



Merchant Securities Group

Merchant Securities Group plc / Merchant Securities Limited - Pillar 3 As at 30 September 2010

Background

Merchant Securities Limited (“MSL”) is a financial services group specialising in institutional sales, research and trading, private client broking and investment management, corporate finance and corporate broking. It is authorised and regulated by the Financial Services Authority (“FSA”).

Under the European Union Capital Requirements Directive (“CRD”) there is a regulatory capital framework across Europe that applies to banks and financial services firms such as MSL.

The CRD consists of three pillars:

Pillar 1 sets out the minimum amount of capital requirement based on the sum of credit, operational and market risk;

Pillar 2 requires the company to review whether any additional capital should be maintained against any risks not covered in Pillar 1;

Pillar 3 requires companies to disclose details about their capital, risk exposures and management.

Review

The Company will review and publish its Pillar 3 disclosure at least annually.

Application of the Banking Consolidation Directive (“BCD”)

BCD disclosures are made on a consolidated basis for the group, including its FSA regulated subsidiary, Merchant Securities Limited.

Corporate Governance

The board recognises that it is responsible for the systems of internal control and for reviewing their effectiveness. Such procedures and systems have been designed to manage rather than eliminate risks.

The board manages the capital in the group to ensure that each company has sufficient capital to meet its current and expected requirements.

The group manages its capital (defined as share capital and reserves) so that the regulated subsidiaries comply with the requirements of the FSA as well as ensuring that their capital base is adequate to cover the risks in their business as set out in the group’s Internal Capital Adequacy Assessment Process (“ICAAP”) document.

The group’s objectives when managing capital are to ensure that it has sufficient capital to support its regulated business, to maximise shareholder value and to safeguard the group’s ability to continue as a going concern in order to provide returns for shareholders and benefits for other stakeholders. The group has complied with the capital requirements as set out by the FSA.



Merchant Securities Group

Risk Management Policies and Controls

The key risks to the group are considered to be principally personnel risk, reputational risk, credit risk, liquidity risk and operational risk. Several high-level procedures are already in place to enable all risks to be managed and controlled. These include profit forecasts by business segment, monthly management accounts and comparisons against forecast, monthly meetings of the full board of directors, and more regular senior management meetings. The Risk Committee monitors and mitigates the principal risks facing the group. The Risk Committee meets at least quarterly and presents its findings to the board and the Audit Committee.

The group currently derives most of its income from activities on behalf of clients who normally hold assets and cash balances which are under our control. Debtors in respect of other business activities are monitored by the finance department. Other risks, including operational and reputational risks are under constant review at senior management level by the executive directors and senior managers at their regular Operations Committee meetings (generally at least fortnightly), and by the full board at their monthly meetings.

The group operates in a heavily regulated financial services sector. The group monitors developments in regulation, assesses the impact on the business, and implements any changes that will be required to meet these requirements.

MSL does not trade as principal and does not therefore take any trading positions for its own account. It trades for clients as agent and in its capacity as a matched principal broker only. Accordingly, MSL has no positional risk exposure arising from its trading activities for clients other than as a result of a trading error. Such errors must be rectified immediately. The group does not have any significant exposure to credit risk and has little or no exposure to foreign exchange risk and interest rate risk.

Internal Capital Adequacy Assessment Process

The group ICAAP includes an assessment of each of the principal risks faced by the group and the internal controls in place to mitigate those risks. This assesses each of the risks faced by the group, the controls in place to mitigate such risk and the likelihood as such risk occurring. It covers among other things, the group's risk appetite, a formal process for the group Risk Committee to review and sign off on potential risks for new business developments, capital planning, stress testing, credit risk, market risk, reputational risk, operational risk, liquidity risk, employee risk and business continuity risk.

Foreign currency and interest rate risk

The group does not have any overseas operations and has no material dealing in foreign currency. The majority of client transactions are in UK based equities, denominated in sterling. The group has limited exposure to movements in interest rates on its own funds.

Market and Counterparty Credit risk

Counterparty credit risk represents the risk that a third party will default on its contractual obligations resulting in financial loss.

It covers amounts outstanding from authorised banks, a limited number of market counterparties and corporate clients. Deposits are only placed with banks with investment grade credit ratings.



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MSL uses Pershing as a Model B clearing firm. Pershing Securities Limited is one of the largest clearing agents in the world and has significant insurance cover to protect client assets. The group therefore has limited market risk.

MSL provides corporate finance and corporate broking services to its corporate clients. Receivables from such clients are reviewed on a regular basis and procedures are in place to highlight overdue receivables and provide for any impairment where it is considered appropriate.

Employee risk

The group's employees are its greatest asset. The future success of the group depends on the group's ability to attract and retain high quality people. The group rewards employees through a remuneration policy which manages conflicts of interest and seeks to align the interests of staff with that of our shareholders and clients.

Reputational risk

One of the group's greatest risks comes from the potential for damage to its reputation. It encourages entrepreneurial employees to expand the business, however all significant new business is subject to a detailed appraisal and approval (sign-off) to ensure that it meets the group's systems and controls requirements.

Liquidity risk

Liquidity risk is the risk arising from a difficulty in realising assets or otherwise raising funds to meet commitments associated with liabilities or financial obligations as they fall due.

The group has a healthy cash position with significant surplus funds available. At 30 September 2010 the group had net cash of £2.4 million at call with bankers.

Cash flow is monitored on a weekly basis. The board monitors the historic cash position which allows them to monitor adverse trends in the cash/liquidity position to identify whether remedial action may be required in the future.

Group forecasts are reviewed by the Chief Executive Officer and the board to determine, in light of the trading performance, whether the income and cost assumptions are still appropriate. In the event that the assumptions are no longer considered to be appropriate the forecasts are revised accordingly.

Operational risk

Operational risk is the risk of loss or other negative impact on the company from inadequate or failed internal processes, staff or systems or from external events.

Operational risk is managed by the Operations Committee with representatives from each department who meet fortnightly, or more frequently, if required.



Merchant Securities Group

Satisfaction of capital requirements

Our regulatory capital ratios are strong, reflecting a significant buffer over the FSA requirements.

Merchant Securities Group plc

Year ended 31 March	2010 £000	2009 £000
Tier one capital		
Share capital	3,272	3,252
Share premium	11,705	11,705
Other reserves	<u>(8,493)</u>	<u>(8,979)</u>
Tier one capital	<u>6,484</u>	<u>5,978</u>
Deductions from tier one capital		
Goodwill/intangible Assets	(3,177)	(3,116)
Investment in own shares	<u>(54)</u>	<u>-</u>
Deductions from tier one capital	<u>(3,231)</u>	<u>(3,116)</u>
Total Regulatory Capital after deductions	<u>3,253</u>	<u>2,862</u>

The group is subject to the Fixed Overhead Requirement for calculation of its Pillar 1 Capital Resource Requirements. For the year ended 31 March 2010 the amount required to be held by the group to meet the Fixed Overhead Requirement was £1,153,000.