SMBC

SMBC DERIVATIVE PRODUCTS LIMITED

ANNUAL REPORT AND FINANCIAL STATEMENTS
31 DECEMBER 2018

Company number 02988637

SMBC DERIVATIVE PRODUCTS LIMITED
COMPANY INFORMATION

Registered number: 02988637

Incorporated with limited liability by shares in England and Wales

Directors

T Coleman

R McCormick

A Moore

N Okubo

T Quinn

R Sato

J D Thomas

A Yates

T Yazawa

Secretary

P Davé

Auditor

KPMG LLP

15 Canada Square

London E14 5GL

Bankers

JP Morgan Chase Bank

125 London Wall

London EC2Y 5AJ

Solicitors

Allen & Overy LLP

One Bishops Square

London E1 6AD

Registered Office

One New Change

London EC4M 9AF

AUTHORISED AND REGULATED BY THE FINANCIAL CONDUCT AUTHORITY

STRATEGIC REPORT

The directors present the Strategic Report of SMBC Derivative Products Limited ("the Company" or "SMBC DP") for the year ended 31 December 2018.

Principal activities

SMBC Derivative Products Limited is an investment firm providing derivatives, securities and business advisory products and services. It is part of the Sumitomo Mitsui Financial Group ("SMBC Group").

SMBC Derivative Products Limited ("the Company", "SMBC DP"), company number 02988637 incorporated in England and Wales, is regulated by the Financial Conduct Authority as a full scope investment firm. SMBC DP is a wholly owned subsidiary of SMBC Nikko Capital Markets Limited ("CM Ltd") which together with another subsidiary forms the CM Ltd group (the Group").

The Company is a specialised derivative products company ("DPC") which holds a credit rating of Aa1 from Moody's Investors Service Inc. ("Moody's") and AA- from Standard & Poor's Ratings Group ("S&P"). It manages its capital in accordance with specific operating requirements to maintain these enhanced credit ratings.

Business model and strategy

The Company is established as a bankruptcy remote DPC whose principal activities are the provision of interest rate and foreign exchange risk hedging products to customers seeking a highly rated counterparty. The Company also provides, for a fee, credit performance guarantees to third party customers.

All principal trades booked by the Company with its customers are hedged with mirror transactions with an affiliated entity SMBC Capital Markets Inc. ("CM Inc"). The Company earns a credit intermediation fee for each transaction. A fee is also earned for all credit guarantees written. Additionally the Company is free to earn a return on its capital. The Company's objectives, policies and processes for managing capital are set out in Note 18.

Principal risks and uncertainties

The Group is subject to a range of risk factors and uncertainties in the course of conducting its principal activities, including credit and counterparty risk, liquidity risk, market risk, cash flow risk, operational risk and other risks, an overview of which is included in Note 14 to the financial statements.

Risk Management

Internal processes and controls are subject to regular self-assessment in addition to verification by an independent internal audit function, reporting to the Board, which has full discretion over the particular processes and controls it chooses to review and the timing of any review.

Other closely monitored risks, all of which are reviewed and assessed at least annually, include regulatory risk and conduct risk. Regulatory risk, a significant factor for authorised and regulated investment firms, is the risk of non-compliance to existing regulations and also the risk of changes to applicable regulations or laws having an adverse impact on the business. Conduct risk concerns potential detriment to the business, counterparties or employees caused by inappropriate judgements made in the course of business.

The Company operates within the risk appetite framework of its parent group. The key risks reviewed by the Board and management are set out in the annual report of CM Ltd within the Strategic Report and notes to the financial statements.

DPC's such as SMBC DP can be structured as either continuation or termination vehicles. SMBC DP is a continuation DPC. A credit rating downgrade of the intermediate parent, Sumitomo Mitsui Banking Corporation ("SMBC") to Baa3 (long-term) / P-3 short-term or below by Moody's, or BB (long-term) / B (short–term) or below by S&P would constitute a "trigger event" for the Company whereby it is required to terminate all trades with affiliated counterparties so exposing itself to market risk. A continuation DPC is then obliged to make and receive scheduled payments on all trades with non-affiliated counterparties until those trades either mature, are novated, or are terminated.

It is typical for DPC's to have contingent manager agreements. Under these agreements, an unaffiliated derivatives dealer agrees to provide portfolio management and other general services should a trigger event take place. On the occurrence of a trigger event, the responsibility for the Company's portfolio would fall to the contingent manager. The Company's contingent manager is BlackRock Financial Management, Inc.

As SMBC is a globally systemic Japanese bank, its own credit rating is inextricably linked to Japan's sovereign risk so exposing the Company to a range of macro-economic, geopolitical and other external business risks, all of which are reviewed and assessed at least annually.

Business Environment

The Group operates in a highly regulated environment with significant requirements in respect of reporting, capital, liquidity, product design, customer service and other business areas, which come from multiple regulators in the countries where the Group offers its services. These regulations constantly change and evolve in response to periods of financial instability, new business practices, economic and political developments, becoming increasingly stringent and detailed in order to promote stability in global financial markets.

The SMBC Group's global derivative business continues to support the Company because it recognises that there is an important and inherent economic value, in the form of enhanced operational flexibility, to having a highly rated DPC as an affiliate.

The effect of Brexit on the business environment is discussed below.

Brexit

Following the formal notification to the EU of the UK's intention to withdraw from the EU pursuant to Article 50 of the Lisbon Treaty in 2017, the UK financial services industry is expected to lose the passporting rights granted to UK authorised financial institutions under the national transpositions of applicable EU law (in particular CRD IV as well as MiFID) which enabled them to freely provide banking business and financial services within the European Economic Area ("EEA").

At the time of approval of the financial statements, uncertainties prevail around the outcome of the UK Government's negotiations of the terms of the UK's withdrawal from the European Union. However, the Company's goal and strategic Brexit planning (developed in collaboration with CM Ltd and the SMBC Group) has been, and continues to be, to provide customers with undisrupted financial services following Brexit, including in the scenario of a 'no-deal' or 'hard' Brexit in March 2019.

However, due to the geographical location of SMBC DP's client base, Brexit does not present a significant challenge to the Company. Further, SMBC Group plans to continue providing the current suite of services to both EEA and non EEA clients. The business strategy of the Group continues to be focussed on organic growth and is significantly informed by the requirements of SMBC Group's customer base. SMBC DP will continue to act as the primary derivatives specialist, and will carefully consider the post-Brexit regulatory landscape and review opportunities to diversify its customer base and develop its derivatives business.

SMBC DERIVATIVE PRODUCTS LIMITED
STRATEGIC REPORT

Business Development and Performance

The Company takes into account a range of strategic, business and operational considerations when reviewing the performance of the business. Such considerations include the efficient allocation and use of capital, earnings stability, balance sheet quality, operational robustness and the maintenance of good regulatory compliance.

Effectiveness is measured through the Company's use of financial indicators such as budgeted revenue targets, new deal revenue and return on capital and also non-financial indicators including conduct considerations, compliance with relevant internal and external rules and targets and the setting of measurable goals for all employees through a comprehensive assessment process. The directors pay particular attention to management information relating to earnings, regulatory capital, leverage and liquidity.

The Company reported a profit for the financial year of $5.0m (2017: $2.1m).

The increase in profit for the financial year was entirely driven by total income growth of 58%, which improved from $4.8m in 2017 to $7.5m in 2018, while the level of operating expenses remained steady at $2.5m for the year (2017: £2.4m).

The increase in total income is largely attributable to an increase of $2.3m in interest income due to higher interest rates in 2018, and partially from growth in net trading income.

No dividend was paid in the year and none has been declared (2017 - $ nil).

At 31 December 2018, the Company had common equity tier 1 (CET1) and total regulatory capital of $227.5m (2017: $222.9m) which resulted in a CET1 and total capital ratio of 159.2% (2017: 118.4%).

The financial position of the Company at the end of the year was satisfactory.

Approved by the Board and signed of its behalf

Antony Yates
Director
One New Change
London EC4M 9AF
Date: 16 April 2019

Directors Report

The directors present their report and financial statements of SMBC Derivative Products Limited for the year ended 31 December 2018.

Results and dividends

The company's profit for the year, after taxation, amounted to $5.0 million (2017: $2.1 million). No dividend was paid in the year and none has been declared (2017: $nil).

Directors

The directors who served during the year and at the date of this report were:

T S Coleman

R S McCormick

A Moore

N Okubo

T Quinn

R Sato

J D Thomas

A Yates

T Yazawa

Each current and former director is indemnified out of the assets of the Company against all costs, charges, losses and liabilities incurred by them in the proper exercise of their duties subject to the provisions of the Company's Articles of Association. The Company maintains directors' and officers' liabilities insurance cover for its directors and officers as permitted by its Articles of Association and the Companies Act 2006. Such insurance policies were reviewed during the period and remain in force.

Disclosure of information to the auditor

The Directors who held office at the date of approval of this Directors' report confirm that so far as they are each aware there is no relevant audit information of which the Company's auditor is unaware, and each Director has taken all steps that he ought to have taken as a Director to make himself aware of any relevant audit information and to establish that the Company's auditor is aware of that information.

Going Concern

Management believe that there are no material uncertainties related to events or conditions that may cast significant doubt upon the ability of the Company or the Group to continue as a going concern. The financial statements have been prepared on a going concern basis.

Events after the reporting date

No significant events occurred after 31 December 2018 that would have a material impact on the financial statements for the year ended 31 December 2018.

Financial risk management

Financial risk management objectives are included in the strategic report.

Future developments

The Company does not expect any significant changes in its principal business activities or business strategy.

Future developments in respect of Brexit are discussed in the Strategic Report.

Auditor

In accordance with section 487 of the Companies Act 2006, an elective resolution is in place that dispenses with the obligation to appoint auditor annually. As a consequence, KPMG LLP continues to hold the position as the Company's auditor.

Approved by the Board and signed of its behalf

Antony Yates
Director
One New Change
London EC4M 9AF

Date: 16 April 2019

SMBC DERIVATIVE PRODUCTS LIMITED
STATEMENT OF DIRECTORS' RESPONSIBILITIES IN RESPECT OF THE ANNUAL REPORT, STRATEGIC REPORT, THE DIRECTORS' REPORT AND THE FINANCIAL STATEMENTS

The directors are responsible for preparing the Strategic Report, the Directors' Report and the financial statements in accordance with applicable law and regulations.

Company law requires the directors to prepare financial statements for each financial year. Under that law they have elected to prepare the financial statements in accordance with International Financial Reporting Standards as adopted by the European Union (IFRSs as adopted by the EU) and applicable law.

Under company law the directors must not approve the financial statements unless they are satisfied that they give a true and fair view of the state of affairs of the company and of the profit or loss of the company for that period. In preparing these financial statements, the directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgements and estimates that are reasonable, relevant and reliable;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU;
- assess the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and
- use the going concern basis of accounting unless they either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

The directors are responsible for keeping adequate accounting records that are sufficient to show and explain the company's transactions and disclose with reasonable accuracy at any time the financial position of the company and enable them to ensure that the financial statements comply with the Companies Act 2006. They are responsible for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error, and have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the company and to prevent and detect fraud and other irregularities.

The directors are responsible for the maintenance and integrity of the corporate and financial information included on the company's website. Legislation in the UK governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions.

INDEPENDENT AUDITOR'S REPORT
TO THE MEMBERS OF SMBC DERIVATIVE PRODUCTS LIMITED

Opinion

We have audited the financial statements of SMBC Derivative Products Limited ("the company") for the year ended 31 December 2018 which comprise the income statement, statement of comprehensive income, statement of financial position, statement of changes in shareholders' equity, statement of cash flows , and related notes, including the accounting policies in note 1.

In our opinion the financial statements:

- give a true and fair view of the state of the company's affairs as at 31 December 2018 and of its profit for the year then ended;
- have been properly prepared in accordance with International Financial Reporting Standards as adopted by the European Union; and
- have been prepared in accordance with the requirements of the Companies Act 2006.

Basis for opinion

We conducted our audit in accordance with International Standards on Auditing (UK) ("ISAs (UK)") and applicable law. Our responsibilities are described below. We have fulfilled our ethical responsibilities under, and are independent of the company in accordance with, UK ethical requirements including the FRC Ethical Standard. We believe that the audit evidence we have obtained is a sufficient and appropriate basis for our opinion.

The impact of uncertainties due to the UK exiting the European Union on our audit

Uncertainties related to the effects of Brexit are relevant to understanding our audit of the financial statements. All audits assess and challenge the reasonableness of estimates made by the directors and related disclosures and the appropriateness of the going concern basis of preparation of the financial statements. All of these depend on assessments of the future economic environment and the company's future prospects and performance.

Brexit is one of the most significant economic events for the UK, and at the date of this report its effects are subject to unprecedented levels of uncertainty of outcomes, with the full range of possible effects unknown. We applied a standardised firm-wide approach in response to that uncertainty when assessing the company's future prospects and performance. However, no audit should be expected to predict the unknowable factors or all possible future implications for a company and this is particularly the case in relation to Brexit.

Going concern

The directors have prepared the financial statements on the going concern basis as they do not intend to liquidate the company or to cease its operations, and as they have concluded that the company's financial position means that this is realistic. They have also concluded that there are no material uncertainties that could have cast significant doubt over its ability to continue as a going concern for at least a year from the date of approval of the financial statements ("the going concern period").

We are required to report to you if we have concluded that the use of the going concern basis of accounting is inappropriate or there is an undisclosed material uncertainty that may cast significant doubt over the use of that basis for a period of at least a year from the date of approval of the financial statements. In our evaluation of the directors' conclusions, we considered the inherent risks to the company's business model, including the impact of Brexit, and analysed how those risks might affect the company's financial resources or ability to continue operations over the going concern period. We have nothing to report in these respects.

However, as we cannot predict all future events or conditions and as subsequent events may result in outcomes that are inconsistent with judgements that were reasonable at the time they were made, the absence of reference to a material uncertainty in this auditor's report is not a guarantee that the company will continue in operation.

Strategic report and directors' report

The directors are responsible for the strategic report and the directors' report. Our opinion on the financial statements does not cover those reports and we do not express an audit opinion thereon.

Our responsibility is to read the strategic report and the directors' report and, in doing so, consider whether, based on our financial statements audit work, the information therein is materially misstated or inconsistent with the financial statements or our audit knowledge. Based solely on that work:

- we have not identified material misstatements in the strategic report and the directors' report;
- in our opinion the information given in those reports for the financial year is consistent with the financial statements; and
- in our opinion those reports have been prepared in accordance with the Companies Act 2006.

Matters on which we are required to report by exception

Under the Companies Act 2006, we are required to report to you if, in our opinion:

- adequate accounting records have not been kept, or returns adequate for our audit have not been received from branches not visited by us; or
- the financial statements are not in agreement with the accounting records and returns; or

- certain disclosures of directors' remuneration specified by law are not made; or
- we have not received all the information and explanations we require for our audit.

We have nothing to report in these respects.

Directors' responsibilities

As explained more fully in their statement set out on page 7, the directors are responsible for: the preparation of the financial statements and for being satisfied that they give a true and fair view; such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error; assessing the company's ability to continue as a going concern, disclosing, as applicable, matters related to going concern; and using the going concern basis of accounting unless they either intend to liquidate the company or to cease operations, or have no realistic alternative but to do so.

Auditor's responsibilities

Our objectives are to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue our opinion in an auditor's report. Reasonable assurance is a high level of assurance, but does not guarantee that an audit conducted in accordance with ISAs (UK) will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.

A fuller description of our responsibilities is provided on the FRC's website at www.frc.org.uk/auditorsresponsibilities.

The purpose of our audit work and to whom we owe our responsibilities

This report is made solely to the company's members, as a body, in accordance with Chapter 3 of Part 16 of the Companies Act 2006. Our audit work has been undertaken so that we might state to the company's members those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the company and the company's members, as a body, for our audit work, for this report, or for the opinions we have formed.

Simon Clark (Senior Statutory Auditor)
for and on behalf of KPMG LLP, Statutory Auditor
Chartered Accountants

15 Canada Square
London E14 5GL
United Kingdom
Date: 16 April 2019

SMBC DERIVATIVE PRODUCTS LIMITED
INCOME STATEMENT
FOR THE YEAR ENDED 31 DECEMBER 2018

	Notes	2018 US$'000	2017 US$'000
Net fees and trading income	2	2,716	2,225
Interest income	3	4,832	2,558
Total income		7,548	4,783
Personnel expenses	4, 5	(120)	(120)
Professional fees	6	(2,054)	(1,959)
Other operating expenses		(375)	(340)
Operating expenses		(2,549)	(2,419)
Profit from ordinary activities before taxation		4,999	2,364
Tax on profit from ordinary activities	7	50	(305)
Profit for the financial year		5,049	2,059

Company profit for the financial year is entirely attributable to the equity holders of the Parent. All results are from continuing operations.

The notes on pages 15 to 35 form an integral part of these financial statements.

SMBC DERIVATIVE PRODUCTS LIMITED
STATEMENT OF COMPREHENSIVE INCOME
FOR THE YEAR ENDED 31 DECEMBER 2018

	2018 US$'000	2017 US$'000
Profit for the financial year	5,049	2,059
Other comprehensive income	-	-
Total comprehensive income for the year attributable to equity holders of the Company	5,049	2,059

The notes on pages 15 to 35 form an integral part of these financial statements.

SMBC DERIVATIVE PRODUCTS LIMITED
STATEMENT OF FINANCIAL POSITION
AS AT 31 DECEMBER 2018

	Notes	2018 US$'000	2017 US$'000
Assets			
Cash at banks	8	111,271	131,452
Trading securities	9	117,541	91,968
Derivative assets	10	15,146	13,688
Other debtors	11	889	274
Total assets		244,847	237,382
Liabilities			
Derivative liabilities	10	13,966	12,759
Other creditors	12	2,340	1,131
Total liabilities		16,306	13,890
Net assets		228,541	223,492
Equity attributable to equity holders of the parent			
Called up share capital	13	200,000	200,000
Retained earnings		28,541	23,492
Total equity		228,541	223,492

The notes on pages 15 to 35 form an integral part of these financial statements.

The financial statements were approved by the Board of Directors on 21 March 2019 and were signed on its behalf by:

Antony Yates
Director
Date: 16 April 2019
Company number 02988637

SMBC DERIVATIVE PRODUCTS LIMITED
STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY
AS AT 31 DECEMBER 2018

	Note	Share capital US$'000	Retained earnings US$'000	Total equity US$'000
At 1 January 2017	13	200,000	21,433	221,433
Profit for the financial year		-	2,059	2,059
Total comprehensive income for the period		-	2,059	2,059
At 31 December 2017		200,000	23,492	223,492
At 1 January 2018	13	200,000	23,492	223,492
Profit for the financial year		-	5,049	5,049
Total comprehensive income for the period		-	5,049	5,049
At 31 December 2018		200,000	28,541	228,541

The notes on pages 15 to 35 form an integral part of these financial statements.

SMBC DERIVATIVE PRODUCTS LIMITED
STATEMENT OF CASH FLOWS
FOR THE YEAR ENDED 31 DECEMBER 2018

	Note	2018 US$'000	2017 US$'000
Cash flows from operating activities			
Profit for the financial year		5,049	2,059
Adjustments to reconcile net income to net cash from operating activities:			
Change in trading securities		(25,573)	3,564
Change in other debtors		(615)	137
Change in derivative assets		(1,458)	3,361
Change in derivative liabilities		1,207	(2,814)
Change in other creditors		1,209	(670)
Net cash from operating activities		(25,230)	3,578
Net change in cash		(20,181)	5,637
Cash and cash equivalents at beginning of year		131,452	125,815
Cash and cash equivalents at end of year	8	111,271	131,452
Net (decrease)/increase in cash		(20,181)	5,637

The notes on pages 15 to 35 form an integral part of these financial statements.

1. Accounting policies

Statement of compliance

The Company financial statements have been prepared and approved by the directors in accordance with International Financial Reporting Standards ("IFRS"), as adopted by the European Union.

Going concern

The Directors have undertaken an assessment of the Company's ability to continue as a going concern and are satisfied that it has the resources to continue in business for the foreseeable future. Further information regarding this assessment is given in the Directors' report. No material uncertainties that may cast significant doubt upon the Company's ability to continue as a going concern have arisen. Therefore, the financial statements continue to be prepared on the going concern basis.

Functional and presentational currency

The Directors consider the functional currency of the Company's activities to be US dollars since the majority of the Company's income is generated in this currency. The directors have chosen to present amounts in thousands.

Preparation of the income statement

The Company has departed from the standard income statement format required by Schedule IV of the Companies Act in order to present interest income within operating profit or loss.

New accounting standards

On 1 January 2018, the Company adopted two new accounting standards: IFRS 9 Financial Instruments and IFRS 15 Revenue from Contracts with Customers. The new standards have been applied in preparing the current year financial statements but, as permitted, comparative information for the previous year was not restated. The adoption of IFRS 9 and IFRS 15 did not have a material impact on the financial statements, either on transition or reporting date. Accordingly, the financial statements were not adjusted. The Company will continue to monitor the standards' effect.

Foreign currency translation

Foreign currency assets and liabilities are re-measured into US dollar equivalents at rates of exchange ruling at the balance sheet date. Gains and losses resulting from re-measurement into US dollar equivalents are reflected in the Company income statement within net trading gain or loss.

Interest income

Interest is earned on trading securities and cash at banks. Interest income is recorded at the effective interest rate, which is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument or a shorter period, where appropriate, to the net carrying amount of the financial asset.

Fees charged to related parties

The Company recharges to CM Inc. the professional fees it incurs in its costs. The fees to CM Inc. are recognised on accruals basis.

Intermediation fees

The Company receives an intermediation fee from CM Inc for each derivative transaction with an unaffiliated counterparty. The fee is equal to the present value of two hundredths of one percent (0.02%) of the notional amount (weighted average for amortising or accreting transactions) times the tenor of the transaction for each primary transaction. For an option transaction, the fee is equal to the prevailing inter-bank broker fee for a transaction of the same type plus a bid-ask spread. Should a trade be terminated prior to maturity there will be a proportionate rebate of the fee earned at inception.

Guarantee fees

The Company provides guarantees to external customers over derivative products sold by CM Inc. The Company is fully indemnified by CM Inc in the event of a default and holds collateral in the form of securities to offset mark to market movements for instruments covered by these guarantees. These arrangements are treated as financial guarantees, and a fee is earned based upon the daily average value of the guaranteed transactions. The income is recognised as accrued.

Professional fees

Professional fees are incurred in respect of contingent manager arrangement, rating verification, audit and audit-related services. The fees are recognised in expenses on an accrual basis.

Financial instruments

Financial instruments at the reporting date are accounted for under IFRS 9, adopted on 1 January 2018. As permitted by IFRS 9, comparative information for the previous reporting period has not been restated and presented under IAS 39, in force at that time. The transition to IFRS 9 is explained in more detail in note 17.

Financial instruments are also governed by IFRS 7, IFRS 13 and IAS 32 which define their disclosures, fair value measurement, classification as debt or equity and offsetting.

i) Categories

The following categories of financial instruments held by the Company are within the scope of IFRS 9 and IAS 39:

- Cash and cash equivalents;
- Trading securities;
- Derivative instruments, including credit guarantees; and
- Other debtors and creditors.

ii) Classification and measurement

Under IFRS 9, financial assets are classified into three categories, measured at:

a) amortised cost;
b) fair value through other comprehensive income; or
c) fair value through profit or loss.

A financial asset is measured at amortised cost if both of the following conditions are met:

a) the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and
b) the contractual terms of the financial asset give rise to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A financial asset is measured at fair value through other comprehensive income if both of the following conditions are met:

a) the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
b) the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

All other assets are classified as measured at fair value through profit or loss.

Under IAS 39, financial assets are classified as:

a) loans and receivables;
b) held to maturity;
c) held for trading; or
d) available for sale.

Loans and receivables and held-to-maturity assets are measured at amortised cost. Assets held for trading are measured at fair value through profit or loss and assets available for sale - at fair value through other comprehensive income.

Both standards permit designation of any financial assets at fair value through profit or loss if it eliminates or significantly reduces an accounting mismatch.

Under both standards, financial liabilities are classified as measured at:

a) fair value through profit or loss (either designated or held for trading); or
b) amortised cost.

At both reporting dates, financial instruments measured at amortised cost included:

- cash at banks;
- other debtors; and
- other creditors.

Instruments measured at fair value through profit or loss comprised of

- trading securities; and
- derivatives;

Trading securities contain assets held to retain the credit rating which were designated, rather than mandatory classified, at fair value through profit or loss.

There were no assets measured at fair value through other comprehensive income.

iii) Recognition and derecognition

Under both IFRS9 and IAS 39, an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.

The standards permit a choice between trade date and settlement date accounting for recording regular way transactions. When applying settlement date accounting it is still required that any movements in fair value between trade date and settlement date are reflected as they occur. The movement in fair value is taken to profit and loss or to other comprehensive income depending upon the classification of the asset. The Company uses settlement date for transactions with trading securities and derivatives.

Assets are derecognised when the entity transfers its contractual rights to receive the cash flows and substantially all the risks and rewards of ownership. Financial liabilities are derecognised when the obligation is either discharged or cancelled or expires.

iv) Fair value

The Company assumes that the asset or liability is exchanged in an orderly transaction between market participants to sell the asset or transfer the liability at the measurement date under current market conditions either: (a) in the principal market for the asset or liability; or (b) in the absence of a principal market, in the most advantageous market for the asset or liability. That assumed transaction establishes a basis for determining the exit price.

The Company manages the credit and liquidity risks in their derivatives portfolio on a net basis. The Company provides fair value information on its derivative portfolio on a net basis to management. Therefore, the Company makes adjustments to the valuation of their derivatives by calculating credit and debit valuation adjustments consistent with IFRS 13 and measures the fair value of the derivative portfolio on a net basis (i.e. the unit of account is the entire portfolio).

v) Impairment

Assets carried at amortised cost and, under IFRS9 at fair value through other comprehensive income, are subject to impairment testing.

IFRS 9 changes impairment testing from an incurred loss model to expected credit loss approach. It establishes three categories of assets for impairment purposes:

a) low risk assets ("stage 1");
b) instruments which credit risk has significantly increased since initial recognition ("stage 2"); and
c) credit-impaired ("stage 3").

Impairment provision of assets in stage 1 is measured as 12-month expected credit losses. Impairment provision for assets in stages 2 and 3 is calculated for their lifetime. IFRS 9 introduces criteria for classification as low, significantly increased risk and credit-impaired. They include rebuttable presumptions of a significant increase in credit risk for instruments over 30 days in arrears and credit impairment for instruments over 90 days in arrears.

Under IAS 39, impairment losses are recognised only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset. If any such evidence exists, the entity is required to do a detailed impairment calculation to determine whether an impairment loss should be recognised.

At the reporting date, the Company had no assets in stage 2 or 3. As most of the Company's assets in scope have a life span of less than 12 months, the impairment provision was calculated for the shorter of the lifetime and 12 months.

Significant accounting judgements and estimates

In the process of applying the Company's accounting policies, management has exercised judgement and estimates, gauged in accordance with industry best practice, when determining the amounts recognised in the financial statements in relation to the fair value of derivative assets and liabilities.

i) Judgements

Judgments do not usually directly address measurement. The management exercises judgements when accounting standards allow a range of possible measurement methods. A different judgement might lead to a materially different accounting treatment and valuation.

Judgement is exercised in respect of the methodology for valuing the Group's collateralised derivative contracts. The management has chosen to use, in line with market practice, the Overnight Indexed Swap curve ("OIS") in order to more consistently manage the associated interest rate and funding risks.

Judgement is exercised as to whether unobservable inputs constitute a significant part of the total value of derivative instruments and therefore the level at which the instruments should be classified in the fair value hierarchy.

ii) Estimates

Estimates use uncertain information and sometimes subjective assumptions to measure carrying values. As a result, estimates bear a risk of material adjustments to the carrying amounts in subsequent accounting periods.

Estimates are used where the fair value of derivative assets and liabilities cannot be derived from active markets and is determined using a variety of valuation techniques that employ mathematical models. The inputs to these models use observable market data where possible but, where observable market data are not available, unobservable inputs are used. The estimates include considerations of liquidity and model inputs such as volatility for longer dated derivatives.

Credit Valuation Adjustments ("CVA") and Debit Valuation Adjustments ("DVA") are incorporated into derivative valuations to reflect the value of counterparty and own credit risk. CVAs, calculated on a counterparty exposure basis across instrument type, are derived from market data and management estimates of exposure at default, probability of default and recovery rates. The DVA is an adjustment to the value of the Company's derivative liabilities that seeks to reflect the Company's own default risk, which involves similar estimates of exposure at default, probability of default and recovery rates.

Judgement was exercised in respect of the methodology for valuing the Company's collateralised derivative contracts. The management has chosen to use, in line with market practice, the Overnight Indexed Swap curve ("OIS") in order to more consistently manage the associated interest rate and funding risks.

The funding fair value adjustment ("FVA") is calculated by applying future market funding spreads to the expected future funding exposure of any uncollateralised component of the OTC derivative portfolio. This includes the uncollateralised component of collateralised derivatives in addition to derivatives that are wholly uncollateralised. The expected future funding exposure is calculated by a simulation methodology, where available. The expected future funding exposure is adjusted for events that may terminate the exposure such as the default of the company or the counterparty.

The FVA, CVA and DVA are calculated independently of each other.

Future accounting developments

The following standard issued by the IASB and endorsed by the EU was not yet effective at the reporting date.

IFRS 16 Leases

The new standard sets out the principles for the recognition, measurement, presentation and disclosure of leases for both parties to a contract, i.e. the customer (lessee) and the supplier (lessor). IFRS 16 replaces the previous lease standard, IAS 17 leases, and related interpretations. IFRS 16 is effective for annual reporting periods beginning on or after 1 January 2019. A company can choose to apply IFRS 16 before that date but only if it also applies IFRS 15 Revenue from Contracts with Customers.

The Company does not expect a material effect on its financial statements due to the adoption of this new standard.

2. Net fees and trading income

This comprises the following items of income and expense:

	2018 US$'000	2017 US$'000
Trading loss on derivative instruments	(5)	(164)
Trading securities loss	(304)	(8)
Fees charged to related parties	1,977	2,182
Guarantee fee income	1,019	802
Derivative reserves	257	(384)
Other losses	(228)	(203)
	2,716	2,225

3. Interest income

Interest income for the year was earned on the following instruments:

	2018 US$'000	2017 US$'000
Interest income on:		
- Floating rate notes	1,768	758
- U.S. treasury securities	956	446
- Short-term deposits	2,108	1,354
	4,832	2,558

4. Operating profit

	2018 US$'000	2017 US$'000
This is stated after charging:		
Directors' emoluments	120	120
Auditor's remuneration		
audit fees to KPMG LLP	76	76
audit related service fees to KPMG LLP	61	46
credit rating assurance fees to KPMG NY	356	279
	613	521

Audit fees relate to the audit of the statutory financial statements. Audit-related services cover CASS review and the quarterly financial reviews.

5. Information regarding directors and employees

The average monthly number of employees of the Company (excluding directors) during the year was nil (2017: $nil).

Three external directors received emoluments during the year for management services to the Company:

	2018 US$'000	2017 US$'000
Directors' emoluments	107	103
Expense reimbursement	10	14
National Insurance	3	3
Total	120	120
Emolument of highest paid director	37	36

No director received pension contributions or any other retirement benefits (2017: $nil).

Certain directors are also directors of the Parent undertaking. Emoluments received by them for their services to the Company are disclosed in the consolidated financial statements of the Parent. They are not separately disclosed as it was not practical to apportion their time.

6. Professional fees

Professional fees consist of the following:

	2018 US$'000	2017 US$'000
Contingent manager fees	1,250	1,250
Rating agency fees	309	308
Auditor's remuneration (see Note 4)	493	401
Other professional fees	2	-
	2,054	1,959

7. Tax on profit from ordinary activities

	2018 US$'000	2017 US$'000
Current tax expense		
Current year	33	259
Adjustments for prior years	(83)	46
Total tax (credit) / charge in income statement	(50)	305

The tax charge on profit for the year differs from the nominal amount that would arise at the standard weighted average rate of corporation tax in the UK. The differences are explained below:

	2018 US$'000	Effective tax rate	2017 US$'000	Effective tax rate
Profit/(loss) excluding taxation	4,999		2,364	
Tax using the UK corporation tax rate of 19% (2017: 19.25%)	950	19.0%	455	19.2%
Banking surcharge	400	8.0%	96	4.1%
Permanent difference	14	0.3%	1	-
APA adjustment	(1,328)	(26.6)%	(235)	(9.9)%
Adjustments for prior years	(83)	(1.7)%	46	1.9%
Utilisation of loss carry forward	(3)	(0.1)%	(58)	(2.5)%
Total tax (credit) / charge	(50)	-1.1%	305	12.8%

There is an unutilised tax loss of $nil (2017: $4,527 thousand), for which no deferred tax asset is recognised. The Company is party to an Advance Pricing Agreement ("APA") between its parent CM Ltd, affiliate CM Inc and Her Majesty's Revenue and Customs ("HMRC"). This defines the basis on which UK tax would be charged on the global profits of the Capital Markets group (i.e. CM Inc, CM Ltd, SMBC DP).

Corporation tax rate

The corporation tax rate remained at 19% throughout the year ended 31 December 2018 (2017: 19.25%). The government announced a further reduction to 17% effective from 1 April 2020. This reduction was substantively enacted at the reporting date.

A bank corporation tax surcharge of 8% has been effective since 1 January 2017. The company has been allocated a portion of a £25m bank surcharge allowance that covers entities within the SMBC UK Group.

8. Cash at banks

	2018 US$'000	2017 US$'000
Cash at bank	4,821	4,969
Short-term deposits	106,450	126,483
	111,271	131,452

None of these amounts were deposited with group undertakings as of 31 December 2018 (2017 – $nil).

9. Trading securities

Trading security assets represent short-term investments in debt and equity instruments, primarily aimed at generating income from value fluctuations, interest, dividends and coupons.

	Listed on non UK Exchanges US$'000	Not listed US$'000	Total US$'000
Fair value as at 31 December 2018			
Floating rate notes	67,654	-	67,654
U.S. treasury securities	49,887	-	49,887
Total	117,541	-	117,541

	Listed on non UK Exchanges US$'000	Not listed US$'000	Total US$'000
Fair value as at 31 December 2017			
Floating rate notes	42,029	-	42,029
U.S. treasury securities	49,939	-	49,939
Total	91,968	-	91,968

The fair values of all trading securities held are observable in an active market.

10. Derivative assets and liabilities

Derivatives are financial instruments which derive their value from other assets, rates, prices, indices or other variables and which settlement does not usually involve the delivery of the underlying instrument. Derivative assets represent contracts with positive fair values and liabilities represent those with negative values.

In line with the requirements of IFRS 13, the Group booked a Debit Value Adjustment ("DVA"), Credit Value Adjustment ("CVA") and Funding Value Adjustment ("FVA") when calculating the fair value of its derivatives. These are all classified as derivative reserves.

	2018 US$'000	2017 US$'000
Amounts due from related parties	15,210	12,748
Amounts due from external parties	-	980
Derivative reserves	(64)	(40)
Derivative assets	15,146	13,688
Amounts due to related parties	-	980
Amounts due to external parties	14,903	12,435
Derivative reserves	(937)	(656)
Derivative liabilities	13,966	12,759

The table below provides an analysis of carrying values and principal amounts by type of contract:

	Carrying value		Notional principal	
	2018 US$'000	2017 US$'000	2018 US$'000	2017 US$'000
Interest rate and currency swaps	14,456	12,562	56,924	59,568
Options	754	1,166	2,566,707	2,841,694
Derivative reserves	(64)	(40)	-	-
Derivative assets	15,146	13,688	2,623,631	2,901,262
Interest rate and currency swaps	14,153	12,256	64,083	62,016
Options	750	1,159	1,560,685	2,841,694
Derivative reserves	(937)	(656)	-	-
Derivative liabilities	13,966	12,759	1,624,768	2,903,710

The table below analyses the carrying values of derivatives, excluding reserves, by contractual maturities:

Carrying values	2018 US$'000	2017 US$'000
Due within 1 to 5 years	2,414	2,145
Due within 10 to 15 years	12,796	11,583
Derivative assets	15,210	13,728
Due within 1 to 5 years	2,404	2,140
Due within 10 to 15 years	12,499	11,275
Derivative liabilities	14,903	13,415

Derivatives are usually used by market participants to hedge risks in non-derivative financial or non-financial contracts. When the host contracts expire, the related derivatives are settled as well. Due to that, contractual maturities represent the maximum expected duration of derivative instruments.

The following paragraphs provide additional information on derivative contracts traded by the Company:

Interest rate and currency contracts

The two parties to an interest rate swap agree to exchange, at particular intervals, payment streams calculated on a specified notional amount with at least one stream based on a floating interest rate. Basis swaps involve two floating rates, such as prime and LIBOR.

The parties to a currency swap generally exchange at the outset a principal amount in two currencies, agreeing to re-exchange the currencies at a future date and agreed upon exchange rate. These foreign exchange contracts relate to major foreign currencies such as Yen, Sterling and Euros.

Options

Interest rate caps, the primary derivative instrument offered to customers by the Company, and floors require the writer to pay the purchaser at specified future dates the amount, if any, by which a specified market interest rate exceeds the fixed cap rate or falls below the fixed floor rate, applied to a notional amount. The cap or floor writer receives a premium for bearing the risk of unfavourable interest rate changes.

11. Other debtors

	2018 US$'000	2017 US$'000
Accrued interest income	383	149
Prepayments	131	125
Corporation tax	375	-
	889	274

12. Other creditors

	2018 US$'000	2017 US$'000

Amounts due to fellow group undertakings	1,630	363
Corporation tax	-	129
Other creditors and accruals	710	639
	2,340	1,131

13. Called up share capital

	2018 US$'000	2017 US$'000
200 million ordinary shares of $1 each	200,000	200,000

14. Risk management

i) Strategy in using financial instruments

The principal activities of the Company are to act as agent and intermediary in a variety of over-the-counter ("OTC") derivative transactions including interest rate caps and interest rate and currency swaps, and the provision of credit guarantees to third party customers conducting hedge transactions with CM Inc. The Company takes no intra-day or overnight derivative trading positions. Most exposures are hedged with mirror transactions undertaken with an affiliated company, CM Inc. The Company records trading income from intermediation fees paid by CM Inc. The Company invests its capital in a portfolio of high quality floating rate notes and treasury bills, seeking to earn an interest margin and when the opportunity arises, realise a trading profit.

ii) Cash flow and fair value interest rate risk

As the Company operates a primarily balanced derivative portfolio (subject to appropriate credit adjustments) and invests in floating rate assets funded through floating rate liabilities or capital there is no significant exposure in the derivative portfolio to changes in cash flow or fair value due to interest rate risk.

iii) Credit risk

a) Credit quality and collateral

Credit risk represents the potential losses that the Company would incur if a counterparty failed to perform its obligations under contractual terms and collateral held was not sufficient to cover them.

Cash at banks

Credit risk of cash at banks, which corresponds to its maturity profile, is characterised by the short-term ratings of the financial institutions it was held at:

S&P rating	2018 Fair value US$'000	2017 Fair value US$'000	*Moody's rating*	2018 Fair value US$'000	2017 Fair value US$'000
A-1+	91,404	111,529	P-1	111,271	126,483
A-1	15,046	14,954	P-2	-	4,969
A-2	4,821	4,969			
	111,271	131,452		111,271	131,452

Trading securities

Credit risk of trading securities is characterised by their long-term ratings:

S&P rating	2018 Fair value US$'000	2017 Fair value US$'000	*Moody's rating*	2018 Fair value US$'000	2017 Fair value US$'000
AAA	-	-	Aaa	49,887	49,938
AA+	49,886	49,939	Aa2	10,012	-
AA-	22,069	14,001	Aa3	40,119	36,727
A+	30,574	8,006	A1	7,514	5,303
A	5,001	20,022	A2	-	-
A-	10,011	-	A3	10,009	-
	117,541	91,968		117,541	91,968

Derivatives

The Company is exposed to the credit risk arising from transactions with CM Inc and other counterparties. The notional or contractual values of swap agreements do not represent exposure to credit risk which is limited to the current cost of replacing the contracts with a positive market value. Credit risk represents the amount of loss that the Company would incur if counterparty failed to perform its obligations under contractual terms.

The table below analyses the carrying values of derivative assets before reserves by credit ratings:

S&P rating	2018 Fair value US$'000	2017 Fair value US$'000
Related parties		
A	15,210	12,748
External parties		
AA+	-	980
	15,210	13,728

Moody's rating	2018 Fair value US$'000	2017 Fair value US$'000
Related parties		
A1	15,210	12,748
External parties		
Aa1	-	980
	15,210	13,728

There were no exposures rated BBB+ or lower by S&P at the reporting date (2017: nil).

The Company's credit exposure arises from the risk of non-performance of its counterparties in fulfilling their contractual obligations pursuant to its derivative transactions. The risk of non-performance can be directly impacted by volatile or illiquid trading markets, which may impair the counterparties' abilities to satisfy their obligations. At the reporting date, the value of the collateral pledged by CM Inc. was nil (2017: $nil).

b) Credit risk concentration

Management determines concentrations of counterparty credit risk in accordance with Bank for International Settlements guidance ('BIS Rules'). Management does not believe that the Group is exposed to significant concentrations of risk identified by currency or product.

Geographical analysis

Below is a geographical analysis of cash at banks by their countries of operation:

	2018 US$'000	2017 US$'000
Japan	15,046	14,954
Singapore	91,404	111,529
USA	4,821	4,969
	111,271	131,452

Geographical analysis of trading securities is based on the countries of the issuers:

	2018 US$'000	2017 US$'000
UK	22,564	14,719
Australia	17,066	14,001
Japan	-	5,303
Netherlands	5,001	8,006
Sweden	10,012	-
USA	62,898	49,939
	117,541	91,968

Derivative assets before reserves are analysed by reference to the countries of the customers:

	2018 US$'000	2017 US$'000
Derivative assets		
USA	15,210	12,749
Others	-	979
	15,210	13,728

c) Impairment

At the reporting date, the Group had no financial assets which were credit-impaired or which credit risk had significantly increased since initial recognition.

iv) Liquidity risk

Liquidity risk is the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities, at a reasonable cost. The Company have no unfunded forward commitments in the one year period.

The tables below show maturities of undiscounted contractual cash flows in respect of financial liabilities of the Company.

As at 31 December 2018	Carrying value US$'000	Less than 1 year US$'000	1-5 years US$'000	More than 5 years US$'000	Total US$'000
Non-derivative financial liabilities					
Other creditors	2,340	2,340	-	-	2,340
Derivative financial liabilities					
Derivative liabilities (excluding reserves)[1]	14,903	-	2,404	12,499	14,903

As at 31 December 2017	Carrying value US$'000	Less than 1 year US$'000	1-5 years US$'000	More than 5 years US$'000	Total US$'000
Non-derivative financial liabilities					
Other creditors	1,131	1,131	-	-	1,131
Derivative financial liabilities					
Derivative liabilities (excluding reserves)[1]	13,415	-	2,140	11,275	13,415

[1] *The maturities of derivative liabilities were prepared on the basis of their present values rather than undiscounted cash flows.*

v) Market risk

All trading instruments are subject to market risk, the potential that future changes in market conditions may make an instrument less valuable, due to fluctuations in security prices, as well as interest and foreign exchange rates. Market risk is directly affected by the volatility and liquidity in the markets in which the related underlying assets are traded. As the instruments are recognised at fair value, those changes directly affect reported income.

Since all of the Company's transactions with third parties are matched by transactions with CM Inc, the Company has no net exposure to market risk on derivative financial instruments.

The Company invests its capital in cash deposits, treasury bills, and a portfolio of high quality floating rate notes; through the latter it seeks to earn an interest margin and, when the opportunity arises, to realise a trading profit. The Company has no borrowings. Interest expense is limited to amounts paid on any collateral received which itself matches the amount this cash earns when deposited.

The Company funds itself from its share capital and retained earnings. As a consequence of this the Company's sensitivity to interest rates is restricted to the direct correlation between interest income and prevailing interest rates.

The weighted average yield on the cash deposits was 1.95% as of 31 December 2018 (2017 – 1.10%). The weighted average yields as of 31 December 2018 on floating rate notes and U.S. treasury securities were 2.77% and 1.69% (2017: 1.71% and 0.85% respectively).

vi) Foreign exchange risk

The Company does not have a significant foreign exchange exposure.

15. Offsetting financial assets and financial liabilities

The disclosure set out in the tables below include financial assets and financial liabilities that are subject to an enforceable master netting arrangement or similar agreement that covers similar financial instruments, irrespective of whether they are offset in the statement of financial position.

The ISDA and similar master netting arrangements do not meet the criteria for offsetting in the statement of financial position. This is because they create for the parties to the agreement a right of set-off of recognised amounts that is enforceable only following an event of default, insolvency or bankruptcy of the company or the counterparties or following other predetermined events. In addition, the Company and its counterparties do not intend to settle on a net basis or to realise the assets and settle the liabilities simultaneously.

The tables below disclose the potential effect of netting arrangements on financial assets and liabilities that do not meet the offsetting criteria. The offset amounts have been capped for each counterparty at the lower of assets and liabilities.

	Net amounts of recognised financial assets / liabilities US$'000	Amounts that do not meet the offsetting criteria US$'000	Net amounts US$'000
At 31 December 2018			
Derivative assets	15,146	-	15,146
Derivative liabilities	13,966	-	13,966
At 31 December 2017			
Derivative assets	13,688	(892)	12,796
Derivative liabilities	12,759	892	13,651

16. Fair value hierarchy

When available, the Company uses quoted market prices to determine fair value and classify such items within Level 1. Trading securities are classified in Level 1 of the fair value hierarchy since they are valued using quoted market prices.

In some cases where a market price not is available the Company will make use of acceptable practical expedients such as matrix pricing to calculate fair value, in which case the items are classified within Level 2.

If quoted market prices are not available, fair value is based upon internally developed models that use current independently sourced market parameters such as interest rates, exchange rates, option volatilities, etc.

If quoted market prices are not available, the valuation model used generally depends on the specific asset or liability being valued. The determination of fair value considers various key input factors, including interest rate yield curves, time value and volatility factors, underlying options and derivatives and price activity for equivalent synthetic instruments.

The majority of derivative transactions entered into by the Company are executed over the counter and so are valued using internal valuation techniques as no quoted market prices exist for such instruments. The valuation technique and inputs depend on the type of derivative and the nature of the underlying reference rate. The principal techniques used to value these instruments are discounted cash flows, Black-Scholes and Monte Carlo simulation.

A given position is categorised as Level 2 or Level 3 depending on the observability of the key inputs to the model.

Fair values of financial instruments measured at amortised cost approximate their carrying values.

The following table presents the fair value hierarchy of financial assets and liabilities, measured at fair value, at 31 December 2018 and 31 December 2017:

	Level 1 US$'000	Level 2 US$'000	Total US$'000
At 31 December 2018			
Assets			
Derivative financial instruments	-	15,146	15,146
Trading securities	117,541	-	117,541
	117,541	15,146	132,687
Liabilities			
Derivative financial instruments	-	13,966	13,966
	-	13,966	13,966
At 31 December 2017			
Assets			
Derivative financial instruments	-	13,688	13,688
Trading securities	91,968	-	91,968
	91,968	13,688	105,656
Liabilities			
Derivative financial instruments	-	12,759	12,759
	-	12,759	12,759

The Product Control department is responsible for the valuation policies and procedures. This department is responsible for running daily valuations and risks on the Company's derivatives portfolio, and reports into the Chief Financial Officer. The Risk Management department is responsible for managing model risk and its related policies and procedures. It reports into the Chief Risk Officer. As all models are owned by the front office under supervision and reporting lines of the Head Trader, independence in the validation process is maintained. All changes in existing models are reported to the Risk Management department and approved by the Model Validation Group ("MVG"). Model use and changes to models are approved by Global Risk Management Committee ("GRMC"), to which the MVG makes its recommendations. The GRMC broader membership extends to include representatives from the Bank, which also supports independence within the validation process. Pricing models are validated based on assigned tiers. Tier 1 models are validated annually, Tier 2 models are validated every 2 years, and Tier 3 models are validated every 3 years. Stress tests are run on a weekly/monthly basis.

17. Transition to IFRS 9

As explained in note 1 Accounting policies, the Company adopted IFRS 9 Financial Instruments on 1 January 2018. The adoption did not result in reclassifications of financial instruments between measurement categories, i.e. amortised cost, fair value through profit or loss and fair value through other comprehensive income. The impairment provision on transition, amounting to US$ 6,000, was considered immaterial and not adjusted for.

As permitted by IFRS 9, the Group did not restate its comparative information. Accordingly, financial instrument at the reporting date are presented under IFRS 9 and at the previous reporting date under IAS 39.

The table below reconciles the categories and amounts on transition date between IAS 39 and IFRS 9.

			IFRS 9 category		
As at 1 January 2018	Notes	IAS 39 value US$'000	Amortised cost US$'000	FVTPL* US$'000	Total US$'000
Financial assets					
Loans and receivables					
Cash at banks	8	131,452	131,452	-	131,452
Other debtors	11	274	274	-	274
Held for trading					
Trading securities	9	91,968	-	91,968	91,968
Derivative assets	10	13,688	-	13,688	13,688
		237,382	131,726	105,656	237,382
Financial liabilities					
Measured at amortised cost					
Other creditors	12	1,131	1,131	-	1,131
Held for trading					
Derivative liabilities	10	12,759	-	12,759	12,759
		13,890	1,131	12,759	13,890

* *Fair value through profit or loss*

18. Regulatory capital

The primary objective of the Company's capital management is to ensure that it complies with externally imposed capital requirements. Regulatory capital comprises share capital, regulator-verified profits (common equity tier 1 capital or "CET1") less deductions. Balance sheet assets and some off-balance sheet items are assigned regulatory weights to arrive at the total risk exposure. The business must maintain capital ratios, a proportion of relevant capital to total risk weighted assets ("RWA"), above minimum thresholds.

Regulatory capital, risk weighted assets and capital ratios are summarised below:

	2018 US$'000	2017 US$'000
Common equity tier 1 (CET1) capital		
Called up share capital	200,000	200,000
Retained earnings	28,541	23,492
	228,541	223,492
CET1 regulatory adjustments		
Other	(1,055)	(618)
	(1,055)	(618)
Total CET1 capital	227,486	222,874
Total regulatory capital	227,486	222,874
Risk-weighted assets (unaudited)	142,882	188,161
CET1 and total capital ratio (unaudited)	159.2%	118.4%

The adequacy of the Company's capital is monitored daily using the rules and ratios established by the BIS rules and enacted through the European Union's Capital Requirement Directive.

In addition, the Company monitors both its capital required and available capital in accordance with the rules and requirements set out in its Operating Policies and Guidelines in order to meet the operational requirements for AAA / Aaa rated derivative products company. The Company is currently rated AA- by S&P (2017: AA-) and Aa1 by Moody's (2017: Aa1). The Company has been in compliance with externally imposed capital requirements throughout the year.

In order to maintain or adjust the capital structure the Company may alter its dividend policy or the structure and liquidity of its trading assets and liabilities. The capital of the Company is also monitored within the context of the requirements of the wider CM Group.

19. Financial and other commitments

The Sumitomo Mitsui Banking Corporation ("the Bank") acts as guarantor for some of the Company's transactions. For this the Company pays a fee based on the notional amount, maturity and deal type for each transaction, which amounted in 2018 to $nil (2017: $nil). The Bank is currently rated A1 long term and P-1 short term, by Moody's and A long term and A-1 short term by S&P.

Under a loan agreement dated 18 April 2016, CM Inc has committed to provide the Company with a $200 million revolving credit facility for a five year period. A commitment fee on the amount of the undrawn facility is payable to CM Inc annually to the maturity date of the agreement. At 31 December 2018, the entire facility was unused (2017: $nil).

As described in note 20, SMBC DP guarantees interest rate caps of CM Inc. In return, CM Inc. provides SMBC DP an indemnity supported by collateral in the form of US Treasury bills.

SMBC DP, as an AA-/Aa1 derivative product company, is required by Moody's and S&P to have a Contingent Manager. Under such an agreement, an unaffiliated derivatives dealer would provide portfolio management and other general services to the firm in the event that the long term senior rating of Sumitomo Mitsui Banking Corporation ('the bank') is downgraded to Baa3 or below by Moody's, or the event that the bank's short term rating is downgraded to P-3 or below by Moody's, or the event that the long term senior rating of the bank is downgraded to BB or below by S&P, or the event that the bank's short term rating is downgraded to B or below by S&P. On 7th December 2018, the Contingent Manager Agreement with Blackrock Financial Management, Inc. rolled for twelve months as no notice to terminate was issued by SMBC DP.

20. Related party disclosures

	2018 US$'000	2017 US$'000
CM Inc.		
Derivative assets	15,242	11,797
Net gain / (loss) on derivatives transactions	3,392	(5,579)
Intermediation fee income for transactions terminated prior to maturity	30	(6)
Operating expenses for trading related services	222	214
Debtor / (creditor) for operating expenses for trading related services	131	258
Trading securities pledged by CM INC *	180,615	108,903
Guarantee fee income	1,019	802
Deferred income related to guarantee fees	1,672	1,243
Agency fee income	1,977	2,182
CM Ltd		
Management fee	180	180
Debtor / (creditor) for operating expenses for trading related services	(85)	-
Sumitomo Mitsui Banking Corporation Europe Limited		
Operating expenses for trading related services	3	-
Debtor / (creditor) for operating expenses for trading related services	(4)	-
SMBC The Americas		
Operating expenses for trading related services	(3)	-
Debtor / (creditor) for operating expenses for trading related services	(2)	-

**In the ordinary course of business the Company guarantees the performance of its affiliate, CM Inc, in relation to interest rate caps sold to third parties. To protect itself against the risk, the Company has obtained an indemnity from CM Inc. To support this indemnity CM Inc pledges securities collateral in the form of US Treasury bills. At 31 December 2018 the termination value of guaranteed interest rate cap transactions, against which collateral was held, was $89,173 thousand (2017: $45,736 thousand). The guarantees are accounted for as financial guarantees.*

21. Ultimate parent undertaking

The smallest group of which this Company is a member and which has included this Company in its group financial statements is SMBC Nikko Capital Markets Limited, incorporated in England and Wales.

Sumitomo Mitsui Financial Group, Inc. incorporated in Japan, is the Company's ultimate parent entity. It is the largest group of which this Company is a member and which has included this Company in its Group financial statements. Copies of these financial statements can be obtained from the following address:

1-2 Marunouchi

1-chome

Chiyoda-ku

Tokyo

Japan