

# Capital Requirements Directive

Pillar 3 Disclosures

Houlihan Lokey EMEA, LLP

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## Background

The Capital Requirements Directive (the “**Directive**”) of the European Union created a revised regulatory capital framework across Europe governing the amount and nature of capital that credit institutions and investment firms must maintain. In the United Kingdom, the Directive has been implemented by the Financial Conduct Authority (“**FCA**”). To 31 December 2013, the guidelines contained in the General Prudential Sourcebook (“**GENPRU**”) and the Prudential Sourcebook for Banks, Building Societies and Investment Firms (“**BIPRU**”) regulated these activities. From 1 January 2014, with the implementation of the Capital Requirement Directive IV (“**CRD IV**”), regulations under BIPRU have been replaced by:

- the Capital Requirements Regulation (“**CRR**”);
- IFPRU sourcebook of the FCA handbook; and
- additional standards released by the European Banking Authority.

The framework continues to consist of three “pillars”:

- Pillar 1 sets out the minimum capital requirements that HL EMEA is required to meet for credit risk, market risk and business/operational risk;
- Pillar 2 requires the Firm, and the FCA, to take a view on whether additional capital should be held against capital risks not covered by Pillar 1. In the UK this is implemented through the Internal Capital Adequacy Assessment Process (“**ICAAP**”) undertaken by the firm and through any subsequent review and evaluation process undertaken by the FCA; and
- Pillar 3 requires the Firm to publish certain details of its risks, capital and risk management process. Articles 431 – 455 of the Capital Requirements Regulation (“**CRR**”) require that a firm subject to the provisions of the CRR must disclose, as appropriate, the relevant information required under Pillar 3. This must be done in accordance with a formal disclosure policy which sets out policies for assessing the appropriateness of our disclosures, including their verification and frequency.

CRR Article 432(1) provides that a firm may omit one or more of the required disclosures if it believes that the information is not material. Materiality is based on the criteria that the omission or misstatement of material information would be likely to change or influence the assessment or decision of a user relying on that information for the purposes of making economic decisions.

CRR Article 432(2) provides that a firm may also omit one or more of the required disclosures where it believes that such information is proprietary or confidential. Proprietary information is that which, if it were shared, would undermine a firm’s competitive position. Information is considered to be confidential where there are obligations binding a firm to confidentiality with its customers and counterparties. Where appropriate, HL EMEA published more general information on the subject matter of the required disclosure.

In this document HL EMEA therefore discloses information in accordance with the following provisions of the CRR unless it is has been determined as immaterial or of a proprietary or confidential nature:

- Article 435 on the Firm’s risk management objectives and policies;
- Article 436 on the scope of application of the CRR;
- Article 437 on the Firm’s own funds;

### *Capital Requirements Directive Pillar 3*

- Article 438 on the Firm's compliance with the capital requirements contained in the CRR;
- Article 439 on the Firm's exposure to counterparty credit risk;
- Article 442 on the Firm's exposure to credit and dilution risk; and
- Article 443 on the Firm's unencumbered assets; etc.

The Firm's disclosures will be published at least once a year and as soon as practicable following material updates to the Firm's ICAAP. The annual disclosure will be published in conjunction with the date of publication of the financial statements. Given its size and complexity, the Firm assesses that this annual publication should meet its disclosure requirement.

These disclosures have been prepared solely for the purpose of fulfilling the Firm's Pillar 3 disclosure requirements and are not used by management for any other purpose. They have not been audited nor do they constitute any form of audited financial statement.

The Firm's Partnership Executive Committee is ultimately responsible to the Firm for its systems and controls and for reviewing the effectiveness of those processes. However, such processes are designed to mitigate, not eliminate, risk and therefore can only provide reasonable, but not absolute, assurance against material losses or financial misstatements.

## Scope of application of CRD IV requirements

The disclosures in this document are made in respect of HL EMEA, which provides corporate finance advisory services and is authorised and regulated by the Financial Conduct Authority with number 732400.

For the purposes of CRD IV, HL EMEA is neither consolidated with nor deducted for accounting and prudential purposes from another regulated entity.

So far as the Firm is aware, there are no known current or foreseen practical or legal impediments to the prompt transfer of capital resources or repayments of liabilities between parent and subsidiary undertakings within the Firm's group.

## Risk management objectives and policies

The Firm's Partnership Executive Committee is responsible for establishing and maintaining the Firm's governance arrangements and designing and implementing a risk management framework. However, such arrangements are designed to mitigate, not eliminate, risk and therefore can provide only reasonable, but not absolute, assurance against material losses or financial misstatements.

The following factors are central to the Firm's risk management strategy:

- the setting of risk appetite by means of consideration of risk in each of the Firm's areas of business and then the implementation of documented and communicated policies and procedures to manage such risks.
- based on the ICAAP, quantification of residual risks is undertaken and capital is allocated accordingly as a buffer;
- clear articulation of roles, responsibilities and reporting lines; and
- regular monitoring of key controls and reporting on risk-related issues to the Partnership Executive Committee and other line managers.

Policies and procedures are frequently developed on a group wide basis with the Firm's other affiliates within the Houlihan Lokey group of companies. These are then adapted, where necessary, by the Firm to take account of local law, regulation and other local risk factors.

The Firm's risk management policy reflects the FCA requirement that it must manage a number of different categories of risk. These include credit, market, business and liquidity risk. Information on all these risks is set out below. Additional information on our business and risks can be found in the financial statements of HL EMEA.

### **Credit Risk**

The main credit risk faced by HL EMEA is non-receipt of payment for fee invoices. The Firm manages its risk by monitoring any unpaid balances, assessing the credit worthiness of potential clients and liaising with clients to secure payment. The Firm also seeks to structure its engagements so that a creditworthy counterparty is responsible for payment of its fees and expenses.

### **Market Risk**

Under Pillar 1, the Firm's material market risk is limited to its exposure to foreign exchange fluctuations, due to some assets and liabilities being denominated in currencies other than sterling. Risk in such regard is sometimes managed through use of foreign exchange hedging arrangements.

### **Liquidity Risk**

Liquidity risk is the risk that current assets are not readily convertible to cash, that funds are either not available to service day-to-day funding requirements or are only available at a high cost, or need to be arranged at a time when market conditions are unfavourable and consequently the terms are onerous.

The liquidity requirements for the Firm arise from day-to-day routine financial activities including the settlement of suppliers, accounts payable and payroll, offset by the receipt of fee income.

Whilst a certain amount of cash volatility is an inevitable consequence of general business activities, the Firm maintains controls to reduce this volatility through cash forecasting. The Firm retains a mixture of substantial cash balances and has significant short notice loan facilities callable from associated entities. It is therefore

### *Capital Requirements Directive Pillar 3*

confident of being able to settle transactions and continue operations in difficult foreseeable circumstances. Cash requirements are monitored and forecast on a regular basis.

#### **Operational Risk**

Most of HL EMEA's risk management efforts are focused on business risk, which is defined as the risk of loss to the Firm resulting from failed or inappropriate internal procedures, people and systems, or from external events. Business risks are identified and managed on a day-to-day basis in relation to the Firm's three principal lines of advisory business, Financial Valuation & Advisory Services, Financial Restructuring and Corporate Finance.

The **primary** means by which the Firm manages business risk is through its senior managers responsible for managing the different business units and for overseeing implementation of Firm policies, procedures and guidance necessary to manage those risks. Such matters include, for example, policies and procedures developed to ensure compliance with relevant broker-dealer and securities laws, confidentiality of client and third party data, the use of formal committees in order to review financial opinions prepared by the Firm, and the use of the Firm's information technology systems to identify and manage conflicts of interest. These are documented within the Firm's Compliance Manual, Code of Ethics and other policies and procedures which are made available to its employees via its Intranet.

In light of the fact that the Firm is a "people driven" business, dependent upon identifying, retaining and developing the brightest and best of its employees, significant effort is expended on ensuring that key individuals are retained and continue to operate effectively. This is achieved by means of competitive remuneration packages, deferred compensation arrangements, contractual restrictions, staff mentoring and formal reviews which are conducted at least once every year.

A **secondary** risk management technique used is via internal groups (and, from time to time, external resources) to develop the Firm wide policies and procedures referred to in the preceding paragraphs. These include:

- the legal and compliance team, which also advises transactional teams on a day-to-day basis as to the implementation of the above policies and procedures, as well as all other matters regarding the Firm's terms of engagement. These may include matters regarding identification and management of risk in interacting with clients and third parties by means of use of engagement letters as well as appropriate disclaimers of liability as well as advising upon aspects of fee recovery;
- the finance function which is responsible for the development, implementation and embedding of certain financial systems and controls, including the timeliness and integrity of the Firm's financial reporting and associated processes; and
- a dedicated human capital management function which is responsible for assisting in monitoring employee performance and related matters.

**Thirdly**, business risks are monitored and managed through "backstop" measures. These include regular reviews (by the internal audit group as well as by its legal and compliance group) of matters giving rise to legal and compliance risk. Results are reported to relevant senior management and the Partnership Executive Committee of HL EMEA. The Firm also takes advantage, where deemed required, of an appropriate level of insurance cover.

Finally, it should be noted that the Firm's business model includes advisory businesses which are both pro and counter-cyclical. This means that the Firm does not suffer peaks and troughs in relation to its business as much as certain other investment banks as each business will perform differently under different market conditions. For example, during economic downturns the Firm's Financial Restructuring Group has tended to outperform other business units whereas in more benign market conditions its Corporate Finance Group is

### ***Capital Requirements Directive Pillar 3***

expected to increase its level of activity.

This is especially important in the current climate, where there has been a higher level of uncertainty and volatility in the operating environment of the Firm from the impact of “Brexit” and the more recent COVID-19 global pandemic. Management’s response to these new risks has also been to set aside additional capital buffers specifically against potential losses, on top of those risks carried from regular operations. The Firm expects that the impact will be short-term in nature and risk capital levels stabilise in future.

Given the limited size, scale and complexity of the Firm’s business, the Partnership Executive Committee has not established a separate risk committee, but deals with such matters directly as and when required. Control functions in the areas of finance as well as legal and compliance operate independently from operational areas and advise the Partnership Executive Committee on the establishment, implementation and maintenance of risk management policies and procedures. In the view of the Firm’s Partnership Executive Committee, such policies and procedures are adequate with regard to HL EMEA’s profile and strategy.

The risks are documented in the Firm’s ICAAP and subject to formal review and update on an annual basis by its Partnership Executive Committee. In addition, our policies and procedures are updated from time to time during the year by the Firm’s legal and compliance team.

## Capital resources

As an IFPRU 50k limited licence firm, HL EMEA is required to hold sufficient capital to cover the greater of its fixed overhead requirement and credit risk & market risk under Pillar 1.

### Compliance with CRR and Pillar 2 Rule Requirements

The Firm's overall approach to assessing the adequacy of its internal capital is set out in its ICAAP. The ICAAP process involves separate consideration of risks to HL EMEA's capital combined with stress testing using scenario analysis. The level of capital required to cover risks is a function of impact and probability. The Firm assesses impact by modelling the changes in its income and expenses caused by various potential risks over a one-year time horizon. Probability is assessed subjectively.

The Firm undertakes its ICAAP at least once annually (or as material changes in conditions warrant) in fulfilment of its Pillar 2 requirements. The Firm's most recent ICAAP document was approved by the Partnership Executive Committee on 26 April 2021.

The Firm is not capital intensive and current calculations show a Pillar 1 capital surplus of £31.1 million for the financial year ended 31 March 2020 (2019: £34.0 million), and a Pillar 2 capital surplus of £20.1 million (2019: £15.7 million), both sufficient to support the Firm's operations.

Pillar I and Pillar II Requirement Comparison FY20 £'000	Pillar I Minimum Requirements	Pillar II Supervisory Review
Pillar I capital requirement is the higher of :		
Fixed overhead requirement	11,613	
and the sum of:		
Credit risk	9,630	9,183
Market risk	2,066	645
Credit risk + Market risk <sup>1</sup>	11,697	9,828
Pillar II Capital also includes:		
Insurance risk		386
Liquidity risk		471
Other business risks		12,069
<b>Capital requirement</b>	<b>11,697</b>	<b>22,754</b>
<b>Capital after deductions</b>	<b>42,818</b>	<b>42,818</b>
<b>Surplus Capital</b>	<b>31,121</b>	<b>20,064</b>

<sup>1</sup> Pillar II Credit and Market risk are calculated based on the Firm's internal capital adequacy calculations, while Pillar I provides a standardised method, resulting in varying levels.



# Remuneration

## **Application**

Houlihan Lokey EMEA, LLP (the “**Firm**”) has determined that it is a Proportionality Level Three investment firm (“**Level Three Firm**”) and has adopted a proportionate approach to remuneration policy. As such, disclosures required under Article 450 of the CRR for the Firm are set out below.

The Firm considers its needs on an ongoing basis and where appropriate will dis-apply provisions which may not be applicable to Level Three Firms by virtue of FCA and EBA guidance. The Governing Body will review any provisions which have been dis-applied as part of its annual review, to ensure that it remains compliant.

## **Decision-making Process for Remuneration Policy (Article 450(1)(a))**

The Governing Body of the Firm is the Firm’s Partnership Executive Committee. The Governing Body is responsible for ensuring a robust remuneration policy is developed to align the Firm’s remuneration practices with its risk tolerance. The Governing Body (or a committee thereof) meets at least annually to review and approve allocation of remuneration among the Firm’s Code Staff.

Review and approval of remuneration has historically been undertaken by the Governing Body with input from Human Capital Management and Finance (the Legal & Compliance function is represented on the Governing Body). As from April 2021, the Governing Body has delegated such activity to a committee of individuals specifically formed for such purposes.

The Governing Body is responsible for the total process of risk management, which includes remuneration risk. The Governing Body, in liaison with all executives and senior management, sets the risk profile of the Firm and its related policies and procedures. This Policy is reviewed by the Governing Body at least annually.

## **Pay and Performance (Article 450(1)(b))**

The Firm’s business model is relatively simple in that it provides financial advisory services in return for payment of fees, without deploying its own capital to take principal positions in securities or other financial instruments. As a consequence, a primary, but not the only, driver of remuneration levels will be by reference to risk-adjusted profits attributable to the business as a whole (except to the extent that for strategic reasons the Firm in conjunction with its US parent determines that additional resources from funds available intra group should be made available to support any given part of our business area), as well as the group and individual’s performance and only after the Firm’s liquidity and capital requirements have been considered.

In establishing the Firm’s top-down remuneration framework, the following factors are taken into consideration:

- the overall results of the Firm;
- the performance of the various groups within our investment banking business area; and
- the performance of the individual (both financial and non-financial performance).

The Firm is dedicated to ensuring that individuals are not remunerated for exceeding the risk tolerances of the Firm. When assessing individual performance, the Firm takes account of financial as well as non-financial criteria.

The Firm’s non-financial criteria, is a combination of effective risk management and compliance with the Firm’s policies and procedures. Poor performance in the Firm’s non-financial criteria may pose a threat to the Firm’s financial soundness. The Firm places a weighted value on the non-financial criteria overriding the metrics of financial performance.

The Firm recognises that performance can be exaggerated within any single year resulting in disproportionate results and therefore takes into account underlying business cycles.

### *Capital Requirements Directive Pillar 3*

#### **Disclosures**

As an *IFPRU* limited licence firm, Houlihan Lokey is required to disclose certain quantitative information regarding remuneration broken down:

- by business area; and
- by senior management and members of staff whose actions have a material impact on the risk profile of the Firm.

***Business area:*** the Firm has one business area, “Investment banking”. The aggregate remuneration for the Firm (including profit share) for the financial year ended 31 March 2020 was £71.5 million (2019: £75.7 million).

***Senior management and others whose actions have a material impact on the risk profile of the Firm:*** the Firm considers all staff with titles: Corporate Officer, Vice President, Senior Vice President, Director and Managing Director as falling within this category. The aggregate senior management remuneration (including profit share) for the financial year ended 31 March 2020 was £56.3 million (2019: £62.2 million).