

# **Pershing Holdings (UK) Limited**

**Pillar 3 Disclosures for the year ended  
31<sup>st</sup> December 2010**

## About Pillar 3 Disclosures

### A. Alignment of Disclosures within UK Regulated Entities

The British Bankers Association ('BBA'), which comprised of a number of UK banks, published guidelines for preparers of Pillar 3 disclosures to better align content, definitions and approaches and to drive comparability and consistency wherever possible. These disclosures have been produced with reference to the outcome of this Working Party. Where necessary, footnotes have been added to the data tables to explain content. However, whilst disclosures are intended to provide transparent information on a common basis, different assumptions may apply to other banking groups especially outside the UK so a reader must understand the basis of each firm's disclosures before making comparisons.

### B. Policy and Approach

Pillar 3 disclosures are required for a consolidated group and for those parts of the group covered by the Basel II framework. Pending implementation of the Basel II framework by The Bank of New York Mellon Corporation, there is currently no comparable disclosure provided on a consolidated basis by the firm's parent undertaking. As such, this disclosure has been prepared for the UK regulated entities.

These disclosures have been approved by the Board of Directors who have verified that they are consistent with formal policies adopted regarding production and validation.

Information in this disclosure has been prepared solely to meet the disclosure requirements about Basel II and to provide certain specified information about capital and other risks and details about the management of those risks and for no other purpose. This paper does not constitute any form of financial statement on the business nor does it constitute any form of contemporary or forward looking record or opinion about the business.

Unless indicated otherwise, information contained within this document has not been subject to external audit.

These disclosures will henceforth be published annually as at the company Accounting Reference Date, 31<sup>st</sup> December and publication will take place as soon as practicable and additionally during the year as market or business conditions dictate.

The company will reassess the need to publish some or all of the disclosures more frequently than annually in light of any significant change to the relevant characteristics of its business including disclosure about capital resources and adequacy and information about risk exposure and other items prone to rapid change.

The Board of Directors at its discretion may omit one or more of the disclosures if the information provided by such disclosures is not regarded as material. The criterion for materiality used in these disclosures is that the firm will regard as material any information where omission or misstatement could change or influence the assessment or decision of a user relying on that information for the purpose of making economic decisions.

The Board of Directors at its discretion may omit one or more of the disclosures if those items include information which, in the light of requirements is regarded as proprietary or confidential. In this circumstance, the Board of Directors will state in its disclosures the fact that specific items of information are not disclosed and the reason for non-disclosure and will publish more general information about the subject matter of the disclosure requirement except where these are to be classified as confidential.

The company undertakes no obligation to revise or to update any forward looking or other statement contained within this paper regardless of whether or not those statements are affected as a result of new information or future events.

This policy will be periodically reassessed and updated in light of market developments associated with Pillar 3.

These disclosures are published on Pershing's website ([www.pershing.co.uk](http://www.pershing.co.uk)) under Financial and Regulatory Disclosures.

Disclosures can also be found on The Bank of New York Mellon Corporation ('BNY Mellon') website ([www.bnymellon.com](http://www.bnymellon.com)). See section investor relations, financial reports, other regulatory filings.

Further information about the company can be found in the latest Annual Report & Accounts.

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## **1. Background**

This document serves as the 2010 Basel II Pillar 3 consolidated disclosures of Pershing Holdings (UK) Limited ('Pershing') in accordance with the Financial Services Authority ('FSA') General Prudential Sourcebook ('GENPRU') and Prudential Sourcebook for Banks, Building Societies and Investment Firms ('BIPRU 11'). Pershing implemented the Basel II standardised approach for measuring Regulatory Capital in January 2008. Pillar 3 disclosure is a compulsory and integral part of our Basel II implementation. The company first published Pillar 3 disclosures for the year ended 31<sup>st</sup> December 2008.

### **1.1. Purpose of Pillar 3**

Basel II is the international banking accord intended to strengthen the measurement and monitoring of financial institutions' capital. The Basel II framework was implemented in the EU through the Capital Requirements Directive ('CRD') which is now law. Basel II framework establishes a more risk sensitive approach to capital management and is comprised of three pillars:

- **Pillar 1** establishes rules for the calculation of minimum capital for credit, market and operational risk.
- **Pillar 2** is an internal discipline to evaluate the adequacy of the regulatory capital requirement under Pillar 1 and other non Pillar 1 risks. This pillar requires the FSA to undertake a supervisory review to assess the robustness of Pershing's internal assessment.
- **Pillar 3** compliments the other pillars and effects market discipline through public disclosure. Expanded disclosure about capital and risk enables interested parties to better understand the risk profile of individual banks and to make comparison.

## **2. Scope and Application of Directive Requirements**

Pershing Holdings (UK) Limited is the London based, wholly owned and operationally independent subsidiary of Pershing Group LLC which is, in turn, a subsidiary of the Bank of New York Mellon Corporation.

As a full scope BIPRU investment firm regulated by the FSA, Pershing Holdings (UK) Limited is required to operate under the FSA's Basel II rules, which includes this disclosure. Senior management have designated the following as "significant subsidiaries" in this disclosure:

- Pershing Limited
- Pershing Securities Limited

Pershing Securities International Limited is not considered material for these disclosures as it is governed by the Irish regulator whose Pillar 3 disclosures are published separately.

There are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities among the parent undertaking and its subsidiary undertakings. The group does not make use of the Solo consolidation waiver provisions laid down in BIPRU 2.1.

## 2010 Highlights

The Executive Committee of Pershing Holdings (UK) Ltd approved several initiatives during the year, the most significant of which are mentioned below:

- Continued expansion of the Intermediate Financial Advisor (IFA) market segment service offering
- Extension of clearing and settlement services to the SIPP market segment
- Expansion of the clearing and settlement services to additional markets

Signing of new business continues, strengthened by the GlobalClear® and IFA product offerings. The pipeline for 2011 is strong. The enhancements to the IFA sector should lead to additional revenue growth over the next few years. The new business acceptance process and oversight committee continues to provide greater due diligence and assessment over the introduction and development of new clients and products.

Pershing's corporate governance structure was further enhanced over the last year with the introduction of new committee's providing additional oversight over assets and liabilities of Pershing and liquidity management. The ICAAP is continually being strengthened and embedded within normal business processes, and Pershing produced an Individual Liquidity Adequacy Assessment.

The operational risk framework within Pershing has been further enhanced during the last year and various new methodology's and processes have been embedded within normal management and business processes. The integrated risk framework is designed to meet all regulatory requirements and industry best practice. Credit risk management processes have also been further enhanced to improve the monitoring of trade and client exposure and business activity.

The risk appetite statements for Pershing, as a whole, and specifically for credit, market and operational risk have been further defined and quantified to articulate the amount of risk that the firm regards as appropriate for it to accept in order to execute its business strategy. The increased quantification of the Pershing risk appetite has enabled improved monitoring of business activity to ensure that related risks are within the overall risk appetite of the firm and define the management actions required should the appetite be exceeded.

The general trend continues to be towards a more conservative approach to risk management whilst at the same time providing both internal and external clients with a greater degree of transparency as to how risk is assessed, quantified and monitored. Clients are assigned single ticket trade limits and gross exposure limits based on an internal model that takes into account both a formulaic approach and expert judgement. Exposure is monitored daily by the Credit & Market Risk Department and reported weekly to the European Credit Committee and measured against additional limits in respect of late settlement and mark-to-market exposure.

The Firm's business model is driven primarily by transaction flow as opposed to balance sheet factors. Close control of counterparty and settlement risk together with a very conservative approach to credit mitigation techniques has enabled Pershing to maintain a strong financial position.

The Firm acts as custodian for substantial amounts of Client Assets in the form of available cash balances. These are placed in segregated accounts with major international banks whose performance is subject to ongoing review and assessment by the Credit & Market Risk Department.

### **3. Risk Management Objectives and Policies**

#### **3.1. Overview of Risk Objectives and Policies**

The primary business of Pershing is the provision of integrated execution, settlement, clearance and custodian services to both retail and institutional clients located largely in the UK and Ireland. Pershing seeks to monitor inherent and systematic risk in the markets while diligently minimising operational, regulatory and business risk.

The overall risk appetite of Pershing is based upon the assessment of the risks around the delivery of our business strategic objectives and the maintenance of a robust risk and control framework, governance structure and risk methodology.

Given the non-complex facilities we offer to high quality clients, credit and market risk is relatively low. Even so, the credit quality of clients is closely monitored. The Credit and Market Risk Committee monitors risk at all levels up to the parent holding company.

The management of operational risk is viewed as being critical to the successful and consistent service and delivery of our products to our clients. The operational risk appetite is viewed as being low, given that any risk materialising in the delivery of our products may have a significant impact in the service levels being offered by our clients and therefore identified, escalated and mitigated in a timely manner.

Pershing considers that the regulatory capital treatments under Pillars 1 and 2 provide an adequate cushion to the realisation of any unforeseen losses and events.

##### **3.1.1. Credit Risk**

Credit risk is the risk of financial loss to Pershing in the event that a client, underlying client or market counterparty fails to meet its contractual obligations to Pershing Limited or Pershing Securities Limited. As a large proportion of Pershing's business is contracted on a Model B (name give-up) basis on a Delivery versus Payment ('DvP') market with settlement finality and/or with a Central Counterparty ('CCP'), the main credit risks are between Pershing and its client; settlement risk also exists between Pershing and the CCP and on the counterparty or its settlement agent. The majority of Pershing's credit risk arises from exposures existing between trade date and actual settlement date.

##### **3.1.2. Market Risk**

For Pershing, market risk arises principally from fluctuations in the value of assets, interest or exchange rates. Pershing's foreign exchange exposure is limited to residual balances resulting from non-marketable amounts within specific intra-day and overnight limits on both an individual currency and overall book basis. Volumes and ticket sizes are thus immaterial. Interest rate risk at Pershing is also considered immaterial as it only arises on interest rate movements that depress the value of securities held as collateral in mitigation of exposures.

### **3.1.3. Operational Risk**

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people, and systems or from external events, including the potential for loss that arises from problems with operational processing, human error or omission breaches in internal controls, fraud, and unforeseen catastrophes.

The managers of the business are responsible for identifying the risks associated with key business processes and threats to meeting their overall business objectives, assessing the quality or design of controls in place to mitigate and manage risk, and are accountable for the operation of those controls.

### **3.1.4. Regulatory Risk**

Regulatory risk covers the risk relating to earnings or capital from violation, or non-conformance with laws, rules, regulations, prescribed practices or ethical standards which may, in turn, expose the firm and its executors to fines, payment of damages, the voiding of contracts and damaged reputation (with accompanying indirect costs).

As a subsidiary of BNY Mellon, Pershing is subject to a number of regulatory policies and benefits from corporate wide training and monitoring of compliance and ethical matters.

### **3.1.5. Liquidity Risk**

Pershing will at all times maintain liquidity resources which are adequate both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met in full as they fall due.

BNY Mellon firms are required to have in place robust strategies, policies, processes and systems to identify, measure, manage and monitor the liquidity risks to which they may be exposed, including intra-day liquidity risk. Firms must have reliable management information to ensure appropriate and timely forward-looking information on the liquidity risk of the firm and early warning indicators to identify increases in liquidity risk.

Senior management is responsible for establishing appropriate liquidity risk tolerances; for approving, reviewing and updating the firm's approach to managing liquidity risk; and for reviewing the firm's liquidity position including compliance with the UK FSA liquidity adequacy rule and regularly reporting this information to the governing body.

Pershing is self-sufficient within the group liquidity framework and complies with local liquidity regulations. On a quarterly basis, stress testing is undertaken to demonstrate continued liquidity adequacy and to evaluate the impact under stress conditions. Pershing has deposit lines with a number of banks which are utilised and monitored on a daily basis by the Treasury department, weekly by the Credit and Market Risk Committee and reported on a monthly basis to the Executive Committee and BNY Mellon. Metrics about the firm's liquidity position are reported to Executive Committee. On a day to day basis, liquidity and funding requirements are actively managed by the Pershing central Treasury function.

Pershing falls under an EMEA Programme designed to ensure that it complies with FSA Liquidity Standards (PS 09/16) issued in October 2009. This is an ongoing Programme of work in which Pershing ensures compliance with FSA BIPRU 12 Systems and Controls standards, including completion of an Individual Liquidity Adequacy Assessment ('ILAA') for review with FSA in 2011 and reporting under the regime including weekly FSA047/FSA048 returns.

FSA Systems and Control requirements oblige the governing body (i.e. Board of Directors ('BOD')) to express and check conformity with the firm's liquidity risk appetite. The outputs of the firm's Stress testing inform the governing body's decisions on whether the firm's liquidity risk appetite should be amended and form the basis of a Contingency Funding Plan.

A common Liquidity Risk Management Framework ('LRM') and Operating Model applies to all BNY Mellon UK regulated subsidiaries, tailored to fit local circumstances. In overview, this LRM framework comprises:

- A regime of senior management oversight and governance of LRM (including defining risk strategy, setting risk appetite and tolerance (limits and triggers) and tracking performance).
- A firm-specific liquidity policy that conforms with Group requirements (including pricing of liquidity risk, management of intra-day liquidity risk and funding diversification and market access).
- A regime of periodic reporting to senior management of data across a 12 month time horizon and firm-specific liquidity performance ratios including assessment of the likely survival period under current conditions.

Stress testing capability at the firm level and enhancement of Contingency Funding Plans is currently in progress to enhance existing capability and effectiveness. This includes creation by senior management of firm-specific and market wide stress scenarios and liquidity risk assumptions which will be modelled across short term (up to two weeks) and protracted (from two weeks to three months) time horizons.

**As at 31<sup>st</sup> December 2010, Pershing enjoys a strong positive liquidity position. Pershing actively manages liquidity across legal entities, business lines and has set individual thresholds for each. Metrics about the liquidity position are reported to the firm Executive Committee on a monthly basis.**

### **3.1.6. Other Risks**

Pershing Limited operates a defined benefit pension scheme for its employees. The scheme was closed to new entrants in 2004, but has 90 eligible current employees and 360 former employees. The risk to Pershing is caused by its contractual responsibility to the pension scheme. There is also the risk that Pershing will find it necessary to make payments or other contributions to the Scheme because of a moral obligation or because Pershing considers that it needs to do so for some other reason. The scheme is valued annually for accounting purposes, and every three years a full actuarial valuation is prepared. The net surplus/deficit is included on the balance sheet of Pershing, and additional Pillar 2 capital has been allocated, following full independent stress testing of the Pension Risk.

### **3.2. Organisational Risk Structure**

The Operational Risk Management ('ORM') department within Pershing champions the design of a robust operational risk management framework and policies and is an enabler to support effective operational risk management within the business. In addition, ORM ensures the continued development of all risk management practices and methodologies necessary to embed a risk aware culture with the Firm. The Operational Risk Committee

provides Senior Management with an oversight of the functioning of the Pershing operational risk framework.

The Credit and Market Risk Management department within Pershing is responsible for assessing the credit worthiness of new or existing clients, the periodic review and approval of existing clients and the day to day monitoring and controlling of any credit exposures incurred. The Credit and Market Risk Committee meets on a weekly basis to consider and approve new clients and review any outstanding exposure and other credit and market risk matters and issues.

### **3.3. Scope and Nature of Risk Reporting Systems**

The purpose of the Firm's risk measurement and reporting processes are to ensure that all identified risks and exposures are comprehensively captured, assessed and reported to enable them to be managed according to the overall risk appetite of the Firm.

Risk measurement and reporting systems are subject to a robust governance, oversight to ensure that their design is fit for purpose and appropriately utilized within the overall risk framework. The continued development of risk processes are a key responsibility of all risk functions and business and senior management.

The measurement and monitoring of the major risks encountered by the Firm including operational risks are increasingly delivered by automated systems or, where for sound business reasons this is not the case, through structures and processes that support comprehensive risk oversight by senior management.

There is a regular reporting of risk issues and data to business line management, to specialist functions and to the senior management of the Firm.

The overall risk oversight reporting includes:

- Daily credit & market risk exposure reports
- Weekly Credit & Market Risk Committee review
- Monthly summary to the Executive Committee of risk issues and data for Credit, Market & Operational risk
- Monthly Operational Risk Committee Reporting
- Monthly Department Operational Risk Dashboards
- Monthly Liquidity Risk Metrics

### **3.4. Governance and Policies**

Policies and procedures are in place to govern and manage the business, which are common to all BNY Mellon entities. Suitable policies and procedures have been adopted by Pershing in order to ensure that an appropriate level of risk management is directed at the relevant elements of the business.

The Pershing Board is the senior strategic and decision making body and it meets quarterly. The Board has delegated day to day responsibility to the Pershing Executive Committee ('Executive Committee'). The Executive Committee has further delegated ongoing oversight of risk management to the Risk Committees (Operational and Credit & Market).

The Board consists of both Executive and Non-Executive members. Non-Executive members are employees of Pershing Group LLC and BNY Mellon. The Pershing Board is responsible for the ongoing success and development of the Pershing business.

To provide adequate, dual oversight for Europe, Middle East and Africa ('EMEA'), BNY Mellon has integrated an EMEA Executive Committee into the governance structure. This committee consists of senior managers across the businesses and shared services within EMEA. One of its responsibilities is to monitor significant governance, regulatory, audit and risk issues to ensure that they are brought to an appropriate conclusion.

Steps are being taken to put in place policies to comply with the FSA remuneration code.

## 4. Capital Resources

During the year ended 31<sup>st</sup> December 2010, the group and individual entities within the group complied with all of the externally imposed capital requirements to which they were subject.

The following table summarises the composition of the group and significant subsidiary company's regulatory capital as reported to the FSA as at 31<sup>st</sup> December 2010. The group does not have any Innovative Tier 1 capital as at 31<sup>st</sup> December 2010.

Resources	Notes	Pershing Holdings (UK) Limited Consolidated	Significant subsidiaries	
			Pershing Securities Limited	Pershing Limited
		£000's	£000's	£000's
<b>Tier 1 capital</b>				
Called up share capital		191,136	13,390	18,092
Share premium account				24,243
Retained earnings and other reserves		7,364	24,946	-2,511
Interim net losses	1	-314	-659	
		<b>198,186</b>	<b>37,677</b>	<b>39,824</b>
<i>Other Tier 1 capital</i>				
Perpetual non-cumulative preference shares				
Minority interests				
		<b>198,186</b>	<b>37,677</b>	<b>39,824</b>
Deductions from Tier 1 capital				
Investment in own shares				
Intangible assets		-112,700		
Securitisation positions				
Illiquid assets				
Excess limits for non-innovative Tier 1 instruments				
Excess limits for innovative Tier 1 instruments				
50:50 Tier 1 deductions				
<b>Total Tier 1 capital after deductions</b>		<b>85,485</b>	<b>37,677</b>	<b>39,824</b>
<b>Innovative Tier 1 capital resources</b>	2			
Perpetual preferred shares				
<b>Tier 2 capital</b>				
Deductions from Tier 2 capital				
Other Tier 2 deductions (Material holdings)				-14,087
<b>Total Tier 2 capital after deductions</b>		<b>0</b>	<b>0</b>	<b>-14,087</b>
<b>Tier 3 capital</b>		<b>0</b>	<b>0</b>	<b>15,160</b>
<b>Deduction from total of Tier 1 and Tier 2</b>				
<b>Total capital resources after deductions</b>		<b>85,485</b>	<b>37,677</b>	<b>40,897</b>

Notes:

1. Unaudited profits are not reported to the FSA as part of Tier 1 capital. As of the date that the regulatory returns were filed, 2010 profits have not been audited and were therefore excluded from capital.
2. Information about capital terms and conditions is set out in the Companies Annual Report and Accounts 2010.

As at 31<sup>st</sup> December 2009:

Resources	Notes	Pershing Holdings (UK) Limited Consolidated £000's	Significant subsidiaries	
			Pershing Securities Limited £000's	Pershing Limited £000's
<b>Tier 1 capital</b>				
Called up share capital		191,136	13,390	18,092
Share premium account				24,243
Retained earnings and other reserves		3,277	20,910	-8,491
Interim net losses	1			
		<b>194,413</b>	<b>34,300</b>	<b>33,844</b>
<i>Other Tier 1 capital</i>				
Perpetual non-cumulative preference shares				
Minority interests				
		<b>194,413</b>	<b>34,300</b>	<b>33,844</b>
Deductions from Tier 1 capital				
Investment in own shares				
Intangible assets		-130,039		
Securitisation positions				
Illiquid assets				
Excess limits for non-innovative Tier 1 instruments				
Excess limits for innovative Tier 1 instruments				
50:50 Tier 1 deductions				
<b>Total Tier 1 capital after deductions</b>		<b>64,374</b>	<b>34,300</b>	<b>33,844</b>
<b>Innovative Tier 1 capital resources</b>				
Perpetual preferred shares	2			
<b>Tier 2 capital</b>				
Deductions from Tier 2 capital				
Other Tier 2 deductions (Material holdings)				-14,087
<b>Total Tier 2 capital after deductions</b>		<b>0</b>	<b>0</b>	<b>-14,087</b>
<b>Tier 3 capital</b>		<b>19,082</b>	<b>9,024</b>	<b>13,882</b>
<b>Deduction from total of Tier 1 and Tier 2</b>				
<b>Total capital resources after deductions</b>		<b>83,456</b>	<b>43,324</b>	<b>33,639</b>

Notes:

1. Unaudited profits are not reported to the FSA as part of Tier 1 capital. As of the date that the regulatory returns were filed, 2009 profits have not been audited and were therefore excluded from capital.
2. Information about capital terms and conditions is set out in the Companies Annual Report and Accounts 2009.

## 5. Capital Requirements and Adequacy

The Board, through setting its risk appetite and focusing on risk assessment, evaluates its current and projected capital requirements under business as usual and stress related conditions.

For Pershing, the Pillar 2 Internal Capital Adequacy Assessment Process (ICAAP) has determined that currently there is sufficient capital to support the ongoing and pipeline projected business. The main sources of risk have been identified, assessed (*impact and likelihood* methodology) and approved by the relevant senior managers after taking into account the mitigating controls and rationale for direction of risk, in light of the risk appetite set by the Board.

The following table summarises the group and significant subsidiary company's capital requirements by exposure class and capital adequacy surplus as at 31<sup>st</sup> December 2010.

Exposure class (unaudited) All figures in £000's	Pershing Holdings (UK) Limited Consolidated	Significant subsidiaries	
		Pershing Securities Limited	Pershing Limited
<b>Credit risk – standardised approach</b>			
Institutions	3,665	2,759	635
Corporates	0	0	0
Retail	0	0	0
Past due items	11	10	280
Other Items	1,046	52	991
<b>Total credit risk</b>	<b>4,722</b>	<b>2,821</b>	<b>1,906</b>
<b>Total operational risk – standardised approach</b>	<b>11,399</b>	<b>9,103</b>	<b>1,492</b>
<b>Market risk – trading book risk not subject to models</b>			
Foreign currency position risk	580	510	661
<b>Total market risk</b>	<b>580</b>	<b>510</b>	<b>661</b>
<b>Total capital requirement</b>	<b>16,701</b>	<b>12,434</b>	<b>4,059</b>
<b>Total capital surplus</b>	<b>68,783</b>	<b>25,243</b>	<b>36,838</b>
<b>Solvency Ratio</b>	<b>512%</b>	<b>303%</b>	<b>1008%</b>

As at 31<sup>st</sup> December 2009.

Exposure class (unaudited) All figures in £000's	Pershing Holdings (UK) Limited Consolidated	Significant subsidiaries	
		Pershing Securities Limited	Pershing Limited
<b>Credit risk – standardised approach</b>			
Institutions	4,355	3,894	467
Corporates	0	0	0
Retail	2	2	0
Past due items	12	12	0
Other Items	752	71	679
<b>Total credit risk</b>	<b>5,121</b>	<b>3,979</b>	<b>1,146</b>
<b>Total operational risk – standardised approach</b>	<b>10,286</b>	<b>8,470</b>	<b>1,128</b>
<b>Market risk – trading book risk not subject to models</b>			
Foreign currency position risk	1,017	225	914
<b>Total market risk</b>	<b>1,017</b>	<b>225</b>	<b>914</b>

<b>Total capital requirement</b>	<b>16,424</b>	<b>12,674</b>	<b>3,188</b>
<b>Total capital surplus</b>	<b>67,032</b>	<b>30,650</b>	<b>30,451</b>
<b>Solvency Ratio</b>	<b>508%</b>	<b>342%</b>	<b>1056%</b>

### 5.1 Retail Exposures

Pershing does not currently have any material retail exposures.

### 5.2 Equity Exposures

Pershing does not currently have any material equity exposures.

### 5.3 Counterparty Credit Risk

Pershing seeks to minimise market counterparty risk by only allowing clients to trade with approved counterparties that have been reviewed by Pershing. Counterparty credit risk arises mainly in the Model B settlement business in which Pershing interposes itself between a client and a market counterparty as principal to a transaction or series of transactions. In the event that a client fails to deliver securities, Pershing is required to honour the failed trade, and in the event of client default may be required to settle the trade by closing out in the open market. Pershing also incurs credit risk in such situations, although in some OTC markets this is limited to the impact of adverse price movements on failed trades in the event that Pershing's client defaults and a market counterparty has to settle the trade elsewhere. Although Pershing regularly reviews credit exposure to clients, underlying clients and market counterparties to address credit concerns, default risk may arise from events or circumstances that are difficult to detect or foresee.

### **5.3.1 Counterparty Credit Risk - Internal Capital and Limits**

The settlement risk on a DvP market (such as SETS using CREST or Euroclear) with settlement finality means that there is little or no market-side counterparty risk given that transactions will either settle fully (both cash and assets) or they will not settle at all. If Pershing's counterparty defaults, settlement may be forced through under Exchange rules, for example, or ensured by settlement finality rules. Where there is a CCP this risk is further reduced by the fact that the CCP should always deliver as buyer to the seller and seller to the buyer.

General Clearing Membership ('GCM') services are made available to Model A clients directly and to Model B clients indirectly as Pershing entities may be both Non Clearing Members ('NCM') and GCM. Pershing Limited, which is a GCM of the London Clearing House ('LCH'), carries out Pershing's LCH Equity Clear clearing services business.

Pershing has credit exposure as GCM as it (a) assumes obligations to deliver stock or cash to the CCP and (b) is reliant upon the CCP to deliver stock or cash to it. In respect of (a), Pershing requires control over, or receives delivery from, its NCM client or underlying client of cash or stock and therefore has credit exposure to its NCM client or underlying client. In respect of (b) Pershing Securities Limited has control of the assets.

### **5.3.2 Collateral and Credit Reserves**

Credit Risk can be mitigated by four methods:

- Collateral and deposits
- Netting (includes set off)
- Guarantees, Indemnities and other contractual mechanisms
- Credit Derivatives (not currently used by Pershing)

Given the nature of Pershing's business, the principal mitigation methods that are pertinent are: (a) collateral which, in the case of standard Model B trades, can take several forms; and (b) contractual recourse to the client in respect of the debts or default of underlying clients.

### **5.3.3 Wrong-way Risk**

Pershing does not accept wrong-way risk collateral.

### **5.3.4 Downgrades in Rating Assessments**

Senior risk managers review these rating changes regularly and consider the liquidity impacts of downgrade scenarios on counterparties.

## **6. Credit Risk and Dilution Risk**

The following disclosures are about Pershing's credit risk management objectives and policies and specifically:

- The strategies and processes to manage credit risk
- The structure and organisation of the credit risk management function
- The scope and nature of credit risk reporting and measurement systems

The policies for hedging and mitigating credit risk plus the strategies and processes for monitoring the continuing effectiveness of hedges and mitigants can be found in section 11.

### **6.1. Credit Risk Management Strategy and Processes**

Credit risk is the risk of financial loss to Pershing in the event that a client, underlying client or market counterparty fails to meet its contractual obligations to Pershing. As a large proportion of Pershing's business is contracted on a Model B (name give-up) basis on a DvP market with settlement finality and/or with a CCP, the main credit risks are between Pershing and its client. Settlement risk exists between Pershing and the CCP and on the counterparty or its settlement agent.

The principal benefits of CCPs are that:

- (a) They standardise (and significantly reduce) counterparty risk on settlement (parties see their risk on the market side as being on the CCP)
- (b) They support, through clearing, post trade efficiencies eg in the form of netting
- (c) They provide post trade anonymity in respect of trades on relevant markets
- (d) They provide a central means of risk management (eg through margin calculations and calls and through the operation of rules, including rules which specifically vary insolvency and other general laws)

Benefits (a) and (d) are reflected in Pershing's assessment of its risk.

### **6.2 Managing Credit Risk**

Pershing manages credit risk exposure by establishing various limits for its clients, as follows:

- Trading limit: normally a function of the client's adjusted Tangible Net Worth ('TNW')
- Total net debt limit: normally a function of the client's TNW
- Markets in which the client can trade
- Financial instruments in which the client can trade
- Clients that are subject to special conditions
- Type of business to be conducted through Pershing

### **6.3 Exposures**

The legal structure of the Model B agreements provides Pershing with the right to set-off any indebtedness of underlying clients against any credit balance in the name of the same underlying client. Pershing also has recourse to investments and cash as collateral and indemnities from clients in respect of any underlying clients. Consequently there is no single point of failure that could lead to a major credit loss. In order for Pershing to suffer a credit related loss several adverse events would have to occur simultaneously.

#### **Exposure**

The definition of exposure used in this report is consistent with that recommended by the BBA Pillar 3 Working Party. Except where stated, exposure is defined as Exposure at Default ('EAD') pre Credit Risk Mitigation ('CRM') i.e. a regulatory exposure value after the application of Credit Conversion Factors ('CCF') for off-balance sheet items (including

undrawn commitments) and, after netting but before application of CRM factors (eg financial collateral and other physical collateral). The calculation of EAD therefore takes into account both current exposure and potential drawings prior to default over a 12 month time horizon. As such, exposure in this context may differ from statutory Generally Accepted Accounting Practice ('GAAP') for balance sheet carrying values. Credit exposure is computed under the standardised approach.

The following credit risk tables (unaudited) (i-iv) relate to Pershing.

**(1) Standardised gross exposure (exposure at default ('EAD') pre CRM)**

Standardised exposure classes All figures in £000's	Group exposure at default pre CRM at 31 <sup>st</sup> December 2010	Group average exposure at default pre CRM at 31 <sup>st</sup> December 2010	Group exposure at default pre CRM at 31 <sup>st</sup> December 2009	Group average exposure at default pre CRM at 31 <sup>st</sup> December 2009
Central governments & central banks	0	815	0	0
Institutions	156,795	285,003	264,999	286,753
Corporates	3,602	17,759	8,858	9,585
Retail	7,877	26,042	20,684	22,382
Past due items	157	2,007	3,859	4,176
<b>Total</b>	<b>168,431</b>	<b>331,627</b>	<b>298,400</b>	<b>322,896</b>

Average exposure is based on a 12 month average.

Standardised exposure classes are defined by FSA in BIPRU 3 and reflect the Basel II RWA calculation applied.

**(2) Standardised gross exposure (EAD pre CRM) by geographic area**

As at 31<sup>st</sup> December 2010

Standardised exposure classes All figures in £000's	UK	Europe, Middle East & Africa	Group total
Central governments & central banks	0	0	0
Institutions	141,185	15,610	156,795
Corporates	3,602	0	3,602
Retail	7,397	480	7,877
Past due items	149	8	157
<b>Total</b>	<b>152,333</b>	<b>16,098</b>	<b>168,431</b>

Geographic allocation is based on the domicile of the obligor.

As at 31<sup>st</sup> December 2009

Standardised exposure classes All figures in £000's	UK	Europe, Middle East & Africa	Group total
Central governments & central banks	0	0	0
Institutions	250,717	14,282	264,999
Corporates	8,858	0	8,858
Retail	19,599	1,085	20,684
Past due items	3,218	641	3,859
<b>Total</b>	<b>282,392</b>	<b>16,008</b>	<b>298,400</b>

Geographic allocation is based on the domicile of the obligor.

### (3) Standardised gross exposure (EAD pre CRM) by industry sector

As at 31<sup>st</sup> December 2010

Industry sector All figures in £000's	Central govts & central banks	Institutions	Corporates	Retail	Past due items	Group total
Banks and other financial	0	156,338	1,729	6,743	157	164,967
Other individual loans/advances	0	457	1,873	1,134	0	3,464
<b>Total</b>	<b>0</b>	<b>156,795</b>	<b>3,602</b>	<b>7,877</b>	<b>157</b>	<b>168,431</b>

All exposures are classified as banks and other financial institutions except collateralised loans to individuals.

As at 31<sup>st</sup> December 2009

Industry sector All figures in £000's	Central govts & central banks	Institutions	Corporates	Retail	Past due items	Group total
Banks and other financial	0	263,202	8,708	20,684	3,859	292,594
Other individual loans/advances	0	1,797	150	0	0	1,947
<b>Total</b>	<b>0</b>	<b>264,999</b>	<b>8,858</b>	<b>20,684</b>	<b>3,859</b>	<b>298,400</b>

All exposures are classified as banks and other financial except collateralised loans to individuals.

**(4) Standardised gross exposure (EAD pre CRM) by residual maturity**

As at 31<sup>st</sup> December 2010

Standardised exposure classes All figures in £000's	On demand	Up to 1 year	Group total
Central governments & central banks	0	0	0
Institutions	97,063	59,732	156,795
Corporates	0	3,602	3,602
Retail	0	7,877	7,877
Past due items	0	157	157
<b>Total</b>	<b>97,063</b>	<b>71,368</b>	<b>168,431</b>

Exposures are allocated to maturity bands based on residual contractual maturity.

As at 31<sup>st</sup> December 2009

Standardised exposure classes All figures in £000's	On demand	Up to 1 year	Group total
Central governments & central banks	0	0	0
Institutions	166,702	98,297	264,999
Corporates	0	8,858	8,858
Retail	0	20,684	20,684
Past due items	0	3,859	3,859
<b>Total</b>	<b>166,702</b>	<b>131,698</b>	<b>298,400</b>

Exposures are allocated to maturity bands based on residual contractual maturity.

**6.4 Past due Exposures and Impaired Assets**

Past due exposures are as defined in FSA BIPRU 3.4.95 ie past due for more than 90 days. Pershing has no impaired assets.

**(1) Impaired, past due exposures and provisions by industry sector**

As at 31<sup>st</sup> December 2010

Standardised exposure classes Figures in £000's	Impaired assets	Past due assets > 90 days (not impaired)	Individual & collective provisions	Charged to income statement in the year ended 31 Dec 2009
Central governments & central banks	0	0	0	0
Institutions	0	157	309	0
<b>Total</b>	<b>0</b>	<b>157</b>	<b>309</b>	<b>0</b>

A credit exposure is past due when its contractual repayment is overdue by 90 days or more (risk definition differs from accounting).

As at 31<sup>st</sup> December 2009

Standardised exposure classes Figures in £000's	Impaired assets	Past due assets > 90 days (not impaired)	Individual & collective provisions	Charged to income statement in the year ended 31 Dec 2009
Central governments & central banks	0	0	0	0
Institutions	0	3,859	1,243	0
<b>Total</b>	<b>0</b>	<b>3,859</b>	<b>1,243</b>	<b>0</b>

A credit exposure is past due when its contractual repayment is overdue by 90 days or more (risk definition differs from accounting).

## (2) Impaired, past due exposures and provisions by geographic area

As at 31<sup>st</sup> December 2010

Industry sector All figures in £000's	Impaired assets	Past due assets > 90 days (not impaired)	Individual & collective provisions	Charged to income statement in the year ended 31 Dec 2010
UK	0	149	309	0
Europe, Middle East & Africa	0	8	0	0
North America	0	0	0	0
<b>Total</b>	<b>0</b>	<b>157</b>	<b>309</b>	<b>0</b>

Table is presented on a UK GAAP accounting basis which is consistent with the approach agreed by the UK banking industry.

Geographic segmentation is based on the country of the obligor, consistent with Financial accounting disclosure.

As at 31<sup>st</sup> December 2009

Industry sector All figures in £000's	Impaired assets	Past due assets > 90 days (not impaired)	Individual & collective provisions	Charged to income statement in the year ended 31 Dec 2009
UK	0	3,218	1,243	0
Europe, Middle East & Africa	0	641	0	0
North America	0	0	0	0
<b>Total</b>	<b>0</b>	<b>3,859</b>	<b>1,243</b>	<b>0</b>

Table is presented on a UK GAAP accounting basis which is consistent with the approach agreed by the UK banking industry.

Geographic segmentation is based on the country of the obligor, consistent with Financial accounting disclosure.

**(3) Movement in allowances for impaired and past due exposures & provisions**

As at 31<sup>st</sup> December 2010

All figures in £000's	Individual & collective provisions	Group total
Opening balance	1,243	1,243
Amounts written off	-967	-967
Charged to income statement in this period	33	33
<b>Closing balance</b>	<b>309</b>	<b>309</b>

Table is presented on a UK GAAP accounting basis which is consistent with the approach agreed by the UK banking industry.

There were no cash recoveries during the year associated with amounts previously written off.

As at 31<sup>st</sup> December 2009

All figures in £000's	Individual & collective provisions	Group total
Opening balance	1,240	1,240
Amounts written off	-286	-286
Charged to income statement in this period	289	289
<b>Closing balance</b>	<b>1,243</b>	<b>1,243</b>

Table is presented on a UK GAAP accounting basis which is consistent with the approach agreed by the UK banking industry.

There were no cash recoveries during the year associated with amounts previously written off.

**7. Standardised Risk Weighting**

Credit exposure is computed under the standardised approach. Pershing uses external credit assessments provided by Fitch, Moody's, and Standard and Poor's to determine the risk weighting of exposures in its portfolios depending on counterparty type and coverage. Fitch, Moody's and Standard and Poor's are all recognised by the FSA as eligible external credit assessment institutions (ECAI) for the purpose of calculating credit risk requirements under the standardised approach.

All ECAI counterparty ratings are subject to validation or amendment by the Credit Risk department.

The following table aligns exposure classes with ECAIs used.

Standardised FSA exposure classes	ECAI	ECAI	ECAI
Central governments & Central banks	Standard & Poor's	Moody's	Fitch
Institutions	Standard & Poor's	Moody's	Fitch
Corporates	Standard & Poor's	Moody's	Fitch
Retail	Standard & Poor's	Moody's	Fitch

All ECAI ratings are mapped to a credit quality steps as defined by the FSA in BIPRU as shown below:

Credit Quality Step (CQS)	Fitch	Moody's	S&P
CQS 1	AAA to AA-	Aaa to Aa3	AAA to AA-
CQS 2	A+ to A-	A1 to A3	A+ to A-
CQS 3	BBB+ to BBB-	Baa1 to Baa3	BBB+ to BBB-
CQS 4	BB+ to BB-	Ba1 to Ba3	BB+ to BB-
CQS 5	B+ to B-	B1 to B3	B+ to B-
CQS 6	CCC+ and below	Caa1 and below	CCC+ and below

The following table summarises the standardised portfolio EAD values by exposure class both pre and post CRM and the relevant CQS.

### Standardised gross exposure by credit quality step

As at 31<sup>st</sup> December 2010

Standardised exposure classes All figures in £000's	Credit quality step (CQS)	Risk weight	EAD pre CRM	EAD after CRM
Central governments & central banks	1	0%	0	0
Institutions	2	20%	156,795	148,940
Corporates	2	20%	3,602	0
Corporates	4	100%	0	0
Retail	4	100%	7,877	0
Past due items	6	150%	157	91
<b>Total Exposures</b>			<b>168,431</b>	<b>149,031</b>

EAD after CRM includes a deduction of £19 million for credit risk mitigation.

As at 31<sup>st</sup> December 2009

Standardised exposure classes All figures in £000's	Credit quality step (CQS)	Risk weight	EAD pre CRM	EAD after CRM
Central governments & central banks	1	0%	0	0
Institutions	2	20%	264,999	212,757
Corporates	2	20%	8,858	0
Corporates	4	100%	0	0
Retail	4	100%	20,684	29
Past due items	6	150%	3,859	0
<b>Total Exposures</b>			<b>298,400</b>	<b>212,786</b>

EAD after CRM includes a deduction of £82 million for credit risk mitigation.

## 8. *Operational Risk*

Pershing has a robust risk management oversight and governance structure, which confirms that policies and procedures are regularly reviewed and updated to reflect the development of the business and changes in industry best practice. Nonetheless, some reliance is placed on manual controls and processes and the skills/capabilities of a relatively small number of employees which can give rise to operational risks. Augmenting this oversight are shared service functions such as Compliance, Internal Audit, IT Security and the Risk Management at a group level.

For the purposes of calculating a Pillar 1 operational risk capital charge under the Basel II Standardised Approach, Senior Management have determined that Pershing business activities fall under either the Agency Services or Retail Brokerage Basel business lines. For the purposes of this calculation, the average 3-year income streams for these activities have been weighted at 15% and 12% respectively.

### Capital requirements for Operational risk

2010: £11,399

2009: £10,286

## 9. *Interest Rate Risk in the Non-Trading Book*

Pershing's non-trading book activities only include Firm Cash deposits with clearing organisations and general overnight bank deposits. As these cash deposits are held in index linked interest bearing accounts, there is interest rate risk present. Pershing does not consider earnings relating to client free money deposits to be part of the non-trading book.

Deposits with clearing organisations usually relate to margin calls for all securities settlement and clearing services for Pershing clients. These margin calls are covered by Firm Cash and overnight borrowing using committed/uncommitted lines. In the event that credit lines are used to cover margin calls, the expense to Pershing is the spread between the credit interest and the cost of funds. The pricing model adopted by Pershing covers this net expense by charging its clients a fixed margin on the principal amount of

the margin call. Therefore a 200bps rate movement in either direction will have little impact to net revenue as the credit interest paid and the cost of funds are both index linked and would move in parallel in the event of a rate shock.

Firm cash balances are held in current accounts with approved banks where the accounts earn a rate of interest indexed to benchmark UK rates. Senior Management consider that interest revenue on Firm cash balances is not material to earnings, consequently a 200bps rate movement would not have a material impact to overall earnings.

## **10. *Non-Trading Book Exposures in Equities***

Pershing has non-trading book Equity exposures to the value of £452,000 (2009 £452,000) in respect of investments in clearing house organisations.

These are defined under a UK GAAP accounting basis (as opposed to a regulatory definition of equity) which is consistent with the approach agreed by the UK banking industry.

The Directors consider the market value of these investment securities (which are all unlisted) to be at least their balance sheet carrying value.

## **11. *Credit and Market Risk Mitigation***

Credit Risk can be mitigated by collateral and deposits, netting, guarantees, indemnities and other contractual mechanisms, and credit derivatives (not currently used by Pershing). Given the nature of Pershing's business, the principal mitigation methods that are pertinent are i) collateral and ii) contractual recourse to the client in respect of the debts or default of underlying clients.

The major mitigants of Pershing's Credit & Market Risk assume that in the event of a failed trade there is sufficient collateral, security deposit and retained commissions to meet mark-to-market exposure and that the residual exposure is not greater than the client's ability to 'make good' its obligation to Pershing. In order to mitigate this risk there is a weekly review by Credit & Market Risk Committee of all debts greater than 30 days past due, against which Pershing withholds commission payable to the client. The total amount of eligible financial collateral used in the Pillar 1 calculation to mitigate exposures is circa £19 million (2009 £82 million) and specific guarantees of £900,000 (2009 £900,000). These are all classified against institutions.

Pershing has no other eligible financial collateral, apart from the implicit guarantees from its institutional broker client's for Pershing's exposure to their underlying clients. This results in an improved risk weighting of these exposures giving rise to reduced capital charges for such exposures.

## **12. *Disclosures not Relevant***

### **A     *Securitisation***

Pershing does not securitise its assets; thus this risk is not relevant.

**B Insurance for the purpose of Mitigating Operational Risk**

Pershing does not use the Advanced Measurement Approach ('AMA') for the calculation of its operational risk. This disclosure is therefore not relevant.

## Glossary of Terms

The following terms are used in this paper

- **ARROW** FSA's Advanced Risk Response Operating Framework
- **Basel II** The June 2006 capital adequacy framework issued by the Basel Committee on Banking Supervision in the form of the 'International Convergence of Capital Measurement and Capital Standards'.
- **BIPRU** The FSA's rules, as set out in Prudential Sourcebook for Banks, Building Societies and Investment Firms.
- **CCR** Counterparty Credit Risk
- **CRD** Capital Requirements Directive
- **Core equity tier 1 capital** Tier 1 capital less innovative tier 1 securities and preference shares.
- **Credit quality step** A step in the FSA credit quality assessment scale which is based on the credit ratings of External Credit Assessment Institutions ('ECAIs'). It is used to assign risk weights under the standardised approach.
- **Credit risk mitigation** A technique to reduce the credit risk associated with an exposure by application of credit risk mitigants such as collateral, guarantees and credit protection.
- **Customer risk rating (CRR)** Internal obligor probability of default scale of 22 grades, of which 20 are non default grades representing varying degrees of strength of financial condition and two are default grades.
- **ECAI** External Credit Assessment Institution, such as Moody's Investors Service, Standard & Poor's Ratings Group or Fitch Group.
- **Economic capital** An internal assessment of the amount of capital required to protect against potential unexpected future losses arising from business activities, across a defined time horizon and confidence interval.
- **Exposure** A claim, contingent claim or position which carries a risk of financial loss.
- **Exposure at default (EAD)** The amount expected to be outstanding, after any credit risk mitigation, if and when a counterparty defaults. EAD reflects drawn balances as well as allowance for undrawn amounts of commitments and contingent exposures.
- **Exposure value** Exposure at default (EAD).
- **Fair value** Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.
- **FSA** The Financial Services Authority of the United Kingdom.
- **GENPRU** The FSA's rules, as set out in the General Prudential Sourcebook.
- **Haircut** With respect to credit risk mitigation, an adjustment to collateral value to reflect any currency or maturity mismatches between the credit risk mitigant and the underlying exposure to which it is being applied. Also a valuation adjustment to reflect any fall in value between the date the collateral was called and the date of liquidation or enforcement.
- **Held-to-maturity** An accounting classification for investments acquired with the intention of being held until they mature.
- **IFRS** International Financial Reporting Standards.
- **Institutions** Under the Standardised approach, Institutions are classified as credit institutions or investment firms. Under the IRB approach, Institutions also include regional governments and local authorities, public sector entities and multilateral development banks.
- **Insurance risk** A risk, other than financial risk, transferred from the holder of a contract to the insurance provider. The principal insurance risk is that, over time, the combined cost of claims, administration and acquisition of the contract may exceed the aggregate amount of premiums received and investment income.
- **Internal Capital Adequacy Assessment Process (ICAAP)** The Group's own assessment of the levels of capital that it needs to hold through an examination of its risk profile from regulatory and economic capital viewpoints.

- **Residual maturity** The period outstanding from the reporting date to the maturity or end date of an exposure.
- **Risk appetite** A definition of the types and quantum of risks to which the firm wishes to be exposed.
- **Risk-weighted asset (RWA)** Calculated by assigning a degree of risk expressed as a percentage (risk weight) to an exposure in accordance with the applicable Standardised or IRB approach rules.
- **Securitisation** A transaction or scheme whereby the credit risk associated with an exposure, or pool of exposures, is tranching and where payments to investors in the transaction or scheme are dependent upon the performance of the exposure or pool of exposures. A traditional securitisation involves the transfer of the exposures being securitised to an SPE which issues securities. In a synthetic securitisation, the tranching is achieved by the use of credit derivatives and the exposures are not removed from the balance sheet of the originator.
- **Standardised approach** In relation to credit risk, a method for calculating credit risk capital requirements using ECAI ratings and supervisory risk weights. In relation to operational risk, a method of calculating the operational capital requirement by the application of a supervisory defined percentage charge to the gross income of eight specified business lines.
- **Tier 1 and Tier 1 capital** Have the meanings given to such terms in the General Prudential Sourcebook (as set out in the FSA's Handbook).
- **Tier 2 capital** Has the meaning given to this term in the General Prudential Sourcebook (as set out in the FSA's Handbook).
- **Wrong-way risk** Defined by the FSA as a situation where there is an adverse correlation between the counterparty's probability of default and the mark-to-market value of the underlying transaction.

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