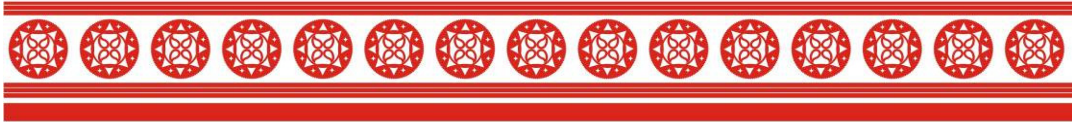

Kotak Mahindra (UK) Limited

Pillar III Disclosures – Basel II

KOTAK MAHINDRA (UK) LIMITED

Pillar III Disclosures Basel II

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I. THE KOTAK GROUP:

Kotak Mahindra UK Limited (the "Company") is a 51% subsidiary of Kotak Mahindra Bank Limited ("the Parent Company) and hence forms part of the The Kotak Mahindra group of companies (the "Group"). The group is a diversified financial services conglomerate that participates in banking, securities and capital markets, insurance, and retail asset businesses. The Group is one of the leading players in the financial services industry and recognizes that in its journey towards achieving growth, leading practices in the area of risk management are quintessential to ensure asset quality and bottom line stability. Diversified business activities require the Kotak Mahindra Group to identify, measure, aggregate and manage risks effectively and to allocate capital among its businesses appropriately.

The Kotak Mahindra Bank, which is the holding company for the Group, manages its risks, as a bank, through a framework implemented through a set of policies and processes. The risk management framework lays emphasis on the Bank's risk philosophy, proper organizational structure, risk and reward balance and is supported by dedicated monitoring and risk measuring mechanism.

The Company's primary focus is investment management, broker dealing and corporate finance. As a broker dealer the firms arranges deals in bonds as well as in depository receipts. The Company is authorised and regulated by the Financial Services Authority ("FSA") and is a member of the London Stock Exchange ("LSE"). The Company has two branches – Dubai (regulated by the Dubai Financial Services Authority) and Singapore (regulated by Monetary Authority of Singapore).

II. THE BASEL II DISCLOSURE REQUIREMENTS:

a. Background:

The new Basel Accord (Basel II) was implemented in the European Union via the Capital Requirements Directive (CRD). It affects banks and building societies and certain types of investments firms like Kotak Mahindra UK Limited.

BASEL II is structured around three 'pillars' which are briefly explained below:

Pillar I – Minimum Capital Requirements:

Pillar I deals with the basis for computation of the regulatory capital ratio. It defines the various classes and the calculations of Risk Weighted Assets (RWAs) in respect of credit risk, market risk and operational risk as well as deriving the regulatory capital base. The capital adequacy ratio is then calculated as the ratio of the entity's regulatory capital to its total Risk Weighted Assets.

Pillar II – the Supervisory Review Process and the Internal Capital Adequacy Process (ICAAP):

Pillar II involves the process of supervisory review of a financial institution's risk management framework and its capital adequacy. Accordingly, this involves both, the entity and its regulators taking a view on whether additional capital should be held against risks not covered in Pillar I. Part of the Pillar II process is the Internal Capital Adequacy Process (ICAAP) which is the entity's self assessment of risks not captured under Pillar I.

Pillar III – Market Discipline:

The third pillar is related to market discipline and requires an entity to publish detailed quantitative information of its risk management and capital adequacy policies and processes to complement the first two pillars and the associated supervisory review process.

b. Basis of Disclosure:

The report has been prepared by the Company in line with its internal policy for Pillar III disclosure and requirements of the Financial Services Authority ("the FSA"). The disclosures in this report are in addition to the disclosures set out in the audited financial statements of the Company for the year ended 31 March 2011.

c. Scope of application:

The Pillar III disclosures set forth here are based on a solo rather than a consolidated basis. The report includes disclosures of the qualitative information and quantitative data required under the FSA BIPRU rules (Disclosure – Pillar III – BIPRU Chapter 11) and is based on Company's current risk management practices.

d. Capital structure:

i. Net Available Capital:

The net available capital of the Company has been set out in the table below:

	31st March 2011 USD'000
Share Capital	1,655
Reserves	19,774
Total Tier I Capital	**21,429**
Tier 2 Capital	-
Total Tier 2 Capital	**-**
Total Eligible Capital Base (Tier 1 + Tier 2)	**21,429**

ii. Capital Requirements:

	31st March 2011 USD'000
Pillar I requirement	3,064
Pillar II uplift	3,475
Total Capital Requirement	**6,539**

iii. Capital Adequacy Ratios:

	31st March 2011 USD'000
Credit Risk	7,450
Market Risk	3,581
Operational Risk	27,081
Counterparty Risk	188
Total Risk Weighted Assets	**38,300**
Available Capital	
Tier 1 Capital	21,429
Tier 2 Capital	-
Total Available Capital	**21,429**
Capital Adequacy Ratio (%)	
On Tier 1 Capital	**56**
On Total Capital	**56**

iv. Solvency Ratios:

Capital Solvency Ratios

	31st March 2011
Tier I - Capital Solvency Ratio (%)	**699**
Total - Capital Solvency Ratio (%)	**699**

III. RISK MANAGEMENT:

The Company has laid out a detailed risk management policy which *inter alia* covers the risk management strategy, appetite, the process for risk identification and measurement. It also covers the risk management structure, describing the roles and responsibilities of various individual, teams and the Board of Directors.

The Company's commitment to implement the best risk management practices and institutionalising a risk culture, supported by a sustainable risk and controls framework across the organisation is formalised vide its risk management policy.

The Board of Directors of the Company oversees the understanding of the risks run by the Company and ensures that they are appropriately managed. The Board during its accomplishment of the tasks mentioned has delegates few of the activities to the Risk Management Committee (RMC). The main responsibilities of the RMC includes compliance to the risk management policy, integration of enterprise wide risk management, providing updates to the Board of Directors on the current risk management procedures and status of key risks on a periodic basis, etc. The senior management is also involved in over all risk management processes and controls by actively involving themselves in considering:

- Operational risk areas of concern;
- New activities and product approval;
- Market and credit risk;
- Audit reports;
- Claims and complaints;
- Compliance monitoring exceptions;
- Training requirements; and
- Updates to procedures and documentation

The Company shall also, based on the guidelines under the Groups risk governance structure, establish a structure appropriate for the business carried on by the Company. The Company shall also endeavour to broadly match the risk management framework to the framework drawn by the Group.

Risk Appetite:

Any risk management cannot succeed without defining a risk appetite. Risk appetite is defined as the amount and type risk the Company is willing to take within the context of its business strategy. Senior management of the Company adopt a conservative approach to risk, ensuring a low risk profile by:

- Following a straightforward business model;
- Recruitment of experienced personnel;
- Limited exposure to credit risk;
- Adequate insurance arrangements.

IV. RISK GUIDELINES AND MANAGEMENT BY CATEGORY OF RISK:

The Company maintains positions in a variety of non-derivative financial instruments as dictated by the investment management strategy. The Company's investment portfolio comprises quoted investments.

The Company's investing activities expose it to various types of risks that are associated with the financial instruments and markets it invests in. The most important types of financial risk to which the Company is exposed are market risk, credit risk and liquidity risk.

Exposure to interest rate, foreign currency, price, credit and liquidity risks arise in the normal course of the Company's business. The other risks that the company may be exposed to are business risk and concentration risk. The risks that may have been identified assessed and evaluated by the management but which are not considered to be material to the Company are also listed below.

These risks are limited by the Company's financial and risk management policies and practices described below:

A. RISKS COVERED UNDER PILLAR I OF THE BASEL II:

a. MARKET RISK:

Market risk is the risk to earnings and capital due to volatility of interest rates, prices of securities, foreign exchange and equities. The Company's strategy on the management of investment risk is driven by the Company's investment objective. The Company's market risk is managed on a daily basis in accordance with policies and procedures in place.

(i) Interest rate risk (Interest rate PRR):

The majority of the Company's financial assets and liabilities are non-interest bearing, with the exception of cash and cash equivalents and investments in foreign currency convertible bonds.

Interest income from cash deposits may fluctuate in amount, in particular due to changes in the interest rates. Most of these deposits are placed in short term deposits to take care of interest rate movement. Some foreign currency convertible bonds earn interest at fixed coupon rates.

Hence, as a result the Company is not subject to significant amounts of risk due to fluctuations in the prevailing levels of market interest rates.

(ii) Price risk (Equity PRR):

Price risk is the risk that the value of investment will fluctuate as a result of changes in market prices, whether caused by factors specific to an individual investment, its issuer or all factors affecting all instruments traded in the market, interest rate movements, etc. The Company's investments in financial instruments are recognised as available – for – sale financial assets and measured at fair value. Any change in market price would affect the fair value of investment.

(iii) Currency risk (Foreign currency PRR):

The reporting currency of the Company is US Dollar and hence it exposed to the currency risk posed by adverse movements in US Dollar vis-à-vis Pounds Sterling and the Singapore Dollar. Though the Company has a branch in Dubai, it is not exposed to the Arab Emirates Dirham (AED) as the rate between the AED and US Dollar is pegged.

b. CREDIT RISK:

The Company takes on exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. Financial assets which potentially subject the Company to concentrations of credit risk consist of bank balances, investment in debt instruments and debtors. Bank balances are held in a number of reputable financial institutions and hence the Company has no significant concentration of credit risk on its bank balances. The investment in debt instruments are monitored with respect to issuer exposure limits laid down in consultation with the group senior management. The ageing analyses of debtors reflect the minimal exposure to credit risk for the Company based on the period for which the debtors were outstanding.

c. LIQUIDITY RISK:

Liquidity risk is the risk that the Company will not be able to meet its financial obligations as they fall due. The Company's approach to managing liquidity is to ensure, as far as possible, that it will always have sufficient liquidity to meet its liabilities when due, under both normal and stressed conditions, without incurring unacceptable losses or risking damage to the Company's reputation.

The Company ensures that it has sufficient cash on demand to meet its expected operational expenses for a period of 90 days, including the servicing of any financial obligations.

d. OPERATIONAL RISK:

Operational risk is the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. The Company constantly strives to minimise operational risks (inherent in the Company's activities, processes and systems) by ensuring that a strong control infrastructure is in place throughout the group and is enhanced where necessary. A rigid internal check system is in place by the separation of front office and back office functions, and a reasonable level of automation of mid-office and back office functions. The various procedures and processes used to manage operational risks are regularly reviewed and updated and implemented through effective staff training, close monitoring of risk limits, segregation of duties, appropriate controls to safeguard assets and records, regular reconciliation of accounts and transactions, and financial management and reporting. In addition, arrangements for insurance cover are in place to complement the processes and procedures where appropriate.

Risks covered under Pillar I and to which the Company is not materially exposed to are:

e. COUNTERPARTY RISK:

Counterparty risk is the risk that the counterparty reneges from the contract on or before the settlement date. The transactions entered into by the Company are based on the principle of delivery versus payment which reduces the exposure to the counterparty should it renege.

f. CONCENTRATION RISK:

The Company doesn't carry any concentration risk as it currently do not have any trading book exposures and consequently no trading book concentration risk excess. However, the Company has considered this risk as a component under the Pillar II requirements based on the concentration of advisory income earned by the Company from sub accounts.

B. RISKS COVERED UNDER PILLAR II OF THE BASEL II:

The key risks relevant to the Company and which have not been covered under the Pillar II are listed below:

g. BUSINESS RISK:

Business risk is the risk that the cash flow of the firm consisting of fee income will be impaired because of adverse economic conditions or changes to regulation making it difficult to meet its operating expenses. The key income drivers include:

i) The size of Funds under Management ("FuM") dictated by investment performance which to a large extent is determined by market conditions; and

ii) The size and frequency of transactions carried out by the entities registered as the firm's sub-accounts with the Securities and Exchange Board of India ("SEBI") determined by market conditions and SEBI regulations.

The exposure of funds managed by the firm is entirely to the Indian markets. Whilst the firm has unrivalled experience in relation to the Indian markets, the performance of the investment management business and the level of transactions undertaken by sub-accounts (and hence the fee income which the firm earns) is significantly impacted by market factors. The Indian equity markets were range bound in year 2010-11. The markets witnessed a rise of about 10% which was primarily captured in the first half of the year; for the remainder of the year markets have been volatile yet range bound. The year was a difficult one with many India dedicated funds seeing net outflow of funds. However, in this environment the firm introduced a number of equity mutual funds into the markets, including an Indian equity fund of funds investing in best of breed Indian funds and an Indian consumption fund investing in companies likely to benefit from the growth in consumption in India. Even given the uncertain conditions, the FuM of the firm increased from USD 1,568 million as on 31 March 2010 to USD 1,874 million as on 31 March 2011.

The Company's fee income shall be largely dependent on the laws dictated by the SEBI in India as the business activities carried out by the Company are based on the regulations therein. An eased regulation shall mean that the Company can make changes in the products it offers to make it more lucrative to its clients and motivate them to continue with the Company. However, a change in the regulation which has an opposite impact shall have a bearing on the Company's fee income. This, if coupled with other risks can lead to strain on the Company's financial resources. These aspects have also been considered in the stress and scenario analysis as mentioned above and have been adequately provided for.

h. REGULATORY RISK:

The Company is required to comply with the regulatory requirements of various regulators including SEBI, the Financial Services Authority (FSA), and the Reserve Bank of India (RBI), The Dubai Financial Services Authority (DFSA), Monetary Authority of Singapore (MAS), and The Securities and Exchange Commission (SEC) of the United States. As a BIPRU investment firm authorised and regulated by the FSA, the European Union's CRD and the Markets in Financial Instruments Directive ("MiFID") apply to the Company. Towards meeting the onerous regulatory requirements, the Company has recently strengthened its compliance function. The Company has in place policies and procedures to ensure that it complies with all regulatory requirements. The compliance function has an independent reporting line to the Board of Directors.

The Company's business shall be significantly affected by changes made by the SEBI, RBI or the Government of India in relation to the Foreign Institutional Investors' investment in Indian capital markets. The impact of these changes has been considered under business risk explained above.

i. CONCENTRATION RISK:

The Company is no longer exposed to material concentration risk as the income streams of the Company has undergone changes which have led to a better diversification of income generation from its clients.

Following risks identified within the over all Pillar II rule have been assessed and evaluated by the management and which are considered to have no material impact on the Company.

j. VALUATION RISK:

The valuation risk for the Company is limited to the debt instruments held by the Company on 31 March 2011. The risk due to change in the interest rates has been considered under "Interest rate risk" above.

k. REPUTATIONAL RISK:

The off shore funds ("funds") managed by the Company have been set up as distinct legal entities. The funds have appointed administrators for the administration of the fund. Whilst any loss arising out of errors and mistakes

committed by the administrators are borne by them, the management recognise that such mistakes do have an adverse impact on the reputation of the Company.

In terms of SEBI regulations, the Company is responsible and liable for all acts of commission and omission of its sub-accounts regardless of whether discretion is exercised or not by it. Accordingly the Company is exposed to significant reputational risk should the activities of the sub-accounts in relation to investments into India are in violation of SEBI regulations. The Company has implemented robust procedures and performs pre-execution and on-going compliance checks to ensure that the sub-accounts do not violate SEBI regulations. The Company has been in this business for almost a decade and till now there have been no instances of violations of SEBI regulations either by itself or by its sub-accounts. The management is satisfied with the robust control framework implemented in this regard and are of the view that no additional Pillar II capital would be required for potential reputational risk.

The management is satisfied that a) capital held under the basis indicator approach for operational risk under pillar I; b) the professional indemnity insurance held; and c) the Directors and Officers Liability insurance cover held by each of the funds managed by KMUK are adequate to cover potential reputational risk.

Following are the risks identified within the over all Pillar II that are not applicable to the Company:

(i) Insurance risk:

Insurance risk is the inherent uncertainty as to the occurrence, amount and timing of insurance liabilities, and is particularly relevant for insurance companies. The Company is authorised to underwrite insurance and hence this risk category is not relevant.

(ii) Residual risk:

Residual risk is risk that remains with the Company after the application of credit risk mitigation techniques. As the exposure to credit risk is insignificant, no additional capital for residual risk is considered necessary.

(iii) Pension obligation risk:

As the Company has no pension scheme in place, the risk is not relevant to it.

(iv) Securitisation risk:

The risk is not relevant to the Company.

V. REMUNERATION DISCLOSURE AS PER BIPRU 11.5.18:

Qualitative:

The qualitative disclosures as per BIPRU 11.5.18 form part of the "Remuneration Policy" which can be found at the end of the document under Annexure I.

Quantitative:

Given below are the quantitative information as per BIPRU 11.5.18(R)(7) on the amounts of remuneration, broken down by senior management and other members of staff whose action have a material impact on the risk profile of the Company indicating the amounts for the financial year 2010-11 split into fixed and variable remuneration and also the number of beneficiaries.

(USD'000)

Category	Number of beneficiaries	Remuneration		
		Fixed	Variable	Total
Senior Management	6	1,193	1,099	**2,291**
Other Members of staff	5	1,010	626	**1,636**
Total	**11**	**2,203**	**1,725**	**3,928**

ANNEXURE I: REMUNERATION POLICY

Kotak Mahindra (UK) Limited believes that our people are key assets in the overall success of our organisation. The aspirations of the company must be supported by compensation programmes that recognise the capabilities and achievements of individual employees and that reward significant and sustained individual and business unit performance.

The objective of the KMUK' remuneration policy is to provide, in the context of the overall business strategy, remuneration in form and amount which will attract, retain, motivate and reward high calibre employees to deliver superior long-term business performance within acceptable risk parameters.

Policy applies to all employees of Kotak Mahindra (UK) Limited and its branches in Dubai and Singapore and specifically to all CODE STAFF[β].

Identification of code staff

All employees who fall under any of the below categories are considered as CODE STAFF by KMUK:

- Controlled functions
- Front end sales
- Fund management
- Dealing/Stock broking
- Regional compliance
- KMUK Board of directors including Non Executive Directors
- Head Products
- Head Finance & Operations
- Head Human Resources
- Head International Business
- Head Operations

Firm categorisation

Following the CEBS guidelines, Kotak Mahindra (UK) Limited is currently being categorised as **TIER III Firm**[φ]

[β] As per CRD3 'categories of staff whose professional activities have a material impact on the risk profile' of firm.
[φ] Full scope BIPRU Investment firms with capital resources less than £100m

The Key aspects of the remuneration policy are as set out below:

Pay-for-performance

- The pay-for-performance system should have its strong foundation in robust performance management system.
- Rewards should be linked to overall group performance, business unit' performance and employee' own performance at work.
- Appropriate account is taken of risk factors associated with each business unit along with various conflicts which are identified and mitigated.

Market Intelligence

- Reward offerings in the respective markets where KMUK and its branches operate should be understood and reward programmes should be designed and developed to maintain market competitiveness with other niche players in industry offering similar financial products focussing on Indian equity and debt markets.

Customisation option

The composition of reward should allow for degree of customisation based on regional taxation regimes and overall KOTAK Group' reward guidelines.

Compliance and governance

Reward design and delivery should comply with appropriate policy, standards, be aligned to industry best practice, meet relevant regulators' criteria and be consistent with effective risk management and long term business and stakeholders' interests.

<u>Components of individual employee' remuneration package</u>

Base Salary/Gross Salary

Base salaries are set in order to remain competitive in marketplace and be able to attract and retain best talent. Base salaries are decided based on the specific business model, market for the business where an individual works, existing internal parity and for the talents, skills and competencies that the individual brings to the company.

The level of fixed pay should be sufficient enough in order to discourage inappropriate risk-taking. Base salaries are reviewed annually using market intelligence provided by a leading global performance/reward consulting and benchmarking firm for financial services industry (McLagan & Partners (An Aon HEWITT Company)) Salary offered to employees across regions is a gross annual amount and there is no further breakup of the gross component. Company ensures that all relevant taxes and statutory deductions are taken into consideration as per local regulations.

Benefits

All employees are eligible for below mentioned benefits:

- Annual Health and Dental Insurance cover for employee and family[*]
- Life Insurance and Critical Illness cover equivalent to gross annual salary of employee
- Annual Leave Travel Allowance for employee[•] and family* (economy class return airfare after successful completion of first year of service with organisation)

Short-term incentives

From time to time company may decide to reward exceptionally good financial and non financial performance to support the business strategy, taking into account the risk, conflicts and personal contribution. For this firm needs to present a clear and reasonable plan to the KMUK Board and this should detail targets based on SMART principles and the proposed pay out/incentives against target achievement. Firm should communicate all such plans/schemes to the employees. All such short-term incentives are subject to appropriate governance, including review by the KMUK senior management, corporate human resources and finance & accounts.

Deferred award

The purpose of deferred awards is to support a performance culture where employees recognise the importance of sustainable group, business and individual performance. A significant proportion of discretionary bonus of selected individual awards will be deferred over a two to four years period. The proportion of the deferred component of the bonus would also be based on the amount and the seniority of the individual.
The threshold limit beyond which the discretionary bonus is paid as deferred award is decided by the Kotak group' board at the end of every financial year[δ]. These deferrals can be either in form of 'Employee Stock Option Plan' (ESOP) or 'Stock Appreciation Rights' (SAR) or both. Deferral period is also decided by the Group' board. It is mandatory to defer variable pay.

Long-term incentive plans

Kotak Group at times may provide employees in Senior Management roles the opportunity to receive awards of long-term incentives. The objective is to encourage the creation of value over the long term and to align the rewards of the participants with the future business growth and returns to shareholders.

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[*] Family- Spouse/Partner and children
[•] Employee- Where the home country is different to the country wherein our offices are located.
[δ] Financial year- Runs from April 1st till 31st March every year

Guaranteed bonuses

The firm should discourage any guaranteed bonuses of more than one year and such bonuses if agreed then can be awarded only to new hires in exceptional circumstances. Rule on guaranteed bonuses apply on a firm wide basis and not only to Code Staff.

Retention awards

Retention awards can be made on an exceptional only basis and "where a very strong case can be made for the retention of particular key staff members on prudential grounds".

Decision making process

- **Identification of performance indicators**: The firm has a strong performance management system in place with separate criteria for Front End Sales and Support Staff. Performance review is based on the assigned targets and individual' achievement against the assigned parameters.

- **Performance review and feedback**: The firm has a well structured annual performance management process wherein the forms are sent to all employees for self appraisal. Supervisor reviews the appraisal ratings in a joint consultation meeting with the employee and assign the final aggregate score ranging from 1-5. Post discussions with reviewer final performance ratings are awarded.

- **Market Intelligence/Compensation Benchmarking**: Human Resources initiate the compensation benchmarking for all key roles in the organisation. An external agency/global consulting company is used for this process. Benchmarking report is submitted by the service provider and data is then compiled and provided to the corporate human resources team.

- **Moderation**: Moderation takes place at the following levels –
    1. Head of Business & Head HR;
    2. Head Business, Head HR and the Kotak Group Management Committee Members

- **Reward Decision:** KMUK board is authorised to take all decisions on firm' codes staff categorisation, remuneration structures and policy issues. KMUK board is further governed by Kotak group' remuneration guidelines on Remuneration & Rewards. Based on group' overall revenue growth and profitability the board decides on a common bonus pool which further gets allocated to various business entities across the Group. This allocation is strictly based on individual business unit' growth and profitability figures. KMUK board along with Head Human Resources awards the allocated bonus pool to employees across KMUK and branches. All such allocations are strongly based on individual performance, achievements and significant contributions.

Governance and compliance

Considering the size of firm there is no provision of separate 'Remuneration Committee' currently. The Board is authorised to take all decisions with regards to employee remuneration and code staff. KMUK Board works closely with Kotak Group Human Resources team on guidelines and policy frameworks if issued from time to time in the area of remuneration practice. KMUK Board is also entrusted with the responsibility to review the remuneration policy annually and identification and mitigation of all associated risks and conflicts.

External & Internal Disclosures

Firm should make all external and internal disclosures as per the timelines defined in the BIPRU 11.5.18R disclosure requirement of the Remuneration code.