

# Royal London Asset Management

## Pillar 3 Disclosure

25 August 2011

### Contents

1. Introduction	1
2. Governance	2
3. Disclosure	2
4. Risk Management objectives and policies	3
5. Capital adequacy	4
6. Notices	7

# 1. Introduction

## Background

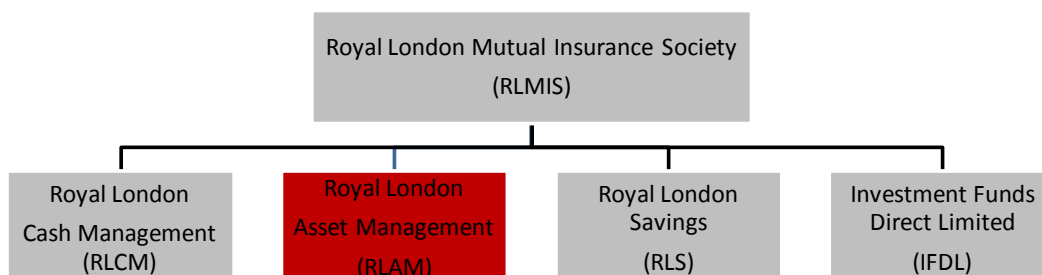
The Capital Requirements Directive “CRD” introduced the need for investment firms under this new legislative framework to publish certain information relating to their risk management and capital adequacy. The aim is to promote market discipline by providing key data on risk exposures and risk management processes.

The disclosure of this information is known as Pillar 3 and is designed to complement the two other pillars of the CRD, namely the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The disclosure has been prepared in accordance with the rules laid out in BIPRU 11 of the FSA Handbook.

The CRD three Pillars:

- Pillar 1 The minimum capital requirements, through the application of measurement rules, of firms to cover credit, market and operational risk;
- Pillar 2 Designed to compliment the existing Pillar 1 requirements by assessing the need to hold additional capital in relation to the actual risk profile of the business, which is achieved through the Internal Capital Adequacy Assessment Process “ICAAP”, as reviewed by the Financial Services Authority “FSA”;
- Pillar 3 A set of disclosure requirements which enable external parties to assess information on firm’s risks, capital and risk management procedures and capital adequacy.

RLAM has been a separate subsidiary of Royal London Mutual Insurance Society “RLMIS” since 1988, with a particular focus on providing asset management services to the UK pension fund market. The structure below shows the subsidiaries of RLMIS which fall under the remit of the CRD:



RLAM is a key firm within the Royal London Group, managing all of the Group’s assets, in addition to successfully providing active investment management solutions to FTSE 250 companies, universities, charities, private clients, corporate and local authority pension funds and wholesale clients throughout the UK. RLAM also manages a range of unit trust funds which are available to the retail market and administered by Royal London Unit Trust Managers Limited “RLUTM”. Additionally, RLAM will also manage the investments held in relation to bonds distributed by RLAM Bond Funds and our closed book of Individual Savings Accounts “ISA’s” managed by Royal London Savings “RLS”.

Since inception, RLAM has built a successful fixed interest fund management business which has been founded on good investment performance and tailored client service forged through strong client relationships and team-oriented fund managers.

To support the proper management of its clients’ assets, RLAM’s organisational structure is designed to ensure strict segregation between the investment management function, client reporting and the monitoring of compliance with clients’ guidelines and regulatory requirements. RLAM is a limited licence BIPRU firm.

## Summary

The Board concludes that RLAM has sufficient financial resources in terms of both capital and liquidity, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. RLAM firmly believes that capital charges do not represent an effective substitute for adequate and effective risk management processes. In this context, senior management have reviewed and enhanced the existing business control environment to make sure risks are managed in a comprehensive and robust manner.

## 2. Governance

The RLAM Board of Directors has responsibility for the overall risk governance and management of RLAM. The RLMIS Board has ultimate responsibility to define the Royal London Group's risk appetite, benchmarks, tolerances and underlying limit controls.

As a wholly owned subsidiary of RLMIS, RLAM will adhere to the risk management objectives and policies set out for companies within the Royal London Group. The Financial Statements to the Report and Accounts for RLMIS detail the governance structure in place for the Royal London Group companies and the approach taken to risk management generally. This specifically covers the Royal London Group's management of the various categories of risk faced by the Group.

This information can be found in the Report and Accounts for the Royal London Group and on the Corporate Governance section of the Royal London website at [www.royallondongroup.co.uk](http://www.royallondongroup.co.uk).

The RLAM Board of Directors and senior management will determine whether actual performance was above, below or in line with RLAM's tolerance level. They determine whether any adjustments need to be made, either to the statement of risk appetite, budget or forthcoming business plan. The Royal London Group maintains a Risk Appetite statement which is applicable to all Royal London Group entities, including RLAM.

The RLAM Board is responsible for setting the RLAM strategy and ensuring that all key risks are effectively and efficiently controlled. Systems of internal control are designed to ensure effective and efficient operations, including financial reporting, and compliance with laws and regulations. The RLAM Board delegates responsibility for the implementation of the RLAM strategy and the day to day management of risk to senior management.

It is the responsibility of RLAM's Risk & Compliance Departments to provide appropriate advice and guidance, not restricted to operational matters. Further specialist or technical knowledge may be drawn from the Royal London Group Risk & Compliance Team or externally as circumstances dictate. RLAM is integral to the overall Royal London Group structure. Controls are reviewed by a number of independent governance committees within the Group and by dedicated Risk & Compliance departments within RLAM, Group Internal Audit as well as the firm's external auditors, who review the control environment within RLAM.

## 3. Disclosure

This information has been prepared purely for the purpose of explaining the basis on which RLAM has prepared and disclosed certain capital requirements and information about the management of risks relating to those requirements, and for no other purpose. It therefore does not constitute any form of financial statement on RLAM nor does it constitute any form of contemporary or forward looking record or opinion of the RLAM business.

These disclosures have been taken from historical and projected information updated to reflect final audited accounts for 2010 in the 2011 ICAAP.

RLAM regards information as material in disclosures if its 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. If RLAM deems a certain disclosure to be immaterial, it may be omitted from this Statement.

RLAM regards information as proprietary if sharing that information with the public would undermine its competitive position. Proprietary information may include information on products or systems which, if shared with competitors, would render the firm's investments therein less valuable. Further, RLAM must regard information as confidential if there are obligations to customers or other counterparty relationships binding the firm to confidentiality. In the event that any such information is omitted, we shall disclose such and explain the grounds why it has not been disclosed.

This information has been subject to internal review but has not been audited by the Group's external auditors.

Although Pillar 3 disclosures are intended to provide transparent capital disclosures on a common basis, the information contained in this document may not be directly comparable with other companies of a similar nature.

This Pillar 3 Disclosure Statement is available on RLAM's website at <http://www.rlam.co.uk/>

This disclosure document has been provided by RLAM in accordance with the requirements of Pillar 3 and the BIPRU Chapter of the Financial Services Authority handbook. Unless otherwise stated, all figures are as at 31/12/2010. Further disclosures will be issued on at least an annual basis, or more frequently in the light of relevant activity in the business.

## 4. Risk Management objectives and policies

RLAM, as a separate subsidiary of RLMIS, follows the Governance principles and practices proscribed by the Group. The Group's approach to risk management can be found within the notes to the Annual Report and Accounts which may be accessed at:

[http://www.royallondongroup.co.uk/CorporateGovernance/Introduction\\_CG.asp](http://www.royallondongroup.co.uk/CorporateGovernance/Introduction_CG.asp)

Our approach for the capture, evaluation and reporting of operational risk is based upon the underlying data within Enterprise Risk Assessor "ERA", the Group wide risk software utilised by RLAM. The overall procedure of capture, cleansing, stressing, and modelling risks in RLAM starts with key ERA risks being evaluated with business owners for impacts at extreme probabilities. All functions supporting the RLAM operation have participated and self assessed their own risks and these assessments are subject to challenge from the Risk & Compliance teams. Outcomes which appear out of line with current risk experience are discussed before inclusion in the process. Senior management have acted proactively in identifying the material risks and assessing the capital requirements taking into account the future business and risk profile. The Board receives regular information to help it determine whether effective risk mitigation is being achieved.

This profile of the risk enables information to be incorporated into scenarios. The use of scenario analyses and stress tests are intended to enable RLAM to gain a better understanding of the significant risks that it potentially faces under extreme conditions and to provide input to the determination of regulatory and economic capital required.

RLAM conducts top down and bottom up scenarios. The top down scenarios concern the analysis of a number of macro or corporate-level events occurring virtually at the same time. Bottom up scenarios concern the analysis of single, but potentially catastrophic events/risks which, ultimately, must cover all risks used for modelling the capital requirement. The objective in each case is to assess the probability of the scenario occurring and to quantify any significant impacts which can then be factored into the ICAAP modelling.

RLAM has also incorporated this in the methods applied to stress tests, where both a top down and bottom up approach can be evidenced. Whatever the approach used the nature and role of Board oversight is no different.

The ICAAP is formally reviewed by the Board and is further considered as part of the annual business planning cycle. Should business plans / significant re-positioning dictate, interim reviews will be undertaken.

Management information allows the Board to regularly monitor RLAM's business against the ICAAP framework and use it to make adjustments throughout the year and when ever else this may prove necessary.

To support this process the following management engagement is undertaken:

- Accounting reports to RLAM Board.
- Risk papers to RLAM Board and Group Committees.
- A monthly meeting between the Head's of Risk & Compliance and Executive Directors.
- Engagement of the executive and senior management through scenario workshops.
- Annual strategic plan preparation and challenge.

## 5. Capital adequacy

In addition to the capital adequacy reporting requirements of the Financial Services Authority, RLAM has prepared an ICAAP. The ICAAP, which sets out RLAM's approach to assessing the adequacy of its internal capital combined with a range of stress testing scenarios, is subject to at least annual review by the RLAM Board and any material events that may impact the ICAAP are subsequently raised at the appropriate Board Meeting.

Senior management intend to manage the RLAM capital base so that the majority of assessed risks have sufficient capital provided to allow RLAM to maintain its business without further capital injection. The Board meet monthly and receive financial reports on Pillar 1 and Pillar 2 capital availability.

The paragraphs below outline RLAM's defined risk categories and provide a statement of the level of risk exposure assessment, together with a summary of the risk mitigants in place where applicable.

### 5.1 Credit risk

Credit risk is the loss resulting from a counterparty's failure to repay amounts in full when due. RLAM has cash balances held across a number of counterparties within its Cash Unit Linked Pooled (CULP) holding. Credit risk relates to the possibility of one of the counterparties defaulting. Also RLAM has a number of debtor balances for fees. These are with institutional pension funds and local authorities. The risk here relates to the non payment of the fees which are therefore written-off as a bad debt.

Fees and other balances due from clients are regularly reviewed and the potential impact on P&L is evaluated on a monthly basis. All amounts that have been recognised to be at risk or overdue for more than 90 days, are monitored regularly.

#### Counterparty failure or exposure

The exposure within RLAM is considered to be quite small, due to the small period of time between trading and settlement. The Credit and Market Risk Management Committee (CMRMC) meets on a frequent basis to review counterparty exposure and ensure that ratings and exposures are appropriate in the current market conditions. Close and continuous monitoring of counterparties continues on a local level, and procedures for immediate escalation to CMRMC members are in operation.

#### Concentration risk

Concentration risk is any single or group of exposures that may have the potential to produce losses large enough to threaten an institutions' health or ability to maintain its core business. This includes large (connected) individual exposures or significant exposures to groups of counterparts, whose likelihood of default is driven by common underlying factors, e.g. sector, economy, geographical location and instrument type. These business risks have been considered through the exercise of potential event scenarios in the light of existing market conditions and experience gained over the last 24 months. Changes in these sectors have not, nor are expected to be, as volatile as previously anticipated. Management have determined that the scenarios presently conducted cover the material risks to which RLAM is exposed and that adequate steps have been taken to make suitable provision.

## 5.2 Market risk

RLAM does not hold investments in its own name and as a Limited License Investment Firms does not typically hold the necessary permissions to trade on their own behalf. Therefore the exposure to market risk is small. Where RLAM is exposed to the impact of market changes is to funds under management. The impact of these market movements on RLAM's fee income is considered under Business Risk.

## 5.3 Operational risk

Operational risk is the risk of loss or negative impact to RLAM resulting from inadequate or failed internal process, people and systems or from external factors such as regulation and key suppliers. It includes legal and financial crime risk but excludes business risk.

Operational risk is a key risk factor for RLAM as an asset manager. RLAM will not engage in activities that in the opinion of the Board would fall outside the scope of the definition of investment management used by the CRD in relation to the calculation of operational risk capital.

The following have been identified as the main sources of operational risk:

- **Trading and dealing errors**

This capital provision had historically been based on a single failed equity trade on the one hand and a derivative failure as the worst case. As these two events were not related by system and process controls it was deemed appropriate to re model this scenario based solely on trading activity, and undertake two additional and separate OTC (Over The Counter) and ETD (Exchange Traded Derivative) derivative trading scenarios. These impacts were then aggregated to arrive at the capital requirement for Pillar 2 trading and dealing errors

- **Key person dependency**

Concerns are very much focused on the importance of retaining our better performing fund managers and having programmes in place to mitigate the possibility of their loss (and potentially other members of their team). The impact of a materialised loss could be the loss of key business.

A dedicated HR team and the use of succession planning are designed to mitigate the potential of this risk.

- **Breach of regulatory rules**

Whilst controls are in place to ensure that RLAM can identify, manage and comply with legal and regulatory requirements, the risk of poor implementation carries significant penalties. With ever increasing regulatory demands in a technically complex environment, it is appropriate to make capital provision for the failure of regulatory controls.

RLAM has dedicated Risk & Compliance teams, which is part of a wider Group Risk & Compliance Function providing Risk & Compliance oversight to the Group.

- **Financial crime**

Our assessment considers the potential for market abuse, internal fraud, e-crime and money laundering. Additionally, during the difficult markets encountered in the last year, we are aware of the FSA's concerns about the use of processes used to provide misleading valuations to reflect enhanced performance.

The use of a recognised outsourced provider for valuing assets, HSBC Holdings plc "HSBC" provides a good level of independence. Additionally, whilst we have a number of stocks (principally fixed income) on client supplied prices, these represent a very small proportion of total assets. The Valuation Oversight Group has also provided an additional control mechanism and it is not felt that the worse case impact needs to be increased as a result. Levels of fine and enforcement action have increased noticeably in recent months, and to some

extent this is reflected in the Breach of Regulatory rules scenario above. Controls continue to be improved in RLAM, with improved segregation of duties and IT system access controls, which have reduced the worst case outcome figure from the scenario.

- **Business continuity/disaster recovery “DR”**

The Gracechurch Street building is unlikely to be a specific target for a terrorist attack, but fallout from one is a distinct possibility and the risk from a pandemic or some form of disaster has to be considered. Various impacts on the building covering flood, terrorist activity and power outage have been considered and a range of documents reflecting our crisis management policy, continuity plans and incident escalation procedures are in place.

Contracts with the DR site provider have been enhanced, the relationship and support from Group has strengthened and testing of RLAM recovery plans and offsite facilities has proved effective. The introduction of a DR SQL Server at the DR site with all critical SQL Databases set up with log shipping from the Live to the DR Server, provides near immediate recovery of critical SQL Databases in the event of a disaster.

Preparations for 2012 Olympics and prospects of civil unrest following government announcements in the forthcoming year mean that considerations for major unrest have been retained.

#### **5.4 Liquidity risk**

This represents the risk that adequate liquid funds are not available to settle liabilities or when the firm experiences sudden unexpected cash outflows. For the purposes of the ICAAP, the approach adopted by RLAM has been incorporated into the projection of cash flows and the adaptation of these to stressed environments. This provides assurance that enough liquid funds are available if this type of risk was to crystallise.

#### **5.5 Operational liquidity planning**

In line with the FSA Policy Statement 09/16 on Liquidity RLAM has satisfied itself with the capital requirements set aside in the liquidity test projection and has considered the costs in winding down its business in the context of a liquidity problem. Should a liquidity crisis arise, RLAM will not pay discretionary bonuses or make payments on incentive plans. In normal circumstances, Royal London Management Services Limited (RLMS) pays all the expenditure incurred by RLAM and recharges these costs to RLAM. Under a liquidity stress situation, RLMS will still incur all expenditure but will not recharge these costs to RLAM. All staff contracts are with RLMS. RLAM will still receive revenue as fees which are charged in arrears, this would cover for costs still incurred and be recharged as the business begins to contract in size. At the same time, RLAM will have the ability to increase the fee charging structure for Royal London with funds managed by RLAM, should such a situation arise.

#### **5.6 Interest rate risk arising from non trading activities**

RLAM is exposed to risks to earnings and capital arising from adverse movements in interest rates. RLAM holds cash deposits; the interest income from which is affected by interest rates as these impact the value of individual portfolios on which fees are based. As the impact on RLAM is indirect, interest rate movements are treated as business risk and assessed through scenario analysis alongside market movements.

#### **5.7 Pension obligation risk**

This type of risk is caused by the firm's contractual or other liabilities to or with respect to a pension scheme. In 2010 Group has required RLAM to make a regular monthly contribution to the RLMIS pension scheme on behalf of its staff who are final salary holders. The Mutual's ICAS assessment continues to set aside capital against pension obligation risk and therefore RLAM does not consider this commitment to require additional capital provision within this assessment.

## 5.8 Contagion risk

The impact of contagion across businesses within the Group through the crystallisation of a risk event in one business entity giving rise to a cost or loss in another, through, for example, financial links or investor sentiment is more common in groups that share brands. Royal London Group carry a number of brands, products, market sectors and legal entities that do not reflect a uniform front that would be materially impacted by contagion. In addition, all the Companies within the Group conduct and operate different business models, under separate brands and each carries appropriate risk capital within their individual ICAAP. Consequently it is not felt necessary to provide additional capital in the RLAM ICAAP.

## 5.9 Reputation risk

Reputation risk is defined as the risk of damage to the firm's reputation that could lead to negative publicity, costly litigation, a decline in the customer base or the exit of key employees and therefore directly or indirectly leading to a loss of revenue. RLAM's reputation is a fundamental tenet of its business and success.

Potential exposure to reputation risk is reduced by having a well established control environment which ensures compliance and adherence to the regulatory, market and ethical obligations imposed on the firm and by the firm. RLAM's aim is to ensure that the services it carries out are of the highest standard at all times and also ensuring the risk of reputation damage is significantly reduced by the effectiveness of the controls it has in place.

To this end RLAM has considered a number of scenarios regarding behaviour, communications, marketing and client reporting where an action (or inaction) could precipitate the loss of goodwill in clients and/or market reputation.

During 2010 RLAM completed a project on enhancing client reporting and successfully launched a new web site, as well updated its policies setting out its responsibilities over quality and basic requirements for all communications. The risk of reputation damage through mis-communication into the public domain by issuing factually incorrect or misleading information can not be disregarded.

## 5.10 Capital resources

Tier 1 capital after deductions is £21.2m which consists of £2m of issued ordinary shares of £1 each, £5.0m capital contribution, (£2.8m) intangibles and £17.0m of retained reserves. RLAM's consolidated capital resources forecast to 31/12/2010 are shown in the table below:

Tier	Element	£000's
Tier 1	Paid up share capital	2,000
	Capital contribution	5,000
	Disclosed reserves & current year's retained profits (verified by external audit)	17,031
	Intangible assets	(2,823)
	Total Tier 1 Capital	21,207
Tier 2	Total Tier 2 Capital	21,207
	Total Capital Base	21,207

The aggregate assessment of capital required from the ICAAP prepared in December 2010 is £17.3m, for Pillar 1 at the same date (£15.6m), leaving a capital excess of £3.9m.

## 6. Notices

This Disclosure is based on RLAM's ICAAP review dated 25/08/2011 and is subject to periodic review and update. The next formal review is scheduled for August 2011. The information contained in this disclosure has not been audited by RLAM's external auditors.

RLAM is a subsidiary of the RLMIS and is authorised and regulated by the Financial Services Authority (reference number 141665). The registered office address of RLAM is, 55 Gracechurch Street, London EC3V 0UF.

Source: rlam as at 31/12/2010 unless otherwise stated.

rlam is a marketing brand including the following companies: Royal London Asset Management Limited registered in England & Wales number 2244297; Financial Services Authority (FSA) register number 141665. Royal London Pooled Pensions Company Limited registered in Scotland number SC048729; FSA register number 110456. Royal London Unit Trust Managers Limited registered in England & Wales number 2372439; FSA register number 144037. Royal London Cash Management Limited registered in England & Wales number 19632; FSA register number 121844. All of the above are authorised and regulated by the Financial Services Authority. It also includes Royal London Asset Management Bond Funds Plc registered in Ireland number 364259 and regulated by the Irish Financial Services Regulatory Authority (IFSRA).

All these companies are subsidiaries of The Royal London Mutual Insurance Society Limited registered in England and Wales number 0099064. Head office: 55 Gracechurch Street, London EC3V 0RL.