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## PILLAR 3 RISK DISCLOSURES

As of 30<sup>th</sup> June 2009

### Document disclaimer

- The purpose of the Pillar 3 disclosures as contained within this Disclosure Document is solely to explain the basis according to which SMBC Capital Markets Limited Group (“CM-UK”) and its constituent entities comply with certain capital related requirements and to provide information about the management of risks relating to those requirements.
  - This Disclosure Document does not constitute any form of financial statement on behalf of CM-UK.
  - This Disclosure Document reflects, where appropriate, information which is contained within the Consolidated Annual Report & Financial Statements of CM-UK.
  - The Information has been subject to internal review but has not been audited by the CM-UK’s external auditors.
  - Although Pillar 3 disclosures are designed to provide transparent capital disclosure by investment firms on a common basis, the information contained in this particular Disclosure Document may not be directly comparable with that made available by other firms. This may be due to a number of factors such as:
    - The mix of approaches allowed under the Capital Requirements Directive (“CRD”);
    - The mix of exposure types;
    - The different risk appetites and profiles of firms;
    - The different waivers applied for and allowed by the FSA.
  - Pillar 2 capital requirements are excluded from this Disclosure Document, but nevertheless play a major role in determining both the total capital requirements of CM-UK and any surplus capital available.
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## **1. Overview**

The CRD, based upon the Basel 2 Accord, has established a revised regulatory framework across the European Union governing the amount and nature of the capital financial institutions must maintain.

The objective of the CRD is to promote the safety and soundness of the financial system by requiring banks and investment firms to hold a level of capital appropriate to the risks inherent in their business model. The CRD disclosure requirements ("Pillar 3") aim to complement the minimum capital requirements ("Pillar 1") and the supervisory review process ("Pillar 2") and seek to encourage market discipline by allowing market participants to assess information provided on the risk exposures and risk assessment processes of the firm.

SMBC Capital Markets Limited Group ("CM-UK") obtained the approval of the United Kingdom Financial Services Authority ("FSA") to calculate its Pillar 1 credit and counterparty credit risk capital requirements using the Foundation Internal Ratings Based ("FIRB") approach to credit risk from 1<sup>st</sup> January 2008. CM-UK therefore uses internal Probability of Default ("PD") rates, with Loss Given Default ("LGD") as per regulatory guidance. However, not all internal models have yet been approved for IRB usage – initial approval was given for Japanese corporate names, financial institutions and sovereign lending only. Assets rated using the non-Japanese corporate model are calculated for regulatory capital purposes according to the standardised approach. The standardised market risk PRR method is used to calculate market risk requirements. Operational risk requirements are calculated using the basic indicator approach. This document is designed to meet the Pillar 3 obligations.

The Pillar 3 disclosures herein have been prepared in accordance with the rules of the FSA, the body charged with implementing the CRD in the United Kingdom, as set out in the General Prudential Sourcebook ("GENPRU") and the Prudential Sourcebook for Banks, Building Societies and Investment Firms ("BIPRU"). BIPRU Section 11 (Disclosure) lays out the disclosure requirements applicable to Investment Firms. The Section 11 requirements are designed to promote market discipline by providing market participants with key information on a firm's risk exposures, risk management processes, and hence capital adequacy. Improved public disclosures of such information lead to increased transparency and should lead directly to more effective market discipline.

The rules of BIPRU 11 allow us to omit any of the required disclosures that are deemed to be immaterial in that such an omission would not change the understanding of a reader relying on this information.

In addition we may omit any disclosures where we believe that the information is proprietary or confidential. Information is deemed to be proprietary where we consider that, if shared, it would undermine our competitive position. Information is deemed to be confidential where there are obligations binding us to confidentiality with our counterparties and suppliers.

Unless otherwise stated all figures in this document are denominated in United States dollars.

## **2. Basis and Frequency of Disclosure**

These disclosures have been prepared based upon the consolidated financial position of CM-UK and the financial position of those of its constituent companies that are regulated, United Kingdom domiciled, investment firms as of 30<sup>th</sup> June 2009.

Future disclosures will be made annually as of CM-UK's financial year end, 31<sup>st</sup> December.

### 3. Location and Verification

This Disclosure Document has been reviewed by senior management but has not been subject to external audit. However, where data is equivalent to that included in the Annual Report and Financial Statements, such data has been subject to external audit during the formal review and verification process.

This report is published on the corporate website of SMBC Capital Markets ([www.smbc-cm.com](http://www.smbc-cm.com)).

### 4. Corporate Structure

CM-UK consists of SMBC Capital Markets Limited (“CM-LTD”) and its wholly owned subsidiaries SMBC Derivative Products Limited (“DP”) and SMBC Capital Markets Asia Limited (“CM-Asia”). Both CM-LTD and DP are full scope BIPRU investment firms domiciled in the United Kingdom and regulated by the FSA, CM-Asia is domiciled in Hong Kong.

CM-UK itself is a wholly owned subsidiary of Sumitomo Mitsui Banking Corporation (“SMBC”) of Japan. CM-UK, together with SMBC Capital Markets Inc. (“CM-INC.”), make up the SMBC Capital Markets Group (“CMG”), the global derivatives arm of SMBC. CMG operates a single trading book overseen by a clearly defined global management structure supported by appropriate policies and procedures. The relationships between the different legal entities within CMG are defined within agency and service level agreements. CMG co-operates closely with SMBC’s international network of branches and subsidiaries.

DP is a bankruptcy remote derivatives company that has been assigned a AAA counterparty rating by Standard & Poor’s and a Aa rating by Moody’s. DP’s conduct of business operations is defined by the document “*Operating Policies and Guidelines SMBC Derivative Products Limited*” which sets the respective rating agencies operational requirements and the calculation process used to calculate the capital required in order to maintain the AAA / Aa credit rating. As long as DP meets rating agency capital requirements there is no hindrance to the transfer of capital, in the form of dividend payments, to the parent CM-LTD.

The CRD framework applies to CM-LTD and DP on a solo basis and to CM-UK on a consolidated basis. The disclosures below are presented on both a solo and a consolidated basis.

### 5. Risk Management

Risk is a natural consequence of the actions it undertaken in order to achieve strategic business objectives. As a consequence of this CM-UK regards risk management as a key discipline and seeks to manage the risks arising through an effective overall risk management framework which is overseen by the Board of Directors.

Effective risk management is the primary means through which management tries to achieve its goals of:

- Optimising the return to, and protecting the interests of, stakeholders (including the shareholder, customers and staff);
- Safeguarding the Group’s assets and protecting its reputation;
- Improving the Group’s operating performance; and
- Fulfilling the Group’s wider strategic objectives.

CMG's risk management department, which has responsibility for the oversight of CM-UK, comprises of two group risk functions, Trade Analysis (market risk) and Credit; additionally there are independent control and support functions including Legal, Compliance, Operational Risk Review and Information Security. These support functions are themselves managed by a series of risk committees staffed by senior-management and other relevant staff:

- The Global Risk Management Committee overseeing strategies for addressing market risk, operational risk and liquidity risk issues;
- The Credit Committee overseeing credit issues and new applications in addition to outstanding credit exposures/credit lines, expected losses and credit reserves;
- The New Products Committee overseeing new products, structures or business strategies or any significant modifications to existing products, structures or business strategies;
- The Compliance Committee overseeing regulatory and compliance issues;
- The Information Technology Assessment Committee overseeing potentially risky IT issues;
- The Capital Management Committee overseeing capital adequacy and capital planning issues for CMG entities subject to prudential regulation.

Independent assurance is provided by the Audit Department of SMBC.

As a wholly owned subsidiary of SMBC, CM-UK will in general seek to ensure the alignment of its strategy in important areas with that of SMBC in order to ensure that a cost-effective and consistent approach is achieved across the SMBC group. CM-UK therefore follows overall SMBC group policy in assessing and managing risks and uncertainties. However, management will at all times ensure local relevance in order to support achievement of local objectives.

CM-UK undertakes an internal assessment of its capital needs, the Internal Capital Adequacy Assessment Process ("ICAAP"), on an annual basis. The ICAAP considers all of the material risks faced by individual entities and the group that are not captured by the minimum capital requirement (these are known as Pillar 2 risks). The ICAAP is subject to Board review and approval.

The most significant risk categories that CM-UK is exposed to are set out below.

#### *Credit Risk*

Credit risk is the risk that a counterparty is unable to honour its obligations to CM-UK as and when they fall due. Adverse changes in the credit quality of individual counterparties or a general deterioration in economic conditions could affect the recoverability and value of CM-UK's assets. CM-UK management recognises that total credit risk, the aggregation of credit, counterparty and concentration risk (GENPRU 2.1.51(i) – (iii)), and in particular concentrations of counterparty credit risk, constitute the greatest risk faced by the Group.

The CMG Risk Management Department employs a broad array of control and monitoring tools including:

- maximum potential exposure (by simulation) credit limits for each counterparty;
- periodic analysis based on grade;
- continuous communication with SMBC's credit departments;
- stress testing;
- measurement and monitoring of settlement risk;
- analysis of rapidly emerging trends in credit quality using the KMV system.

CM-UK has adopted the Foundation Internal Ratings Based ("FIRB") approach for calculating Pillar 1 capital requirements for credit and counterparty risk except for exposures to non-Japanese corporate customers where the standardised approach is used.

Central to the credit assessment is the internal credit grading system. CMG uses SMBC's grading models for all counterparties and submits all internal rating results for approval. SMBC's credit departments proactively prevent different ratings from being used for the same credit by different units of the group, if need be by asking CM-UK to re-examine its inputs to the model. CM-UK therefore operates within the overall credit governance structure of SMBC. All major developments associated with the IRB approach, including developments with relation to internal rating systems design and implementation, are subject to the approval of senior management, up to and including the board of the parent bank. CM-UK has established an arrangement with the wider SMBC Group whereby CM-UK's Capital Management Committee, consisting of board members and relevant risk management, accounting and compliance staff drawn from across CMG, can share regular reports on internal ratings model developments.

CM-UK has three major ways of addressing credit risk: fundamental credit analysis and control by the relevant credit departments of SMBC; a credit reserve based upon market fair value; and active involvement of management, through the front office, in pursuing credit mitigation in the day to day business over and above the credit requirements of the institution and fostering a culture of pricing to reflect all risks. A more detailed discussion of credit risk mitigation is set out in section 8.

#### *Market Risk*

Market risk is the risk of an adverse change in the value of CM-UK's assets and liabilities arising from movements in market rates, including interest rates, equity prices, commodity prices and currencies.

CM-UK fully hedges the market risk of all its customer transactions through matching trades with either its associated company, CM-INC. or a market counterparty. As a result the derivatives portfolio is left with minimal market risk. Market risk does arise on the securities portfolio, where the charge is calculated in accordance with the interest rate PRR rules, and on any balance sheet foreign exchange exposures arising, where the charge is calculated in accordance with the foreign currency PRR rules.

CM-UK has no position limits for commodity, equity, interest rate or currency derivatives.

#### *Liquidity Risk*

Liquidity risk is the risk that CM-UK is unable to meet its financial obligations as they fall due.

As CM-UK's derivative transactions are intermediation trades it has minimal funding liquidity risk. Funding requirements are limited to current expenses and, far more significantly, collateral. Collateral payments are only an issue for CM-LTD as DP is prevented by its operating policies and guidelines from collateralising exposures.

As at 30<sup>th</sup> June 2009 CM-LTD had pledged collateral of \$2.1 billion however it was in receipt of collateral of \$2.4 billion. All surplus cash held by CM-LTD is passed to its associated company, CM-INC. under the terms of an uncommitted demand loan agreement between the two parties. CM-INC. performs the role of group treasurer. Additionally, as a liquidity buffer, CM-UK holds a securities trading portfolio funded by share capital.

Under current circumstances there is minimal liquidity risk in CM-UK. Nevertheless, CM-UK is currently developing an enhanced liquidity framework in line with the proposed requirements to be set out in BIPRU 12 Liquidity.

### *Operational Risk*

Operational risk is the risk of losses being incurred as a result of inadequate or failed internal processes, people or systems, or from external events. CMG manages operational risk through a variety of techniques most importantly the monitoring of key risk indicators, particularly the requirement that any adjustments with an impact greater than +/- \$10,000 must be formally reported and explained to management.

CMG has adopted a risk and control self-assessment methodology whereby it identifies the operational risks arising within each business area, identifies the controls in place to mitigate these risks and evaluates the effectiveness of these controls. This assessment is undertaken quarterly.

Due to the relative simplicity of its mono-line business model CM-UK calculates Pillar 1 operational risk capital using the Basic Indicator Approach.

### *Residual risk*

Residual risk is the risk that losses may arise from the partial performance or failure of credit risk mitigation techniques (see 8 below) for reasons that are unconnected with their intrinsic value, through a risk self-assessment process. Residual risk can arise from, for example, ineffective documentation, a delay in payment or the inability to realise payment from a guarantor in a timely manner.

CM-UK has undertaken a self-assessment process and has determined that its credit risk mitigation process using treasury bills and cash collateral is robust. All credit support agreements are documented under ISDA or a broadly equivalent legal framework. Acceptable collateral is restricted to cash or government securities (to which an appropriate haircut is applied). CM-UK further mitigates residual risk by close monitoring of all collateral agreements and the submission of daily settlement failure reports, which cover collateral, to management. The vast majority of credit support agreements are with highly rated financial institutions so this risk is deemed to be minimal.

### *Reputational risk*

Reputational risk is the risk arising from a deteriorating perception of CM-UK's standing in the eyes of, particularly, the wholesale markets. Management has considered how this might arise and, consequently requires that consideration is given to any potential legal and reputational issues arising in credit applications, or in the decision as to whether a credit application is required. Deals with any potential legal or reputational issues, whilst not unknown, are a small percentage of activity so each is brought to the attention of management regardless of credit impact.

### *Data quality risk*

CMG undertakes a quarterly self-assessment of any data processing errors. Key risk indicators show that the impact of such errors has been immaterial.

CM-UK recognises that it is insufficient to simply understand and quantify the above risks as they currently exist and that it must also understand the risks that might arise in times of economic stress. In order to meet this requirement CM-UK regularly undertakes a number of stress tests that model the impact of movements in factors such as interest rates, foreign exchange, credit spreads and equity index levels on the portfolio. CM-UK also runs stress tests specifically for capital planning purposes that seek to capture specific vulnerabilities.

## 6. Capital Resources

Table 1 provides a summary of the relevant capital ratios as at 30<sup>th</sup> June 2009:

Table 1

	CM-UK	CM-LTD	DP
Tier 1 (after deducting material holdings):	40%	22%	134%
Total Capital:	70%	55%	138%

Ratios are calculated by taking the relevant capital resources as a percentage of risk weighted assets. Total risk weighted assets as at 30<sup>th</sup> June 2009 were (\$'000):

CM-UK:	1,378,674
CM-LTD:	1,153,832
DP:	223,829

Table 2 provides a summary of the composition of regulatory capital resources as at 30<sup>th</sup> June 2009:

Table 2

	CM-UK (\$'000)	CM-LTD (\$'000)	DP (\$'000)
<i>Tier 1 capital</i>			
Called up share capital:	597,000	597,000	300,000
Retained earnings and other reserves:	-243,502	-243,763	297
Perpetual non-cumulative preference shares:	200,000	200,000	-
<b>Total tier 1 capital:</b>	<b>553,498</b>	<b>553,237</b>	<b>300,297</b>
<i>Tier 2 capital</i>			
Surplus provisions:	8,272	-	1,343
Subordinated debt:	150,000	150,000	-
<b>Total tier 2 capital:</b>	<b>158,272</b>	<b>150,000</b>	<b>1,343</b>
<b>Total tier 1 plus tier 2 capital:</b>	<b>711,770</b>	<b>703,237</b>	<b>301,640</b>
<i>Deductions from total of tier 1 and tier 2 Capital</i>			
Material holdings:	-	302,000	-
Other:	-	2,390	-
<b>Total tier 1 plus tier 2 capital after deductions:</b>	<b>711,770</b>	<b>398,847</b>	<b>301,640</b>
<i>Tier 3 capital:</i>			
Short term subordinated debt:	222,000	222,000	-
Net interim trading book profit and loss:	26,563	19,229	7,333
<b>Total capital before deductions:</b>	<b>960,333</b>	<b>640,076</b>	<b>308,973</b>
Deductions from total capital:	868	581	286
<b>Total capital after deductions:</b>	<b>959,465</b>	<b>639,495</b>	<b>308,687</b>

### *Tier 1 Capital*

#### *CM-LTD:*

Tier 1 capital includes of 597 million \$1.00 and 2 GB£1.00 ordinary shares fully paid up and 200 million perpetual, non-cumulative preference shares of \$1.00, fully paid-up. The preference shares are callable, at the option of the Company from December 2012.

#### *DP:*

Tier 1 capital consists of 300 million \$1.00 ordinary shares fully paid-up, wholly owned by CM-LTD.

#### *CM-Asia:*

CM-LTD holds 2 million \$1.00 ordinary shares in CM-Asia, the subsidiary's entire issued share capital. CM-Asia is not subject to any standalone capital requirements but is consolidated within the consolidated prudential returns of CM-UK.

### *Tier 2 Capital*

CM-LTD's long term subordinated loan facilities mature on 30<sup>th</sup> June 2015. Under FSA rules subordinated loan capital cannot exceed 50% of tier 1 capital and, in the last five years to maturity dated subordinated loans must be amortised on a straight line basis.

### *Tier 3 Capital*

CM-LTD's short term subordinated loan facilities mature on 30<sup>th</sup> June 2012. Under FSA rules short term subordinated loan capital must be amortised on a straight line basis over the last two years to maturity.

CM-UK regularly stresses its financial resources to model the potential effect of extreme impact events on the Group's capital and its capital resources requirement.

## **7. Capital Resources Requirement**

CM-UK determines its minimum regulatory capital charge on a daily basis using a capital calculator compliant with BIPRU rules. A summary report is then distributed to the Capital Management Committee.

Table 3 provides a summary of the overall minimum capital requirement for each regulated entity and the group.

