

## **Silchester International Investors Limited**

### **Pillar 3 Disclosure Statement**

#### **Introduction**

Silchester International Investors Limited (“**Silchester**”) is a BIPRU €50,000 limited license firm authorised by the Financial Services Authority (“**FSA**”). The FSA is responsible, in the United Kingdom, for the implementation of the 2006 Capital Requirements Directive of the European Union, which set up a new regulatory capital framework for the financial services industry. The new framework consists of three pillars:

- Pillar 1 specifies the minimum capital that Silchester is required to carry to cover business risks;
- Pillar 2 sets out the supervisory review process to be used by Silchester and the FSA to determine whether additional capital should be maintained against any other risks not covered under Pillar 1;
- Pillar 3 specifies the disclosure requirements which Silchester is required to make of its capital, risk exposures and risk assessment processes.

The FSA regulations for the disclosures required under Pillar 3 are contained in the Prudential Sourcebook for Banks, Building Societies and Investment Firms (“**BIPRU**”). Further information on BIPRU can be found on the FSA website ([www.fsa.gov.uk](http://www.fsa.gov.uk)). These rules allow the business to exclude disclosures where the information is regarded as immaterial, proprietary or confidential. Disclosures have been made in this document in compliance with BIPRU11 unless that disclosure has been regarded as immaterial, proprietary or confidential. Additional information is available from Silchester’s Chief Compliance Officer ([tlinehan@silchester.com](mailto:tlinehan@silchester.com)).

#### **Business Structure**

The disclosures contained in the document relate to Silchester’s business. Silchester is a privately held firm that is majority owned and controlled by employees that are active in its business.

Silchester’s audited financial statements are prepared in accordance with UK GAAP. Silchester has two wholly owned subsidiaries – Silchester International Investors, Inc. (“**SII Inc.**”) and Silchester International Investors (Bermuda) Limited (“**SII Bermuda**”). SII Inc. and SII Bermuda are fully consolidated with Silchester as part of the Silchester Group for audit and regulatory capital purposes. Silchester also holds 49.9% of six other investment management firms – Colchester Global Investors Limited (“**Colchester**”), Sanderson Asset Management Limited (“**Sanderson**”), Heronbridge Limited (“**HB Ltd**”), Nippon Value Investors KK (“**NVI**”), Highclere International Investors Limited (“**Highclere**”) and Edgbaston Investment Partners Limited (“**Edgbaston**”). Silchester accounts for its investments in Colchester, Sanderson, HB Ltd, NVI, Highclere and Edgbaston using an equity accounting method. For the purposes of FSA reporting, Silchester, SII Inc., SII Bermuda, Colchester, Sanderson, HB Ltd, NVI, Highclere, and Edgbaston form a UK Consolidated Group. Each UK regulated affiliate is responsible for calculating their own FSA capital requirements and for the submission of their own individual FSA returns. In certain circumstances, Silchester must also include its pro rata share of the underlying affiliate’s capital obligations and large exposures.

There is no current or foreseen material practical or legal impediment to transfers of intra-group capital between Silchester, SII Inc. and SII Bermuda. Because Silchester is only a minority shareholder in the other affiliated entities, Silchester is unable to require these other firms to make any formal transfer of capital to Silchester. Likewise, none of the other affiliated entities can compel Silchester to make any loan or capital injection. There is no deficit of capital and no wholly owned subsidiary is excluded from the consolidated group.

#### **Risk Management**

Silchester’s Board of Directors is responsible for determining the risk strategy of the company, setting the company’s risk appetite and ensuring that risk is monitored and controlled effectively. The Board of Directors works closely with the Compliance and Risk Management Groups. The company’s risk management framework has been designed and implemented and will be updated, as necessary, to take into account material changes in Silchester’s business, capital obligations, or resource

requirements. Silchester’s risk appetite is regularly reviewed by considering various stress tests and sets out the amount and type of risk that it regards as appropriate for Silchester to accept in order to execute its strategy. Silchester has developed a risk matrix that is broken down by business function and each underlying process within the business function. Each risk is then assessed to determine (i) the type of risk exposure (ii) if it is material, (iii) whether it is covered by insurance, and (ii) what mitigating procedures can be put in place to control the risk of error. Silchester’s culture ensure that each member of staff is focused on improving procedures and minimising risk to Silchester’s business fostering an enterprise-wide risk management culture to establish a robust risk, capital and performance management setup.

Silchester is exempt from the operational risk requirement at Pillar 1 and is not required to calculate an operational risk capital charge. As a BIPRU limited license firm Silchester’s minimum capital requirement is the greatest of:

- The base capital requirement of €50,000;
- The sum of its capital and risk requirements; and
- Silchester’s fixed overhead requirement.

As market and credit risks are not considered material for Silchester, the fixed overhead requirement is the greatest and therefore establishes the minimum capital requirement of £4.3 million. As at 31<sup>st</sup> March 2010, Silchester capital reserves are as follows:

Tier 1 Capital	£9.8 million
Deductions from Tier 1 Capital	£ 0
Tier 2 Capital	£0.4 million
Deductions from Tier 2 Capital	£ 0
Tier 3 Capital	£ 0
Deductions from Tier 3 Capital	£2.3 million
Total capital resources, net of deductions	£7.9 million
Fixed Overhead Capital Requirement	£4.3 million
Surplus over ICAAP Capital	£3.6 million

Silchester’s ICAAP analysis highlights that Silchester had surplus liquid capital as of 31<sup>st</sup> March 2010 compared to the capital resource requirements computed under applicable capital resource requirement rules known as **Pillar 1**.

Silchester does not exercise any day to day management or control over the Affiliates. Silchester has structured its affairs and the contractual relationships with the Affiliates such that Silchester is not financially liable for any losses, liabilities, costs, or other expenses incurred by the Affiliates. Silchester has taken legal advice with respect to this issue. With the exception of certain funding commitments outlined in the shareholders agreements for newer Affiliates, there is no capital support or other financial guarantee agreements in place between Silchester and any of the Affiliates and so no additional group capital requirements. Under Pillar 2 of the CRD, the firm is required to enact an Internal Capital Adequacy Assessment Process (“ICAAP”). The ICAAP document is prepared by the Risk Management and Compliance Groups, under the supervision of Silchester’s Compliance Officer. However, the sufficiency of the ICAAP is ultimately the responsibility of Silchester’s Board of Directors. In its ICAAP analysis, Silchester has prepared various scenario analyses. The most extreme scenario (that of a complete wind down of the firm over a six month period with no revenues received during this time), highlights the fact that Silchester need to maintain £8 million of capital or a further of £3.7 million over its Pillar 1 obligations. Despite this conservative (and extreme) example, Silchester has surplus liquid capital compared to the capital resource requirements computed under **Pillar 2**.

As a long only asset manager that primarily invests client assets in publicly traded non-US equity securities, Silchester is mainly exposed to operational risk; however there is additional exposure both to business risk and credit risk. All of these exposures are regarded as typical for a business engaged

in the activity of asset management. Silchester's Chief Compliance Officer, who is independent of Silchester's investment function, acts as operational risk manager and monitors and manages the risk exposures of the business with input from Silchester's various business groups. In assessing the risk appetite of the business, consideration has been given to identifying the material risks facing Silchester's operations.

These include risks at both the client level and at the firm entity level taking the form of loss of revenue, loss of assets or higher cost. These risks are detailed in the ICAAP and are reviewed by the Risk Management and Compliance Groups on a regular basis. Two specific factors have been considered in defining the risk appetite; firstly, the likelihood of occurrence of an event and secondly, the impact level of an event. Further information on Silchester's risk exposures are set out below:

- **Credit Risk.** As an asset management company, Silchester is subject to credit risk. Silchester receives investment management fees on a monthly basis. These fees are computed based on the value of each underlying investor's holdings in the commingled funds. US investment management fees are paid within five business days of each month. Non-US investment management fees are paid on a quarterly basis after an invoice is provided to Silchester Bermuda. As the commingled funds are "long only" equity funds that cannot use leverage, margin or derivative products, there is little, if any, credit risk associated with the fees. Silchester's free cash flow is placed on deposit each month. Deposits are normally split between financial institutions depending on available interest rates. The eligible banks are each approved by the SII Board. The credit rating and financial strength of each bank is subject to an annual re-appraisal by the Risk Management Group. The Dealing Group also monitors certain credit ratings a monthly basis. Silchester does not utilise any risk mitigation techniques (i.e., credit default swaps) to minimise our financial exposure to bank deposits.
- **Market Risk.** As an asset management company, Silchester's portfolios are subject to market risk. Silchester's fees are asset based fees and Silchester's revenue increases as AUM increase and will fall if as AUM fall. Silchester has structured its business so that many costs are variable (i.e., custody costs) and will fall as its assets under management fall. More importantly, Silchester keeps base salaries low and remunerates employees through discretionary bonuses. Surplus liquid capital is not at risk until a loss fully offsets Silchester's profit before remuneration and taxes ("PBRT") less any committed salaries and staff benefits. Silchester's core regulatory capital, surplus capital and free cash flow is primarily invested in (i) cash deposits, (ii) index-linked UK government gilts, and (iii) unregulated collective investment schemes sponsored by Silchester and its affiliated companies. Cash deposits and index-linked gilts are not subject to market risk. The investments in the unregulated collective investment schemes are subject to market risk as their value will increase/decrease depending on portfolio performance. To mitigate against market risk, Silchester's Board does not invest capital that is (i) needed to meet core regulatory requirements, or (ii) needed to fund the operations of the business.
- **Liquidity Risk.** Liquidity Risk consists of two primary items – funding liquidity risk and market liquidity risk. Funding liquidity risk is the risk that the counterparties who provide Silchester with short-term funding will withdraw or not roll over that funding. Market liquidity risk is the risk of a generalised disruption in asset markets that make normally-liquid assets illiquid. Silchester has no borrowing and is not dependent on external financing for any aspect of its business. As a result, Silchester is not exposed to funding liquidity risk. Silchester has some limited exposure to market liquidity risk. For example, one of Silchester's banking counterparties could suffer severe financial distress and elect not to return some of Silchester's cash deposits. Alternatively, redemptions from one of the unregulated collective investment schemes could be suspended, preventing Silchester from redeeming its investments on a timely basis.
- **Operational Risk.** Operational risk refers to the risk of a direct or indirect loss resulting from inadequate or failed internal processes, people and systems or from external events. Silchester attempts to mitigate the impact of operational risks by (i) maintaining substantial financial resources, (ii) aligning the interests of all staff and shareholders with supervision of the operations

of the business through remuneration/ dividends, (iii) maintaining a risk matrix and key operating procedures (“KOPs”) for all material business areas, (iv) reviewing the operations of all material business groups annually, and (v) keeping Silchester’s business, structure and operational requirements relatively simple.

- **Concentration Risk.** Concentration risk is the risk that exposures to specific sectors or asset concentration could result in losses to Silchester or our business. Silchester principally invests client assets in publicly traded non-US equity securities and earns its revenue primarily from a US client base. Silchester’s business could suffer (i) from a decline in its investment performance relative to benchmark indices, (ii) if US institutional investors spoil on investing overseas and/or shift their asset allocations to private equity, hedge funds, commodities or other types of investments, or (iii) the US dollar sharply appreciates, negatively impacting relative returns. There is little Silchester can do to minimise this risk except focusing on keeping its business simple and aligned with clients, and minimising overheads.
- **Business Risk.** Business risk arises from changes in the core structure of the business that would prevent Silchester from carrying out its business plan and desired strategy. Silchester is a small, closely held organisation, where senior management also own a significant stake in the business. All material structural changes to Silchester’s business are subject to discussion at the SII Board level. The SII Board consults the Compliance and Risk Management Groups before agreeing to any of the following material transactions:
  - Before an investment, loan or capital subscription is made;
  - Before an investment is made in any Silchester or affiliate collective investment scheme;
  - Before any material change in Silchester’s cost structure or base salaries; or
  - Before any share buyback occurs.
- **Interest Rate Risk.** A significant part of Silchester’s core regulatory capital is invested in index-linked gilts. As a result, Silchester’s core regulatory capital should be protected in the event of sharp changes in interest rates. Silchester does not engage in any principal trades or run any trading book exposures that could be subject to interest rate risk. From a corporate perspective (given its cash balances) and assuming no impact on investment performance, Silchester would expect to benefit from increases in interest rates as its interest income would rise.
- **Insurance Risk.** Silchester maintains fiduciary liability (also referred to as professional indemnity), crime (also referred to as errors and omissions) and ERISA insurance cover with AIG UK Limited. Professional Indemnity, Crime and ERISA fidelity bond cover is set at a limit which Silchester considers appropriate for the business of Silchester and subject to a deductible which Silchester can reasonably afford to meet if called upon. Silchester would be exposed to potential losses in the event that an error occurred and AIG UK Limited was unable to recover anticipated insurance settlement proceeds. Silchester attempts to obtain ensure only from well capitalised insurance firms to minimise the risk of loss arising from insurance risk.

### Capital Resources

Silchester has calculated its capital needs in accordance with the relevant FSA regulations. Silchester has surplus regulatory capital on a solo and consolidated basis.

### Other Disclosures

The approach of the business to assessing the adequacy of its internal capital to support current and future activities is contained in Silchester’s ICAAP document. This process includes an assessment of the specific risks to Silchester’s business and the internal controls in place to mitigate those risks. These are tested under different scenarios in order to provide a robust picture of exposures for the business. Finally, an assessment is made of the probability of occurrence and the potential impact, in order to arrive at a level of required capital. The required capital level has been assessed, in accordance with Pillar 2, to be less than the Pillar 1 requirement – which is the minimum level of capital which the business is required to maintain and is the fixed overhead requirement.