

Cheviot Asset Management Ltd Pillar 3 Disclosures

31 December 2009

Overview

The Capital Requirements Directive (“CRD”) of the European Union created a revised regulatory capital framework across Europe governing how much capital financial services firms must retain. The rules are set out in the CRD under three pillars:

Pillar 1 sets out the minimum capital resource requirement firms are required to maintain to meet credit, market and operational risks.

Pillar 2 requires firms to assess firm-specific risks not covered by Pillar 1 and, where necessary, maintain additional capital.

Pillar 3 requires firms to disclose information regarding their risk assessment process and capital resources with the aim to encourage market discipline by allowing market participants to assess key information on risk exposure and the risk assessment process.

The rules in the FSA Prudential Sourcebook for Banks, Building Societies and Investment Firms (“BIPRU”) set out the provision for Pillar 3 disclosure. This document is designed to meet our Pillar 3 disclosure obligations.

Frequency of disclosure

Future disclosures will be issued on an annual basis.

Verification

These disclosures have been prepared in order to comply with regulatory requirements and provide information on risk management policies and certain capital requirements. They do not constitute financial statements and are based on unaudited financial positions and should not be relied upon in making judgements about Cheviot Asset Management Ltd (“the Firm”).

Location

This report will be published on the Firm’s website.

Scope and application of the requirements

The Firm is authorised and regulated by the Financial Services Authority (“FSA”) to conduct investment business, with permission to hold and control client money. The Firm is categorised as a Limited Licence firm by the FSA for capital purposes.

Cheviot Asset Management Ltd, Cheviot Partners LLP (“the Partnership”), Cheviot Capital (Nominees) Ltd and European Stockbrokers Ltd form a UK Consolidation

Sub-Group (“Cheviot Group” or “the Group”). The FSA supervises the Group on a consolidated basis and receives information on the capital adequacy of, and sets capital requirements for, the Group as a whole.

There are no current or foreseen material, practical or legal impediments to the prompt transfer of capital resources, or repayment of liabilities, intra-Group.

Risk appetite and management

The Firm is exposed to a variety of risks, as analysed and quantified below. However, the Board have adopted a conservative approach to risk, resulting in a low risk profile for the Group, for the following reasons:

- The business model is straightforward agency investment management. As principal positions are not taken, the Group’s risk exposure is limited to counterparty risk and the impact on income;
- The recruitment of experienced personnel throughout the Group;
- Limited exposure to credit risk;
- The corporate governance structure ensures that responsibilities within the Group are apportioned correctly within ‘oversight’ functions staffed by experienced personnel with access to Senior Management;
- Comprehensive insurance arrangements which provide substantially higher levels of cover than historic loss data would indicate was required.

Risk management is a fundamental part of the day to day management of the Firm, both within operational procedures to ensure that the risks associated with the provision of investment management services are mitigated by appropriate controls and processes and also within our fundamental approach to stock selection and daily management of the client investment portfolios.

The Board meets quarterly, or as and when necessary, and has primary responsibility for governance and oversight of the Group. The Risk Officer provides independent oversight over the Firm’s risk management process and controls, and has overseen the development of the Risk Management Policy. This sets out the Firm’s processes for the management of internal and external risks arising from Market, Credit, Operational, Liquidity and other relevant risk categories, which form the basis for the risk management procedures. The Risk Management Policy is reviewed and updated on a regular basis.

Operational, market, credit and regulatory risks are reviewed monthly by the Operations, Compliance and Risk (“OCR”) Committee. A monthly management pack is produced by the Risk Officer and reviewed by the OCR Committee. The pack includes key risk metrics.

Capital adequacy and ICAAP

The Firm’s overall approach to assessing the adequacy of our internal capital is documented in the Internal Capital Adequacy Assessment Process (“ICAAP”).

The ICAAP process includes an assessment of all material risks faced by the Group and the controls in place to identify, manage and mitigate those risks. The risks identified are stressed-tested against various scenarios to determine the level of capital that needs to be held.

Where risks can be mitigated by capital the Group has adopted a “Pillar 1 plus” approach whereby the Pillar 1 capital calculations are assessed. Where the Board considers that the Pillar 1 calculations do not adequately reflect the risk, additional capital is added on in Pillar 2.

Whilst the ICAAP is formally reviewed by the Board once a year, Senior Management reviews risks and the required capital more frequently and will particularly do so when there is a planned change impacting risks and capital or when changes are expected in the business environment potentially impacting the ability to generate income. The ICAAP process has also been challenged internally by the Compliance Office and Head of Operations.

Capital resources

The capital requirements of the Group are monitored on an ongoing basis to ensure that at any time there is always sufficient capital in place. As at 31 December 2009 the Group’s capital resources for regulatory purposes were as follows:

£000's	Note	Pillar 1 Minimum capital	ICAAP Pillar 2 capital	Total Pillars 1 & 2
Credit risk		784	-	784
Market risk		3	-	3
Fixed Overhead Requirement		3,248	-	3,248
Pillar 1 total (Higher of FOR and CCR+MRR)		3,248	-	3,248
Pillar 2 total		-	625	625
ICAAP capital		3,248	625	3,873
Current total capital		-	-	12,885
Surplus		-	-	9,012

The Group had £12.9m of regulatory capital after deductions in place as at 31 December 2009, compared with an ICAAP capital requirement of £3.9m, resulting in a £9m (233%) surplus.

The regulatory capital which is required to be held by FSA regulations, is defined by the FSA as consisting of share or partnership capital as well as non cumulative preference shares (known as tier one capital), cumulative preference shares, long term subordinated debt and securities, revaluation reserves and provisions (known as tier two capital) and short term subordinated debt and trading book profit/loss (known as tier three capital). The Firm follows FSA regulations accordingly and has calculated its regulatory capital in accordance with these definitions.

Material risks

The material risks for the Firm are as follows:

Credit & Settlement Risk

Credit risk is the risk that unexpected losses may arise as a result of the Firm's clients and counterparties failing to meet their obligations to settle transactions.

Credit risk is limited. The only material credit exposures are amounts receivable from market and client counterparties, including bank deposits. Since the great majority of business is carried out on a delivery versus payment basis, exposure to unsettled market and client positions is limited to the extent of market movements between trade date and settlement date. UK market counterparties are members of the London Stock Exchange and / or are FSA regulated, hence credit risk is significantly reduced. The Firm has a small number of overseas market counterparties which are reviewed on a regular basis.

Capital is set aside to mitigate against the risk in accordance with the Pillar 1 Counterparty Credit Risk Requirement.

Liquidity Risk

Liquidity risk is the risk that the Group will not be able to meet its financial obligations as they fall due.

The Group is equity funded and has no reliance on debt financing. Working capital ratios are considered adequate given the DVP nature of trade settlement and the stable nature of administrative expenses. The Board are satisfied that there is no specific risk arising from liquidity.

Concentration Risk

Concentration risk is the risk arising from a lack of diversification in the business.

The Firm deals with a range of market counterparties, and revenue is generated from a well diversified client base. Concentration risk within individual client portfolios is managed by the Investment Manager and monitored by the Investment Committee. The Firm is not overly exposed to specific counterparties.

Business Risk

The key business risk is a reduction in funds under management, following a market downturn or loss of clients, resulting in lower management fees. Management carry out stress-testing in order to assess the impact on profit and loss from various scenarios where funds under management fall.

Market Risk

The Firm is exposed to a small amount of foreign exchange risk through its foreign currency trade receivables and payables. Foreign exchange positions are held on an intra-day basis only and purely for settlement purposes. In the opinion of the Directors, the residual foreign exchange risk is adequately addressed through the Pillar 1 market risk capital requirement for this risk.

Operational Risk

Operational risk is the risk of loss to the Firm resulting from failed or inappropriate internal procedures, people and systems, or from external events.

The Directors consider the Firm's arrangements for monitoring, recording and mitigating operational risk to be appropriate to the size, nature and complexity of the business. Extensive management information is prepared on a monthly basis by the Finance Department and the Risk Officer and there are clear lines of escalation within the Firm.

The Firm employs experienced staff in the management of operational risk, together with clear segregation of duties and robust documented operational procedures.

The management and monitoring of outsourcing relationships is a key control. The Firm monitors qualitative performance of functions outsourced to third party service providers to ensure adherence to contractual obligations.

Business continuity risk is the risk of interruption to the business due to the unavailability of systems or office space. The Firm has a comprehensive business continuity strategy which is tested on an annual basis.

The Group also mitigates its operational risk by means of a comprehensive Professional Indemnity insurance policy.

Regulatory Risk

Regulatory change and compliance with the Firm's ongoing regulatory compliance obligations is an area of continued focus for the Board. The Directors are satisfied that the Firm's risk management and internal control framework is sufficiently robust to mitigate against the risk of non-compliance. Considerable resource has been invested in the ongoing development of the Risk and Compliance functions.

The Board of Directors recognise that not all of the risks to which the Group is exposed can be mitigated by the addition of incremental capital, hence those other risks, such as reputation and legal risks, are managed by internal policies and procedures and monitored by management on an ongoing basis.

Additional risks identified within the overall Pillar 2 rule have been assessed and evaluated by the Directors, and are not considered to be material to the Group.