# Daiwa Capital Markets Europe Limited

# Pillar 3 disclosures for the year ended 31 March 2010

June 2010

## Contents

# 1. Overview

***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 Company") adopted the Pillar 1 standardised approach to credit risk and operational risk with effect from 1 January 2008 and were subject to the Pillar 2 and Pillar 3 requirements from that date.

***Structure***

On January 1st 2010, Daiwa Securities Group Inc acquired Sumitomo Mitsui Financial Group's 40% minority stake in their investment banking joint venture, Daiwa Securities SMBC. Following this change, the firm has been renamed and is now globally branded as Daiwa Capital Markets. The European company name is Daiwa Capital Markets Europe Limited.

Daiwa Capital Markets Europe Limited ("the Company") 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 Company has its head office in London and operates a small branch and representative office network in Europe and the Middle East. At 31 March 2010, the Company has two wholly owned subsidiary undertakings, Close Brothers Corporate Finance and Empire Nominees Limited.

The acquisition of Close Brothers Corporate Finance Holdings Limited (CBCF) was formally completed on 1st July 2009. CBCF provides Corporate Finance and M&A advisory services in Europe. For statutory accounting purposes, it is not consolidated in the Company'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 Company is required to file consolidated returns and has been filing on this basis since September 2009. Subsequent to the year end, on 11th May 2010, CBCF was renamed Daiwa Corporate Advisory Partners Limited. Its operating companies across Europe have also been rebranded, and are now collectively known as DC Advisory Partners, reflecting their parentage and advice led business.

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

***Principal Activities***
The Company's principal activities are to provide investment banking services in Equities, Fixed Income, Derivatives and Corporate Finance Advisory, through its subsidiary group DC Advisory Partners (formerly Close Brothers Corporate Finance).

***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 2010, which is the Company's accounting reference date and financial year-end.

***Basis of Disclosures***
The Pillar 3 disclosures presented here are the consolidated view for the Company and include both the quantitative and qualitative information as required by the CRD and 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.

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 Company. Any disclosure requirements that do not apply have not been included.

***Location and Verification***
The Pillar 3 disclosures have been approved by the Company's Audit Committee and the Board of Directors of the Company and are published on the Company's website (www.uk.daiwacm.com). Disclosures will be updated at a minimum on an annual basis and made available on the website as soon as practicable.

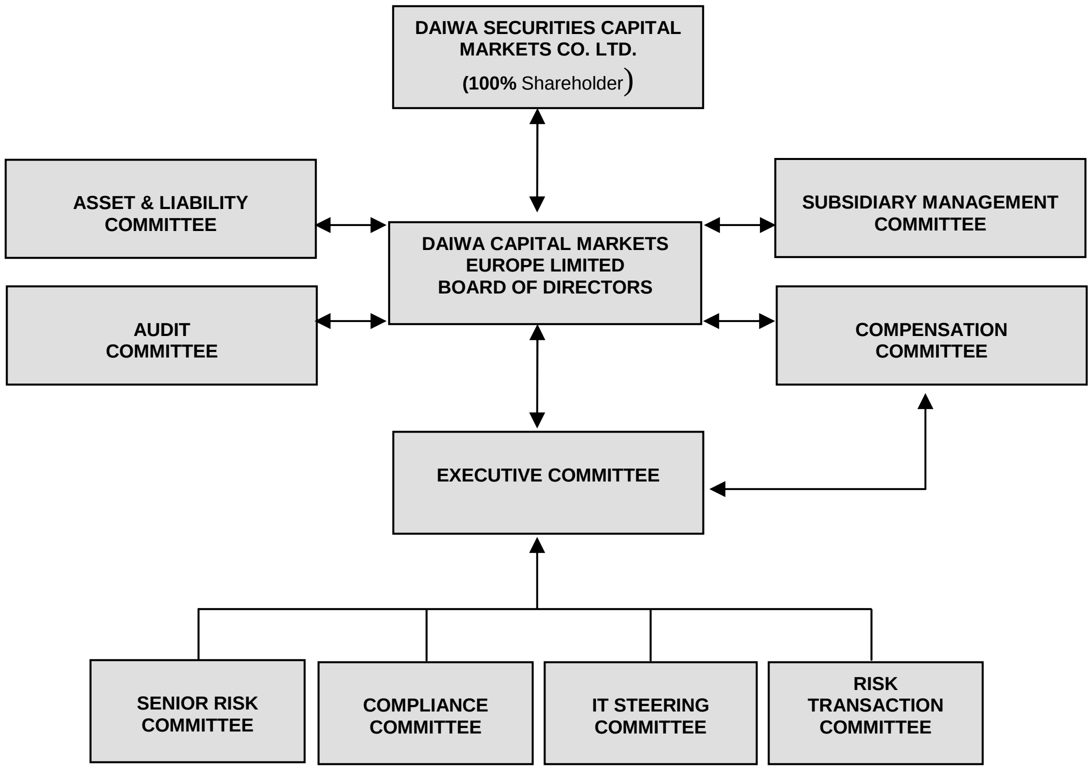
This document has not been subject to audit by the Company's external auditors.

# 2. Risk Management Objectives and Policies

## Governance and Structure

The Board of Directors of the Company (“the Board”) is ultimately responsible for the management of the Company – 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 included two Non-Executive Directors at 31st March 2010, is also responsible for determining the Company’s strategic direction and risk appetite.

The Board meets on a quarterly basis and more frequently should the need arise, however day to day management responsibilities are delegated to the Company'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 an illustration of the Company'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.




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

***Asset and Liability Committee (ALCO)***

Operating under the delegated authority from the DCME Board, ALCO’s prime role is to ensure that the Company’s financial resources are appropriately understood and managed in a manner consistent with its agreed strategy, business plans and risk appetite. Coverage includes capital management, funding, liquidity and balance sheet management.

***Audit Committee***

Responsible for monitoring and reviewing the adequacy of the Company’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.

***Subsidiary Management Committee***

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

***Compensation Committee***

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

***Executive Committee***
Provides ongoing oversight of the Company's key business and operational areas in the context of approved budgets and business plans. Specific responsibilities are delegated to the subordinate committees listed below and any responsibilities not delegated to those committees reside with the Executive Committee.

***Senior Risk Committee***
Sets corporate policy for market, credit, liquidity and operational risk and oversees the management of those risks within the Company. The committee is also responsible for overseeing the Company's capital adequacy assessment process and for the promotion of a strong and effective risk management culture throughout the Company.

*Stress Testing Focus Group* - Although not in the formal documented Committee structure, the Stress Testing Focus Group reports into the Senior 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. The Group also evaluates the capacity of the Company 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 the Company sets.

***Compliance Committee***
Provides the Company'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.

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

***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.

A formal, corporate level, organisation chart is also maintained and all changes to this are discussed and approved at Executive Committee. A set of core policies are in place and made available on the Company's intranet site, these cover key areas including compliance, risk management, administration, personnel and information security. All areas of the Company are required to maintain up-to-date procedures as necessary.

## Significant Risks
The most significant types of risks to which the Company is exposed are discussed below:

***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.

The Senior Risk Committee (SRC) is responsible for establishing the Company's overall risk appetite subject to approval by the Board and for establishing and monitoring the Company'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 SRC fulfils its responsibilities in consultation with the Parent's Risk Management Department (RMD) 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 Company's exposure to risk.

The Market Risk department is responsible for presenting a fair picture of the risk in the Company'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 Company 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 SRC.

Clear position limits (gross and net) are in place, with corresponding limits for Value at Risk (VaR). VaR is a methodology used industry-wide to estimate, based on certain assumptions, the maximum likely loss, in market value terms, for existing risk positions. VaR is calculated at 99% confidence, 1 day holding period. The model used is provided by an external vendor, with risk figures checked regularly for reasonableness by the Market Risk department, using such techniques 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 SRC.

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. These limits include basis point value (gross and net) measuring the impact on market values of a one basis point shift in the yield curve and of the impact of the same change in bond spreads: - by rating band; issuer; country and for credit spreads. Additional limits are set such as gamma and vega limits for fixed income derivatives.

***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 Company as they become due.

The SRC sets credit policy and oversees the control of credit risk. It is supported by the Counterparty Risk department of the Company's Risk Management division.

Formal Credit approval is required for all potential counterparties as part of the Company'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 CRMD of the Parent. The counterparty base is predominantly investment grade banks, financial institutions, fund managers including hedge funds and large corporates.

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 Company uses an internally developed risk rating system as well as external credit rating assessment institutions (ECAI) (where available) to perform counterparty risk classification. 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 SRC is appraised of the Company's credit risk profile/concentration according to risk rating, geographic location and industry type. A process is in place for credit reserving, however these are not utilised at the moment as the type of business conducted at this point does not require it. This is under constant review as the business changes.

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 Company are cash, government bonds, supranational bonds and listed equities from primary exchanges globally. Lower quality 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 Company policy and any breach of limits, policy or procedures is recorded and reported immediately to senior management and reported in detail at the monthly SRC.

***Liquidity Risk***

Liquidity risk is the risk that the Company, 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 Company's liquidity framework which is reviewed at least annually to ensure its continued relevance.

In considering Company's business plans, the Board will review the Company's projected funding and liquidity position plan over a three year horizon, to ensure that the Company 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 Company'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 Company. The Company's funding sources comprise capital and reserves, Parental support and secured funding from a range of professional counterparts. In addition, the Company has access to a range of wholesale uncommitted lines. These are accessed periodically as part of the Company'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 Company's liquidity buffer of cash deposits and unencumbered government securities.

The cornerstone of the Company'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 Company'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 Company 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 Company'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 Company 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.

***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 SRC, are in place for the key risk mitigation and monitoring activities within the Company.

The Company 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 Company maintains comprehensive business continuity plans together with appropriate information security policies and standards. The Company 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 Company. 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 Company's key operational risks, monitoring activities and risk incidents experienced during the month to the SRC.

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. Output from the R&CSAs is fed into the Internal Capital Adequacy Assessment Process. 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 Company'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 Company.

***Other Risks***

It is the Company's policy to have low open foreign exchange (FX) risk. A process is in place to review outstanding positions to ensure that there is no material exposure at each month-end.

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

# 3. Capital Resources

The table below details the composition of the Company's consolidated regulatory capital as at 31 March 2010.

| | Notes | As at 31.3.2010 £'000 |
|---|---|---|
| **Tier 1 capital** | | |
| Called up share capital | | 207,121 |
| Profit and loss account and other reserves | | 124,979 |
| Less total deductions from tier 1 capital | **1** | (57,171) |
| **Total tier 1 capital** | **2** | **274,929** |
| **Tier 2 capital** | | |
| Revaluation reserve | | 3,520 |
| Deductions | | - |
| **Total tier 2 capital** | **3** | **3,520** |
| Deductions from total tier 1 and tier 2 capital | | - |
| **Total capital resources** | | **278,449** |

Notes

1. Goodwill on acquisition of Close Brothers Corporate Finance Holdings Limited.
2. Tier 1 capital consists of share capital and reserves, excluding revaluation reserves. The Company has no innovative Tier 1 instruments.
3. Tier 2 capital consists of reserves representing unrealised gains on available for sale assets.

The Company's capital resources are primarily Tier 1 capital. At 31 March 2010 and during the year, the Company 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. Capital Adequacy

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

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

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

| | As at 31.3.2010<br>£'000 |
|---|---|
| **Minimum capital requirements** | |
| *Trading book* | |
| Interest rate PRR | 24,346 |
| Equity PRR | 1,971 |
| Foreign currency PRR | 836 |
| **Market risk requirement** | 27,153 |
| *Trading book* | |
| Counterparty risk capital component | 23,366 |
| Concentration risk capital component | 4,554 |
| Credit Risk Capital Component | 5,690 |
| **Credit risk requirement** | 33,610 |
| Operational Risk Capital Requirement | 26,461 |
| **Total Pillar 1 capital requirement** | **87,224** |

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

| | Counterparty Risk Capital Component As at 31.3.2010 £'000 | Credit Risk Capital Component As at 31.3.2010 £'000 |
|---|---|---|
| **Standardised Approach** | | |
| Institutions | 20,009 | 1,475 |
| Corporates | 2,405 | - |
| Other Items | 952 | 4,215 |
| **Total** | **23,366** | **5,690** |

# 5. Counterparty Credit Risk

The following table details the derivative contracts as at 31 March 2010:

| | Gross Positive Fair Value of contracts | Total Netting Benefits | Netted Current Credit Exposure (A) | Collateral Held * (B) | Net Derivatives Credit Exposure (C) = (A)+(B) |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'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 2010, there were no credit derivative hedges held by the Company. All credit derivatives are held in the Company'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 2010:

| | Protection Sold | Protection Purchased | Total |
|---|---|---|---|
| | £'000 | £'000 | £'000 |
| Trading Book - Credit default swaps | 3,294 | 3,294 | 6,588 |
| **Total** | **3,294** | **3,294** | **6,588** |

# 6. Credit Risk and Dilution Risk

**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 Company 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 2010, the Company did not have any impaired assets and no provision was made.

**Analysis of credit risk exposures**

The gross credit risk exposure (before credit risk mitigation) and the average for the year ended 31 March 2010 are summarised as follows:

| | Average Gross Credit Exposures * £'000 | Total Gross Credit Exposures £'000 |
|---|---|---|
| Sovereigns | 13,879 | 22,187 |
| Institutions | 15,837,555 | 19,958,672 |
| Corporates | 229,354 | 243,029 |
| Other | 54,534 | 64,570 |
| **Total** | **16,135,322** | **20,288,458** |

* Average gross credit exposure will be based on data from the four previous quarter-ends.

The geographical distribution of these exposures at 31 March 2010 is as follows:

| | UK £'000 | Japan £'000 | Europe £'000 | North America £'000 | Rest of the World £'000 | Total £'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** |

The distribution of exposures by industry and exposure class at 31 March 2010 is as follows:

| | Sovereigns | Institutions | Corporates | Other Items | Total |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'000 |
| Central Government/Central Banks | 22,187 | - | - | - | 22,187 |
| Banks | - | 12,714,680 | - | - | 12,714,680 |
| Financials | - | 6,082,245 | - | - | 6,082,245 |
| Clearing houses | - | 1,161,747 | - | - | 1,161,747 |
| Corporates | - | - | 243,029 | - | 243,029 |
| Other | - | - | - | 64,570 | 64,570 |
| **Total** | **22,187** | **19,958,672** | **243,029** | **64,570** | **20,288,458** |

The residual maturity breakdown of exposures by exposure class as at 31 March 2010 is as follows:

| | 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** |

# 7. Credit Risk Standardised Approach

The Company uses Moody's 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 2010:

| Credit Quality Step | Sovereigns | Institutions | Corporates | Other | Total Exposures |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'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 2010:

| Credit Quality Step | Sovereigns | Institutions | Corporates | Other | Total Exposures after Credit Risk Mitigation |
|---|---|---|---|---|---|
| | £'000 | £'000 | £'000 | £'000 | £'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** |

## 8. Market Risk

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

The following table shows the Company's Pillar 1 capital requirement on market risk as at 31 March 2010.

| | **As at 31.3.2010** **£'000** |
|---|---|
| *Trading Book* | |
| Interest rate PRR | 24,346 |
| Equity PRR | 1,971 |
| Foreign currency PRR | 836 |
| **Total Pillar 1 capital requirement on market risk** | **27,153** |

## 9. Operational Risk

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

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

| | **As at 31.3.2010** **£'000** |
|---|---|
| Operational risk | 26,461 |
| **Total Pillar 1 capital requirement on operational risk** | **26,461** |

## 10. Non-Trading Book Exposures in Equities

The Company does not have any significant equity exposures in its non-trading book. As at 31 March 2010, the Company 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 2010 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 Company 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 Company's total available for sale investments as at 31 March 2010.

| | **As at 31.3.2010** **£'000** |
|---|---|
| Available for sale investments | 3,933 |
| **Total available for sale investments** | **3,933** |

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

The total unrealised gains of £3,519,623 are included in the Company's tier 2 capital at 31 March 2010.

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

The Company 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 Company's risk assessment process, stress and scenario testing was performed indicating that interest rate risk in its non-trading book was not material.

## 12. Credit Risk Mitigation

Please refer to Section 2 Risk Management Objectives and Policies for a summary of the Company'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):

| | **Exposure covered by Eligible Financial Collateral As at 31.3.2010 £'000** |
|---|---|
| **Standardised Approach** | |
| Sovereigns | 3,802 |
| Institutions | 19,234,631 |
| Corporates | 234,913 |
| **Total** | **19,473,346** |