

Daiwa Capital Markets Europe Limited

Pillar 3 disclosures for the year ended 31 March 2014

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1. Overview

1.1. Background

The European Union (EU) Capital Requirement Regulation (CRR) and Capital Requirements Directive (CRD) (collectively known as CRD IV) implements the revised Basel capital adequacy framework (Basel III) and applies it to all investment firms, building societies and banks. The CRD IV package was formally adopted by the EU on 26 June 2013 and became effective in the UK on 1 January 2014.

CRD IV is a continuation of the now repealed CRD III which introduced the concepts of minimum capital requirements (Pillar 1) and supervisory review processes (Pillar 2) in the determination of those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 International Holdings Inc. (“the Parent”), which is headquartered in Japan and is a wholly owned subsidiary of Daiwa Securities Group Inc (“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 2014, the Firm has one active wholly owned subsidiary undertaking, Daiwa Corporate Advisory Holdings Limited.

Daiwa Corporate Advisory Holdings Limited (formerly Daiwa Corporate Advisory Partners 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 Group Inc. (DSGI). 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.

1.4. Scope

Daiwa Capital Markets Europe Limited is regulated by The Financial Conduct Authority (“the FCA”) in the UK. These Pillar 3 disclosures have been prepared as at 31 March 2014, 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 Part Eight of the Capital Requirement Regulation from CRD IV which replaced Chapter 11 of the Prudential Sourcebook for Banks, Building Societies and Investment Firms (BIPRU) section of the FCA handbook.

Daiwa Capital Markets Europe Limited is a “Tier 2” firm (according to the definition within FCA 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 fewer disclosures than a “Tier 1” firm with regard to remuneration in the rules set out in Part Eight of the Capital Requirement Regulation from CRD IV.

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 Risk Asset and Liability Committee, (“RALCO”) 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](#)¹ as soon as practicable.

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

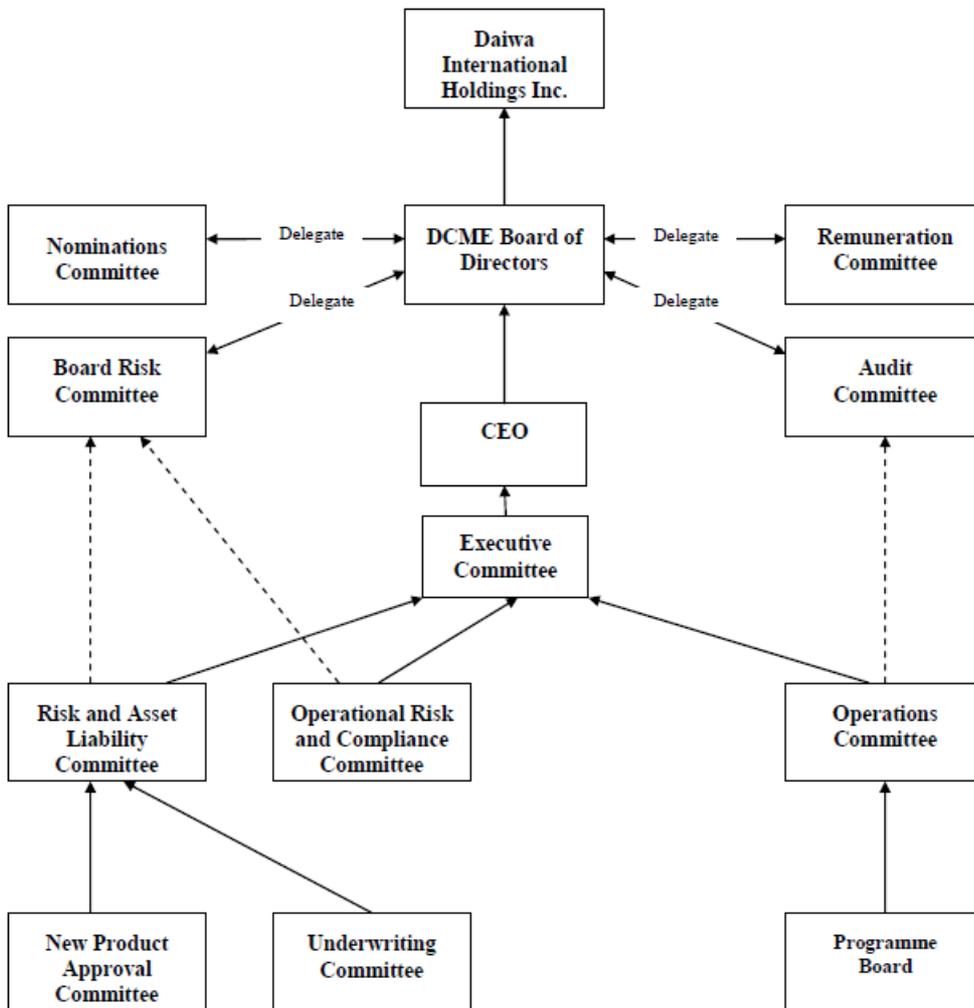
¹ <http://www.uk.daiwacm.com/about-us/corporate-governance-and-regulatory>

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 Chief Executive Officer. To fulfil its responsibilities the Board is supported by a number of committees including a Board Risk Committee which has been established to focus specifically on risk management issues. The formal committee structure which is illustrated below is maintained centrally and any changes to these are approved by the Board.



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

2.2. Board Committees

2.2.1. Board Risk Committee

The Board Risk Committee, chaired by an independent non-executive director and composed of non-executives, is directly accountable to the Board and has delegated responsibility for oversight of high-level risk management, including:

- Reviewing in detail the risk appetite statement prepared by executive management;
- Recommending DCME's risk appetite and future risk strategy including capital and liquidity management strategy to the Board;
- Approving policy and key methodologies in relation to capital, funding, liquidity, credit, market, operational and other material risks;
- Monitoring the firm's exposure to material risks.

2.2.2. Audit Committee

The Audit Committee, chaired by an Independent non-executive director, is responsible for monitoring and reviewing the adequacy of the Firm's financial controls, internal controls and accounting policies.

The Audit Committee monitors and reviews the adequacy of DCME's financial, risk management and other internal control systems; it monitors and reviews DCME's accounting policies, the integrity of its financial statements, its external reporting responsibilities, and oversees the relationship with external auditors.

2.2.3. Remuneration Committee

The Remuneration Committee is responsible for reviewing and approving the firm's remuneration principles and approach, ensuring such principles are consistent with the promotion of effective risk management and discourages excessive risk taking.

2.3. Executive Committees

2.3.1. Executive Committee

The Executive Committee provides on-going oversight of the Firm's key business and operational areas in the context of approved budgets and business plans. The Head of Risk Management Division is a member of the Executive Committee and ensures that risk management perspectives and requirements are reflected in the firm's business activities. The Executive Committee also receives reports and information from the Risk and Asset Liability Committee and Operational Risk & Compliance Committee as appropriate.

2.3.2. Risk, Asset and Liability Committee (RALCO)

RALCO manages DCME's structural and business risk framework for the assessment and allocation of financial resources in a way that is consistent with the agreed strategy, business plans and risk appetite of the firm. RALCO oversees the framework for the management and control of market, credit and liquidity risk for DCME.

The responsibility of RALCO can be analysed into the following main components:

- Market Risk
- Credit Risk
- Capital
- Funding & Liquidity, and
- Balance Sheet Management.

The New Product Committee and Underwriting Committee report into RALCO.

2.3.3. Operational Risk & Compliance Committee (ORCC)

The ORCC, which meets on a bi-monthly basis, is responsible for:

- Overseeing the establishment of a sound operational risk management framework within DCME and monitoring the operational risk profile of the firm;
- Providing oversight of DCME's regulatory obligations and the Compliance framework put in place to help ensure they are met.

The ORCC monitors the firm's operational risk profile against the defined risk appetite, and compliance with regulatory requirements. Additionally, the ORCC reviews key operational risk and compliance policies and methodologies and recommends to the Board Risk Committee for approval. The ORCC reports on matters within its scope of responsibility to the Executive Committee and onwards to the Board Risk Committee.

2.3.4. Underwriting Committee

Responsible for assessing proposed transactions from a market, credit and reputational risk perspective.

2.3.5. New Product Committee

Responsible for ensuring there is a clearly defined approval process for the evaluation of new products and businesses from an operational perspective. The Committee ensures that new products are only approved after full consideration of the risks involved and the establishment of an adequate control environment.

2.3.6. Programme Board

The Programme Board oversees significant developments and implementations to ensure that they are carried out in accordance with business plans, IT strategy and policies and conducted to an appropriate standard.

2.4. Governance arrangements (Articles 88-96 of the Capital Requirements Directive IV)

1. The management body of DCME is the Board of Directors (the "Board"). The Board:

- (a) has the overall responsibility for DCME and approves and oversees the implementation of DCME's strategic objectives, risk strategy and governance;
- (b) ensures the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards;
- (c) oversees the process of disclosure and communications; and
- (d) is responsible for providing effective oversight of senior management;

2. The Board has established a Nominations Committee comprised of non-executive directors which has the responsibility to:

- (a) identify potential candidates to fill Board vacancies, evaluate the balance of knowledge, skills, diversity and experience of the Board and prepare a description of the roles and capabilities for a particular appointment, and assess the time commitment expected;
- (b) decide on a target for the representation of any underrepresented gender on the Board and prepare a policy on how to increase the number of any such underrepresented gender;
- (c) assess the structure, size, composition and performance of the Board;
- (d) assess the knowledge, skills and experience of individual members of the Board and of the management body collectively;
- (e) review the policy of the Board for selection and appointment of senior management.

2.5. Management body

Members of the Board of Directors are all registered with the appropriate regulatory authorities. DCME has systems in place to monitor the good repute, knowledge, skills and experience of the directors. DCME monitors compliance with the requirements of Article 91 of the Capital Requirements directive.

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.

Risk is actively managed or hedged by the business within the policies and procedures set by the Risk Management Division and within the trading book policy statement. 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 daily to ensure that both individual trader exposures and overall exposures are within the pre-agreed limits framework.

Market risk limits are set top down with overall Group level limits agreed between the firm and parent. DCME's own market risk appetite is set by the Board in conjunction with BRC and RALCO to define a set of DCME Regional Market Risk limits. These limits are then allocated among the individual divisions together with a set of locally managed business specific limits.

Internal reports that identify daily trader and business limit utilisation levels are reviewed and distributed to front office staff and senior management.

Breaches of the pre-agreed Group limits are reported immediately to the Parent and any extensions agreed upon are ratified where appropriate by the Risk Asset Liability Committee (RALCO). Breaches of DCME Regional level limits are reported to RALCO only and require approval from the head of risk and head of the relevant business unit. Breaches of business level specific limits are reported monthly to RALCO and require the same approval as per the DCME Regional limits.

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 securities. Should the security not be rated, an external issuer rating is used and in the absence of any external rating an internal issuer rating would be applied.

Option positions are adjusted into their delta equivalent positions and gamma and vega limits are applied. Concentrated holdings and aged inventories are monitored to check balance sheet utilisation. 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 two year observation period. The calculations are made using an internal model and are checked regularly for reasonableness by the Market Risk department, using techniques such as back testing 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 RALCO.

The VaR analysis for the year was as follows:

	Year to Mar 2014	Year to Mar 2013
	£'000	£'000
Year-end	2,696	2,794
Average	2,744	2,317
Maximum	3,594	3,070
Minimum	1,910	1,813

Figure 1

The VaR numbers shown for 2014 incorporate full diversification offsets between businesses.

The VaR figures have continued to grow for Fixed Income, especially the first half of the year, whereas the Convertible Bonds VaR figures have oscillated around the £ 1.25m mark, the VaR for the Equities Division remains negligible.

The increase in Fixed Income came predominantly from the Government Bond Trading area, increasing our footprint in Australia (now trading government and semi-government bonds as well) and on the back of increased risk taking in European and US government bonds. The Secondary Credit Trading business, which mainly holds positions in high rated corporate, supranational and agency paper reduced its risk profile especially during the last months of the calendar year.

Any increase in Convertible Bonds originated mainly from the Japan desk, where market liquidity continued to grow. Although the European Market Making business was closed during the summer of 2013, the business started a new principal trading initiative, slowly building up its risk exposures across Japan, Asia-ex and Europe. Overall levels of risk have remained relatively stable throughout the year.

DCME adopts standardised approaches for calculating its regulatory capital requirements in relation to market risk accordance with CRD IV, Part Three, Title IV (Own funds requirements for Market Risk).

3.2. Credit Risk

Credit risk is defined as the potential financial loss arising from a customer or counterparty failing to meet its financial obligations to the Firm as they become due. Credit Risk includes Counterparty Risk and Issuer Risk, along with Reputational, Litigation and other risks.

Counterparty Risk primarily arises on over the counter (OTC) transactions, including derivatives and securities financing transactions, and is the risk that a counterparty may default before completing the satisfactory settlement of the transaction. Counterparty Risk is also present in the form of nostro balances and as cost of replacement in cash securities transactions where the firm has intermediated as simultaneous principal. Credit Risk is also present as Issuer Risk, where an event of default (or similar) creates a loss in the Firm's inventory through the issuer's inability to repay its obligation.

RALCO sets credit policy and oversees the control of credit risk. It is supported by the Credit Risk Department of the Firm's Risk Division. Counterparty exposure is managed by counterparty rating, limit setting (notional, credit, settlement and issuer, each applied where necessary), exposure monitoring and exception reporting.

Formal Credit approval is required for all potential counterparties as part of the Firm's account opening process. Using an internally developed rating system, internal ratings ['ICR'] are then key in formalising an appropriate limit structure. ICRs are determined through a combination of quantitative and qualitative factors, trend analysis, global peer comparisons, scorecard-based factors and publicly available information and accounts, to ensure overall consistency with external ratings provided by ECAI's (External Credit Assessment Institutions).

Credit Limits are set at individual counterparty (legal entity) level and for groups of connected counterparties; Per Issuer Limits are set similarly. The overall limit profile approved for counterparties and groups of connected counterparties takes due consideration of constraints imposed on limits to ensure the Firm's adherence to the FCA's Large Exposure Rule. Credit requirements beyond Risk Division approval authority must be approved by senior management and/or the Risk Management Department of the Parent.

The counterparty base is predominantly investment grade banks, financial institutions, fund managers, funds and large corporates. At 31st March 2014 credit limits extended to investment grade counterparties represented 92% (2013: 94%) of total credit limits granted and credit exposure to all sub-investment grade counterparties was lower at less than 0.2% (2013: 0.5%) of the total.

The credit limit framework is calculated recognising principal risk, settlement risk and pre-settlement risk factors. Exposures are 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 netting methodology applied only when legally enforceable within controlling documentation. Exposure to groups of connected entities is managed similarly.

The use of market standard trading and collateralisation documentation is employed whenever practicable. The collateral management and margining of counterparty exposure is actively managed on a daily basis, and exposures revalued using independent price sources. Quality, concentration risk, correlated ('wrong way') risk, illiquidity, pricing risk and haircuts are all considered when determining acceptable collateral. The vast majority of collateral accepted by the Firm is government and supranational bonds, and cash. Lower quality collateral is accepted when warranted by the counterparty quality and appropriate haircuts employed.

All counterparty ratings and limits are reviewed periodically and ad hoc upon financial or business developments. Credit limits may be reduced or cancelled, particularly in the case of dormant accounts. Reinstatement of a previously cancelled credit facility requires formal re-approval of the counterparty.

The basis upon which credit is granted is set out in the Firm's policy manual and any breach of limits, policy or procedure is recorded and reported immediately to senior management and Tokyo Risk Division, and highlighted again at the monthly RALCO when appropriate.

RALCO and management are further apprised of the Firm's Credit Risk profile/composition according to risk rating, geographic location and industry type, covering both aspects of exposure and limits granted.

No counterparty losses were suffered during the year.

DCME adopts standardised approaches for calculating its regulatory capital requirements in relation to counterparty and credit risk.

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 Risk Asset Liability Committee (RALCO). This committee is responsible for on-going development of all components of the liquidity framework including providing feedback to the Board to allow it to discharge its obligations.

RALCO 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 uncommitted lines 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.

The Regulatory Department undertake daily monitoring of the Firm's funding and liquidity positions. Treasury is responsible for operational liquidity management – raising financing for the Firm in both Secured and Unsecured markets. RALCO 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 a Liquid Asset Buffer (LAB) portfolio comprising high quality unencumbered bonds issued by core European sovereigns, multilateral development banks, Japanese Government Bonds and the US Government. The composition of the LAB portfolio reflects the currency mix of the Firm's underlying balance sheet.

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 behavioural assumptions used are subject to a sequence of executive challenges, including agreement by RALCO 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 one year under a severe market wide liquidity

stress and for all periods out to one month (without parental support) under a severe combination liquidity stress (market wide and name specific scenario). 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, the impact of multiple downgrades to the parent's credit rating 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.

From a regulatory viewpoint, Daiwa Europe is governed by the Financial Conduct Authority's (FCA's) prudential liquidity regime in the UK. The FCA requires the company to undertake an annual assessment into the adequacy of its liquidity resources and liquidity risk management framework. This self - assessment process is termed an Individual Liquidity Adequacy Assessment (ILAA) and it is subject to a Supervisory Liquidity Review Process (SLRP), conducted by the FCA. The SLRP leads to Individual Liquidity Guidance (ILG) being conferred on the company that requires the company to adhere to minimum quantitative standards on liquidity. The company holds a significant liquid asset buffer which ensures that it adheres to this minimum standard at all times.

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. The definition includes legal risk, but excludes reputational and strategic risk.

Operational risks within DCME are limited by means of a network of controls, procedures, reports and responsibilities. Within the Firm, each division and department has responsibility for its own operational risks and establishes appropriate resources, processes and controls for limiting such risks. The focus is primarily on the early recognition, reduction and management of risks as well as the measurement and monitoring of risks.

An independent Operational Risk Management (ORM) function within the Risk Management division is responsible for establishing, and ensuring effective maintenance of, the framework within which operational risk is managed and for its consistent application across the Firm.

DCME's operational risk framework incorporates the following group-wide processes for the identification, measurement, monitoring, mitigation and reporting of operational risks:

- Monthly monitoring and reporting of key risk indicators (KRI) which are established to monitor the firm's key operational risks and identify potential issues at an early stage;
- Performance of risk and control self-assessments for assessing possible effects of potential risk sources and the effectiveness of existing controls for reducing risks. Where significant risks are identified, mitigation plans are defined and implementation monitored by ORM;
- Capturing, assessing and reporting of operational risk incidents, including loss events. This procedure helps to identify where process improvements may be required to reduce the likelihood of a recurrence;
- Focussed risk assessments of specific functions or processes in conjunction with the affected specialist units;

- Co-ordination of the new product approval process, to ensure identification of risks which may be associated with new products or business activities and the establishment of appropriate mitigating controls.

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

ORM presents a summary of the firm's key operational risks, monitoring activities and operational risk incidents to the Operational Risk & Compliance Committee. ORM also provides regular reports to the Board Risk Committee and Audit Committee.

DCME adopts the standardised approach for calculating its regulatory capital requirements in relation to operational risk in accordance with Basel 2.

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.

4. Capital Resources

The table below details the composition of the Firm's consolidated regulatory capital as at 31 March 2014.

	Notes	31 March 2014 £'000	31 March 2013 £'000
Common Equity Tier 1 capital			
Called up share capital		732,121	732,121
Profit and loss account and other reserves		(96,793)	(74,405)
Less total deductions from tier 1 capital	1	(26,805)	(39,248)
Revaluation reserve		215	4,639
Total Common Equity Tier 1 capital	2	608,738	623,107
Total capital resources		608,738	623,107

Figure 2

Notes

1. Deductions comprise: Goodwill on acquisition of Close Brothers Corporate Finance Holdings Limited, and of the convertibles business of KBC Financial Products £25,524k and prudential valuation adjustments £1,281k
2. Common Equity Tier 1 capital consists of share capital and reserves, including revaluation reserves. The Firm has no innovative Tier 1 instruments.

The Firm's capital resources are exclusively Common Equity Tier 1 capital. At 31 March 2014 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 FCA 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 Risk Asset and Liability Committee and Board 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:

	31 March 2014 £'000	31 March 2013 £'000
Minimum capital requirements		
<i>Trading book -</i>		
Interest rate PRR	56,509	54,595
Equity PRR	8,517	18,542
Option PRR	0	11,641
CIU PRR	0	53
Foreign currency PRR	1,135	1,263
Market risk requirement	66,161	86,094
<i>Trading book</i>		
Counterparty risk capital component	14,016	16,437
Credit Risk Capital Component	6,156	5,520
Concentration risk capital component	0	1,091
Credit Valuation Adjustment	2,773	
Default Fund Contribution capital charge	39	
Credit risk requirement	22,984	23,048
Operational Risk Capital Requirement – Standardised Approach	24,956	30,439
Total Pillar 1 capital requirement	114,101	139,581
Total Tier 1 Capital	608,738	
Total risk weighted assets	1,426,278	
Tier 1 capital ratio	42.7%	

Figure 3

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):

As at 31 March 2014	Counterparty Risk Capital Component £'000	Credit Risk Capital Component £'000
Standardised Approach		
Central Governments and Central Banks	1,118	22
Institutions	6,398	938
Corporates	6,500	5,196
Other Items	0	0
Total	14,016	6,156
As at 31 March 2013:		
	Counterparty Risk Capital Component £'000	Credit Risk Capital Component £'000
Standardised Approach		
Central Governments and Central Banks	139	1
Institutions	10,526	1,440
Corporates	5,544	1,144
Other Items	228	2,935
Total	16,437	5,520

Figure 4

DCME adopts standardised approaches for calculating its regulatory capital requirements in relation to counterparty and credit risk.

The following table details the OTC derivative contracts

As at 31 March 2014

	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	355,270	312,236	192,586	64,192	128,394
Total	355,270	312,236	192,586	64,192	128,394

As at 31 March 2013:

	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	629,674	660,972	265,497	131,157	134,339
Total	629,674	660,972	265,497	131,157	134,339

Figure 5

All exposure values were calculated using the CCR mark to market method.

4.3. Credit derivative transactions

As at 31 March 2014, 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 2014:

As at 31 March 2014	Protection Sold £'000	Protection Purchased £'000	Total £'000
Trading Book - Credit default swaps			
Specifically hedging	-	7,889	7,889
Other	-	128,251	128,251
Total	-	136,140	136,140

As at 31 March 2013	Protection Sold £'000	Protection Purchased £'000	Total £'000
Trading Book - Credit default swaps		-	
Specifically hedging	-	6,585	6,585
Other	6,585	52,228	58,813
Total	6,585	58,813	65,398

Figure 6

4.4. Credit Risk and Dilution Risk

4.4.1. 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 assets 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 2014, the Firm has an impaired a financial asset (loan and receivable) as the result of an impairment review of its non-financial asset (investment in subsidiary undertakings). The intercompany loan with the Firm's subsidiary was impaired by £27.720m as at 31 March 2014 (31 March 2013 £19.741m).

Analysis of credit risk exposures

The gross credit risk exposure (before credit risk mitigation) and the average for the year ended 31 March 2014 are summarised as follows

	Year Ended 31 March 2014 Average Gross Credit Exposures ² £'000	As at 31 March 2014 Total Gross Credit Exposures £'000	Year Ended 31 March 2013 Average Gross Credit Exposures* £'000	As at 31 March 2013 Total Gross Credit Exposures £'000
Sovereigns	788,722	634,569	85,739	307,983
Institutions	12,726,424	11,217,848	12,087,048	12,857,376
Corporates	1,411,567	1,772,475	857,151	1,412,411
Other	624	1,485	32,045	39,539
Total	14,927,337	13,626,377	13,061,983	14,617,309

Figure 7

The geographical distribution of these exposures is as follows

As at 31 March 2014

	UK £'000	Japan £'000	Europe £'000	North America £'000	Rest of the World £'000	Total £'000
Sovereigns	2,769	6,767	623,413	1,244	377	634,569
Institutions	4,501,898	3,157,797	1,475,346	1,544,020	538,786	11,217,848
Corporates	59,953	4,682	365	1,705,435	2,040	1,772,475
Other	1,485	-	-	-	-	1,485
Total	4,566,105	3,169,246	2,099,124	3,250,699	541,203	13,626,377

As at 31 March 2013

	UK £'000	Japan £'000	Europe £'000	North America £'000	Rest of the World £'000	Total £'000
Sovereigns	12,521	-	295,413	-	49	307,983
Institutions	4,292,601	4,630,775	1,761,014	1,357,950	815,036	12,857,376
Corporates	63,503	8,561	6,321	1,333,963	63	1,412,411
Other	39,539	-	-	-	-	39,539
Total	4,408,164	4,639,336	2,062,748	2,691,913	815,148	14,617,309

Figure 8

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

² Average gross credit exposure is based on data from the four previous quarter-ends.

As at 31 March 2014

	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total £'000
Central Government/Central Banks	634,569	-	-	-	634,569
Banks		5,769,644		1,485	5,771,129
Financials		5,488,204		-	5,448,204
Corporates	-		1,722,475	-	1,722,475
Other	-	-	-	-	0
Total	634,569	11,217,848	1,772,938	1,485	13,626,377

As at 31 March 2013

	Sovereigns £'000	Institutions £'000	Corporates £'000	Other £'000	Total £'000
Central Government/Central Banks	307,983	-	-	-	307,983
Banks		7,857,306		-	7,857,306
Financials		5,000,070		-	5,000,070
Corporates	-		1,412,411	-	1,402,806
Other	-	-	-	39,539	39,539
Total	307,983	12,857,376	1,412,411	39,539	14,617,309

Figure 9

The distribution of exposures by residual maturity is as follows:

As at 31 March 2014

	One year or less £'000	Over one year not exceeding five years £'000	Over five years £'000	Total £'000
Sovereigns	608,832	15,726	10,011	634,569
Institutions	11,029,145	102,647	86,057	11,217,848
Corporates	1,772,367	67	41	1,772,475
Other	1,485	-	-	1,485
Total	13,411,828	118,440	96,109	13,626,377

As at 31 March 2013

	One year or less £'000	Over one year not exceeding five years £'000	Over five years £'000	Total £'000
Sovereigns	298,047	5,375	4,561	307,983
Institutions	12,329,442	361,879	166,055	12,857,376
Corporates	1,401,285	11,126	-	1,412,411
Other	39,539	-	-	39,539
Total	14,068,313	378,380	170,616	14,617,309

Figure 10

4.5. Credit Risk - Standardised Approach

The Firm 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
- 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. The credit quality steps are those used by the FCA and reflect the credit quality of exposures. The steps are determined by factors such as the type of exposure, credit rating and maturity. The highest credit quality is 1 and the poorest is 6.

As at 31 March 2014

	Sovereigns	Institutions	Corporates	Other	Total Exposures
Credit Quality Step	£'000	£'000	£'000	£'000	£'000
1	384,689	4,577,264	430	1,485	4,963,868
2	-	2,986,140	117	-	2,986,257
3	249,519	2,648,907	-	-	2,898,426
4	103	8,696	-	-	8,799
5	-	-	125	-	125
6	-	-	-	-	-
Unrated	258	996,841	1,771,803	-	2,768,902
Total	634,569	11,217,848	1,772,475	1,485	13,626,377

As at 31 March 2013

	Sovereigns	Institutions	Corporates	Other	Total Exposures
Credit Quality Step	£'000	£'000	£'000	£'000	£'000
1	274,684	1,359,772	49,566	-	1,684,022
2	-	6,160,272	38,350	-	6,198,622
3	12,704	3,985,053	142	-	3,997,899
4	20,586	432	-	-	21,018
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	9	1,351,847	1,324,353	39,539	2,715,748
Total	307,983	12,857,376	1,412,411	39,539	14,617,309

Figure 11

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

As at 31 March 2014					
	Sovereigns	Institutions	Corporates	Other	Total Exposures after Credit Risk Mitigation
Credit Quality Step	£'000	£'000	£'000	£'000	£'000
1	27,698	180,940	430	1,485	210,553
2	-	160,069	117	-	160,186
3	27,848	84,081	-	-	111,929
4	103	-	-	-	103
5	-	-	125	-	125
6	-	-	-	-	-
Unrated	258	90,255	132,544	-	223,056
Total	55,907	515,346	133,216	1,485	705,953

As at 31 March 2013					
	Sovereigns	Institutions	Corporates	Other	Total Exposures after Credit Risk Mitigation
Credit Quality Step	£'000	£'000	£'000	£'000	£'000
1	17,870	27,187	3,625	-	48,682
2	-	329,481	2,691	-	332,172
3	3,248	179,276	142	-	182,666
4	-	432	-	-	432
5	-	-	-	-	-
6	-	-	-	-	-
Unrated	9	62,442	81,380	39,539	183,370
Total	21,127	598,818	87,838	39,539	747,322

Figure 12

4.6. 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.

	As at 31 March 2014 £'000	As at 31 March 2013 £'000
<i>Trading Book</i>		
Interest rate PRR	56,509	54,595
Equity PRR	8,517	18,542
Option PRR	0	11,641
Collective Investment Undertakings PRR	0	53
Foreign currency PRR	1,135	1,263
Total Pillar 1 capital requirement for market risk	66,161	86,094

Figure 13

DCME adopts standardised approaches for calculating its regulatory capital requirements in relation to market risk in accordance with CRD IV, Part Three, Title IV (Own funds requirements for Market Risk).

4.7. 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 CRD IV Part Three, Title II (Own funds requirements for operational risk). The Firm has adopted the standardised approach for calculating the Pillar 1 capital requirement for operational risk.

	As at 31 March 2014 £'000	As at 31 March 2013 £'000
Operational risk	24,956	30,439
Total Pillar 1 capital requirement for operational risk	24,956	30,439

Figure 14

4.8. Non-Trading Book Exposures in Equities

The Firm does not have any significant equity exposures in its non-trading book. As at 31 March 2014, 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 2014 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.

	As at 31 March 2014 £'000	As at 31 March 2013 £'000
Available for sale investments	885	5,344
Total available for sale investments	885	5,344

Figure 15

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

4.9. 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.

4.10. 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):

	Exposure covered by Eligible Financial Collateral	
	As at 31 March 2014 £'000	As at 31 March 2013 £'000
Standardised Approach		
Sovereigns	590,686	287,645
Institutions	10,815,546	12,152,782
Corporates	1,687,307	1,310,187
Total	13,093,538	13,750,614

Figure 16

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) and represent 92% (94% in 2013) of total credit limits extended, whereby the largest credit limits are extended to the most renowned and the largest global financial institutions.

As a second level of mitigation, in the event that 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.

Cross - Product 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 over-collateralising

current and potential exposure through the use of cash or high grade government bonds, or otherwise exposure is limited to collateral-recall risk.

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 the Firm's risk appetite. The Committee is comprised of four Non-Executive Directors and receives contributions from other staff including the Heads of HR, Compliance and Risk divisions, as required.

During the period in question, remuneration consisted of fixed pay (base salary and benefits) 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.

The Firm has a deferral scheme in operation for the period in question. Code Staff subject to deferral have additional performance adjustment measures in place under this scheme which may be applied at the discretion of the Remuneration Committee. Deferrals and vesting schemes for previous periods will continue to be applicable on amounts due to be paid under these arrangements.

5.2. Remuneration disclosure

The disclosures under the Remuneration Code are shown below. A comparison of 2012/13 and 2013/14 has been made.

5.2.1. Aggregate remuneration expenditure

Years to 31 March 2014 & 31 March 2013

Investment Banking		Other Business		Equity		Fixed Income	
2013/14	2012/13	2013/14	2012/13	2013/14	2012/13	2013/14	2012/13
£'000	£'000	£'000	£'000	£'000	£'000	£'000	£'000
353	0	748	330	613	614	1,729	2,223

Figure 17

³ That is, those staff whose remuneration is subject to disclosure under the Remuneration Code, defined as Senior Management and those whose activities materially impact the firm.

5.2.2. Remuneration for Financial Year

Analysis between fixed and variable amounts

Years to 31 March 2014 & 31 March 2013

	Code Staff			
	Senior Management		Non Senior Management	
	2013/14	2012/13	2013/14	2012/13
Number of code staff	14	14	5	3
Fixed pay:-	£'000	£'000	£'000	£'000
Cash based Fixed Remuneration	3,690	3,691	1,210	711
Variable Pay:-				
Cash	1,538	1,594	808	673
Variable as Units	-	-	-	-
Deferred cash	419	466	160	250
Total variable pay	1,957	2,060	968	923
Overall Total	5,647	5,751	2,178	1,634

Figure 18

5.3. Code Staff Remuneration

Total Compensation EUR	Number of code staff within bracket
<1,000,000	18
1,000,000-1,500,000	1

Figure 19