14,215,684	-	-	14,215,684
Financials	-	8,790,141	-	-	8,790,141
Corporates	-	-	2,516,704	-	2,516,704
Other	-	-	-	99,857	99,857
Total	**57,831**	**23,005,825**	**2,516,704**	**99,857**	**25,680,217**

As at 31 March 2010

	Sovereigns	Institutions	Corporates	Other	Total
	£'000	£'000	£'000	£'000	£'000
Central Government/Central Banks	22,187	-	-	-	22,187
Banks	-	12,714,680	-	-	12,714,680
Financials	-	7,243,992	-	-	6,082,245
Corporates	-	-	243,029	-	243,029
Other	-	-	-	64,570	64,570
Total	**22,187**	**19,958,672**	**243,029**	**64,570**	**20,288,458**

The distribution of exposures by residual maturity is as follows:
Table 10

As at 31 March 2011	One year or less	Over one year not exceeding five years	Over five years	Total
	£'000	£'000	£'000	£'000
Sovereigns	46,825	6,016	4,990	57,831
Institutions	22,455,740	124,073	426,011	23,005,824
Corporates	2,498,317	18,388		2,516,705
Other	25,370	74,487		99,857
Total	**25,026,252**	**222,964**	**431,001**	**25,680,217**

As at 31 March 2010	One year or less	Over one year not exceeding five years	Over five years	Total
	£'000	£'000	£'000	£'000
Sovereigns	13,657	8,530	-	22,187
Institutions	19,847,716	82,918	28,038	19,958,672
Corporates	231,307	11,715	7	243,029
Other	31,399	33,171	-	64,570
Total	**20,124,079**	**136,334**	**28,045**	**20,288,458**

4.4. Credit Risk Standardised Approach

The Firm uses Moody's and S&P as its external credit assessment institution (ECAI) for the purpose of calculating risk weighted exposure amounts in accordance with the standardised approach to credit risk.

The following details the standardised credit risk exposure classes for which the ECAI was used.

- Sovereigns (Central Governments/Central Banks)
- Regional Governments/Local Authorities
- Institutions
- Corporates
- Multilateral Development Banks
- Other Items

The following table shows the exposure values (before the application of supervisory hair-cuts) associated with each credit quality step as at 31 March:

Table 11

As at 31 March 2011

Credit Quality Step	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total Exposures £'000
1	57,831	6,771,676	559,286	-	7,388,793
2	-	8,766,869	206,222	-	8,973,091
3	-	3,375,772	-	-	3,375,772
4	-	-	-	-	-
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	-	4,091,508	1,751,196	99,857	5,942,561
Total	**57,831**	**23,005,825**	**2,516,704**	**99,857**	**25,680,217**

As at 31 March 2010

Credit Quality Step	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total Exposures £'000
1	22,187	8,962,606	-	-	8,984,793
2	-	1,844,711	-	-	1,844,711
3	-	2,932,121	-	-	2,932,121
4	-	1,316,513	-	-	1,316,513
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	-	4,902,721	243,029	64,570	5,210,320
Total	**22,187**	**19,958,672**	**243,029**	**64,570**	**20,288,458**

The following table shows the exposure values after credit risk mitigation (including the application of supervisory hair-cuts) associated with each credit quality step as at 31 March:

Table 12

As at 31 March 2011

Credit Quality Step	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total Exposures after Credit Risk Mitigation £'000
1	22,285	412,169	9,162	-	443,616
2	-	832,696	89,809	-	922,505
3	-	12,310	-	-	12,310
4	-	-	-	-	-
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	-	295,769	277,222	90,024	663,015
Total	**22,285**	**1,552,944**	**376,196**	**90,024**	**2,041,446**

As at 31 March 2010

Credit Quality Step	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total Exposures after Credit Risk Mitigation £'000
1	17,584	529,053	-	-	546,637
2	-	109,814	-	-	109,814
3	-	81,803	-	-	81,803
4	-	6,380	-	-	6,380
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	-	174,532	29,889	64,570	268,991
Total	**17,584**	**901,582**	**29,889**	**64,570**	**1,013,625**

4.5. Market Risk

Please refer to Section 2 Risk Management Objectives and Policies for a summary of the Firm's approach to the management of market risk.

The following table shows the Firm's Pillar 1 capital requirement on market risk as at 31 March.

Table 13

	As at 31 March 2011 £'000	As at 31 March 2010 £'000
Trading Book		
Interest rate PRR	68,223	24,346
Equity PRR	27,070	1,971
Foreign currency PRR	3,548	836
Total Pillar 1 capital requirement on market risk	**98,841**	**27,153**

4.6. Operational Risk

Please refer to Section 2 Risk Management Objectives and Policies for a summary of the Firm's approach to the management of operational risk.

The Firm has followed the criteria for the approach and assessment set out in BIPRU 6.4. The Firm has adopted the standardised approach for calculating the Pillar 1 capital requirement for operational risk.

Table 14

	As at 31 March 2011 £'000	As at 31 March 2010 £'000
Operational risk	30,206	26,461
Total Pillar 1 capital requirement on operational risk	**30,206**	**26,461**

4.7. Non-Trading Book Exposures in Equities

The Firm does not have any significant equity exposures in its non-trading book. As at 31 March 2011, the Firm held a number of equity shareholdings in clearing houses for historical reasons and not for investment purposes. Management intends to hold those investments for the foreseeable future.

Those assets are classified as available for sale investments on the balance sheet as at 31 March 2011 and are held at fair value. Fair value is determined by reference to the quoted price in an active market wherever possible. Where no such active market exists, the Firm uses a valuation technique to arrive at the fair value, including the use of prices obtained in recent arms-length transactions and other valuation techniques commonly used by market participants.

Gains and losses arising from changes in fair value are included in a fair value reserve until sale when the cumulative gain or loss is transferred to the profit and loss account. The available for sale assets are reviewed for impairment if necessary.

The following table shows the Firm's total available for sale investments.

Table 15

	As at 31 March 2011 £'000	As at 31 March 2010 £'000
Available for sale investments	3,901	3,933
Total available for sale investments	**3,901**	**3,933**

The carrying amount of available for sale investments approximates to their fair value.

The total unrealised gains of £3,492k are included in the Firm's tier 2 capital at 31 March 2011 (2010-£3,520k).

4.8. Exposures to Interest Rate Risk in the Non-Trading Book

The Firm does not have non-trading book business. All non-trading book items included at the year-end represented tangible fixed assets, available for sale investments and working capital.

As part of the Firm's risk assessment process, stress and scenario testing was performed indicating that interest rate risk in its non-trading book was not material.

4.9. Credit Risk Mitigation

Please refer to Section 2 Risk Management Objectives and Policies for a summary of the Firm's approach to the management of credit risk mitigation.

The following table shows the total exposure value that is covered by collateral (after the application of supervisory hair-cuts):

Table 16

	Exposure covered by Eligible Financial Collateral	
	As at 31 March 2011	**As at 31 March 2010**
	£'000	**£'000**
Standardised Approach		
Sovereigns	33,435	3,802
Institutions	21,627,033	19,234,631
Corporates	2,249,093	234,913
Total	**23,909,561**	**19,473,346**

Credit risk mitigation is defined within policies, procedures and guidelines. It represents, in general terms, the processes by which the Firm seeks to mitigate counterparty credit risk against the Firm i.e. potential loss for the firm in the event of a counterparty default (positive mark-to-market risk).

The first level of mitigation is via the process of trading with only credit-worthy entities, controlled via the Firm's credit management processes. The Firm's principal trading counterparties are investment grade (Internal Credit Ratings), represent 98% of total credit limits extended, wherein the largest credit limits are extended to renowned and largest global financial institutions.

As a second level of mitigiation ,in the event that a counterparty is determined to be a weak member of a larger credit-worthy group, a parental guarantee will be sought. The Firm's Legal Department will negotiate the implementation of such documentation.

The third level of mitigation is via the implementation of market standard trading agreements with counterparties before a trading relationship occurs.

The negotiations and implementation of market standard trading documentation facilitates legal netting of counterparty exposure. Financing and OTC Derivative trading outside of documentation is not permitted without express approval by Credit Risk and is, in any event, a very rare occurrence.

The standard trading agreements most commonly in use between the Firm and its counterparties are the:

- GMRA – Global Master Repurchase Agreement
- GMSLA – Global Master Securities Lending Agreement
- OSLA – Overseas Securities Lending Agreement
- ISDA – International Swaps & Derivatives Association Master Agreement.

For ISDAs, specific addenda (Credit Support Annexes "CSAs ", and Net Paying Addenda "NPAs") are normally implemented. The Firm's Legal Department negotiate agreements using terms set by Credit Risk, who seek to minimise potential future exposure against the Firm, by imposing small bilateral thresholds and minimum transfer amounts.

Master Netting Agreements are not yet used within the Firm, although such capacity is recognised when the counterparty is also a UK legal entity whereupon the 'right of set off' is enshrined within UK Law.

The fourth level of mitigation is via processes conducted within our Collateral Management function whereby margining activity is conducted daily in accordance with the legal terms contained within respective trading agreements. Over 99% of the Firm's trading agreements include capacity for daily margining to be conducted; extended margining terms are rare.

The main types of *incremental* collateral taken by the firm are predominantly cash (USD, EUR), a smaller element by way of G7 Government Bonds, and a minor element in the form of highly rated Corporate Bonds. Sub-investment grade or unrated bonds

are generally avoided, and bonds with correlated risk (wrong way risk) are not acceptable forms of incremental collateral/credit mitigation.

The Firm does have limited exposure to hedge funds that are sub-investment grade (according to the Firm's Internal Credit Rating), wherein the risk here is predominantly mitigated by counterparties pledging Independent Amounts to mitigate potential future exposure – these incremental collateral pledges are also largely cash and US Treasury bonds.

Liquidity and Concentration risks within incremental collateral, are judged not to be of material concern given they are predominantly represented by G3 cash and G3 Government bonds.

By following these parameters, the Firm seeks to ensure that when trading with any counterparty it should enjoy risk mitigation and at least two methods of repayment .

5. Remuneration

5.1. Committee

The Firm has a Remuneration Committee. Authority is delegated by the Board to the Remuneration Committee to review, approve and ensure remuneration policies across the Firm are consistent with the promotion of effective risk management and do not encourage risk taking which exceeds Firm's risk appetite. The Committee is comprised of the Chairman & CEO, the President & COO and the Head of Human Resources and received contributions from other senior staff, including the Heads of Compliance and Risk divisions as required.

During the period in question, remuneration consisted of fixed pay (base salary) and variable pay (e.g. annual discretionary bonus) designed to reward performance. The annual discretionary bonus is used to reflect financial performance, as well as to reward and encourage good non-financial performance.

Bonuses may be reduced or withheld completely if the employee has failed to comply with the Firm's risk management policies, or where there has been any breach of regulatory requirements. The bonus may also be reduced to zero where there is poor performance, or where the employee is subject to a disciplinary warning, for example. The range of criteria chosen to determine discretionary bonuses may vary from year to year and from one business area to another. The actual levels of pay will be influenced by a number of factors including the Firm's profitability and strategic objectives, which may change from time to time and taking into account competitive market practice.

A number of different deferral and vesting schedules were applicable during the period in question depending on business area.

5.2. Remuneration disclosure

The disclosures under the Remuneration Code are shown below. No comparatives are given as this is the first year of disclosure.

Table 17 - Aggregate remuneration expenditure

Year to 31 March 2011			
Code Staff[2]			
Corporate Finance	**Derivatives**	**Equity**	**Fixed Income**
£'000	£'000	£'000	£'000
3,955	1,098	866	1,454

[2] Code staff, that is those staff whose remuneration is subject to disclosure under the Remuneration Code are defined as Senior Management and those whose activities materially impact the firm

Table 18- Remuneration for Financial Year

	Year to 31 March 2011		
Analysis between fixed and variable amounts	Senior Management	Code Staff Non Senior Management	Total
Number of code staff	*6*	*13*	***19***
Fixed pay:-	£'000	£'000	**£'000**
Cash based Fixed Remuneration	1,426	2,047	**3,473**
Variable Pay:-			
Cash	327	4,769	**5,096**
Shares	-	-	**-**
Deferred cash	11	626	**636**
Total variable pay	338	5,394	**5,732**
Overall Total	**1,764**	**7,441**	**9,205**

Table 19 - Analysis of sign-on and severance payments

	Year to 31 March 2011		
	Senior Management	Code Staff Non Senior Management	Total
Sign on Payments	£'000	£'000	**£'000**
Made in the year	-	800	**800**
Number of beneficiaries	-	2	**2**
Severance Payments	£	£	**£**
Made in the year	-		
Number of beneficiaries	-	-	**-**