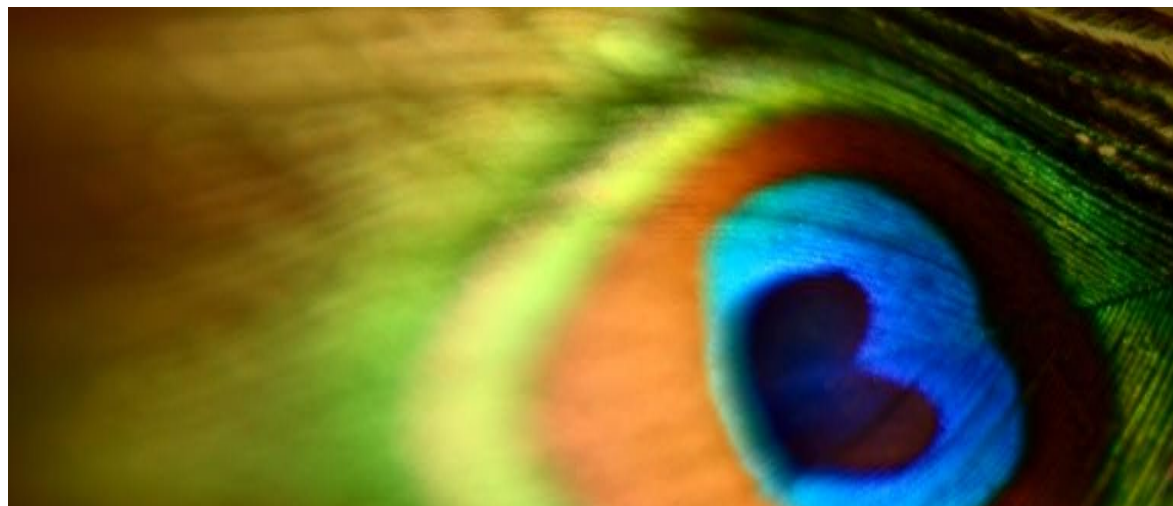




ARBUTHNOT BANKING GROUP PLC

Annual Report 2011





1	Corporate Philosophy
2	Group Highlights
4	Chairman's Statement
	Business Review
6	Private Banking – Arbuthnot Latham & Co.
8	Retail Banking – Secure Trust Bank
10	Financial Review
14	Group Board
16	Directors' Report
18	Corporate Governance
20	Remuneration Report
22	Independent Auditor's Report
24	Consolidated Statement of Comprehensive Income
25	Consolidated Statement of Financial Position
26	Company Statement of Financial Position
27	Consolidated Statement of Changes in Equity
29	Company Statement of Changes in Equity
30	Consolidated Statement of Cash Flows
31	Company Statement of Cash Flows
32	Principal Accounting Policies
41	Notes to the Consolidated Financial Statements
70	Five Year Summary
71	Response to Independent Commission on Banking Report
74	Corporate Contacts & Advisers

Corporate Philosophy

Arbuthnot has a 179 year history of serving its customers, as well as a long track record of progress against the background of a continually changing environment. The ability of Arbuthnot to adapt and grow has come from managing the business through seven key principles developed over time. These principles, always applied with pragmatism and common sense, govern the activities of the Group, ranging from major strategic issues to smaller day-to-day operational matters.

The continued application of these principles will allow the business to pursue growth in a controlled manner, providing a high quality service to its customers whilst delivering good returns to shareholders and securing the well-being of its employees.

Henry Angest

Chairman & CEO
14 March 2012

1. Arbuthnot serves its **shareholders**, its **customers** and its **employees** with **integrity** and **high ethical standards**. This is expressed in a **progressive dividend policy**, in **fair pricing** and **pay for performance**.
2. Arbuthnot attaches great importance to **good relations** with customers and business partners, and treating them **fairly and promptly**. Arbuthnot believes in **reciprocity**.
3. Arbuthnot is **independent**, and **profit and growth oriented** while maintaining a **controlled risk profile**.
4. Arbuthnot's approach is based on **diversification**, a **long-term view**, **empowerment of management** and a culture of **rewards for achievements**.
5. Arbuthnot's business is conducted in an **innovative**, **flexible** and **entrepreneurial** manner, with an **opportunistic** and **counter-cyclical** attitude.
6. Arbuthnot does not sacrifice **long term prospects** for short term gains – nor sacrifice **stability** for quick profits.
7. Ultimately, the success of Arbuthnot depends on the **teamwork**, **commitment**, and **performance** of its employees, combined with the **determination** to win.

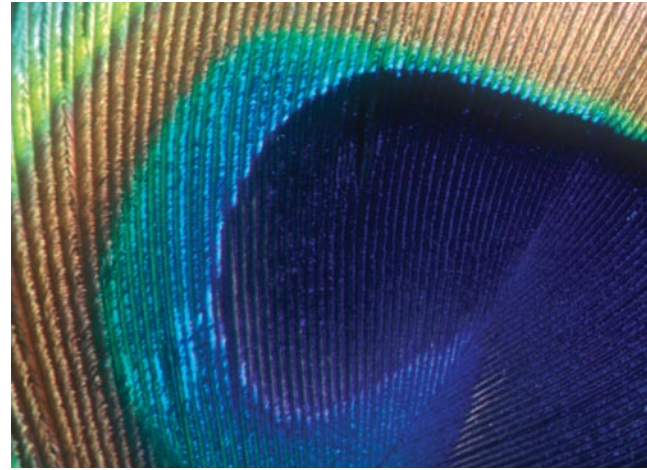
“He whose ranks are united in purpose will be victorious”

Sun Tzu
The Art of War
circa 500 BC

Group Highlights

Overall, 2011 was a transformational year for Arbuthnot Banking Group. Following the successful flotation of Secure Trust Bank and the sale of Arbuthnot Securities, the Group has ended the year in a strong position to take advantage of new opportunities.

Operating income	Total dividend per share
£45.5m	24.0p
£37.8m 2010	23.0p 2010
Profit before tax	Total assets
£5.1m	£769.3m
£4.1m 2010	£565.1m 2010
(Loss)/profit attributable to Equity holders of the Company	Regulatory capital
(£5.0m)	£55.7m
£3.7m 2010	£43.9m 2010
Net asset value per share	
312.2p	
227.7p 2010	

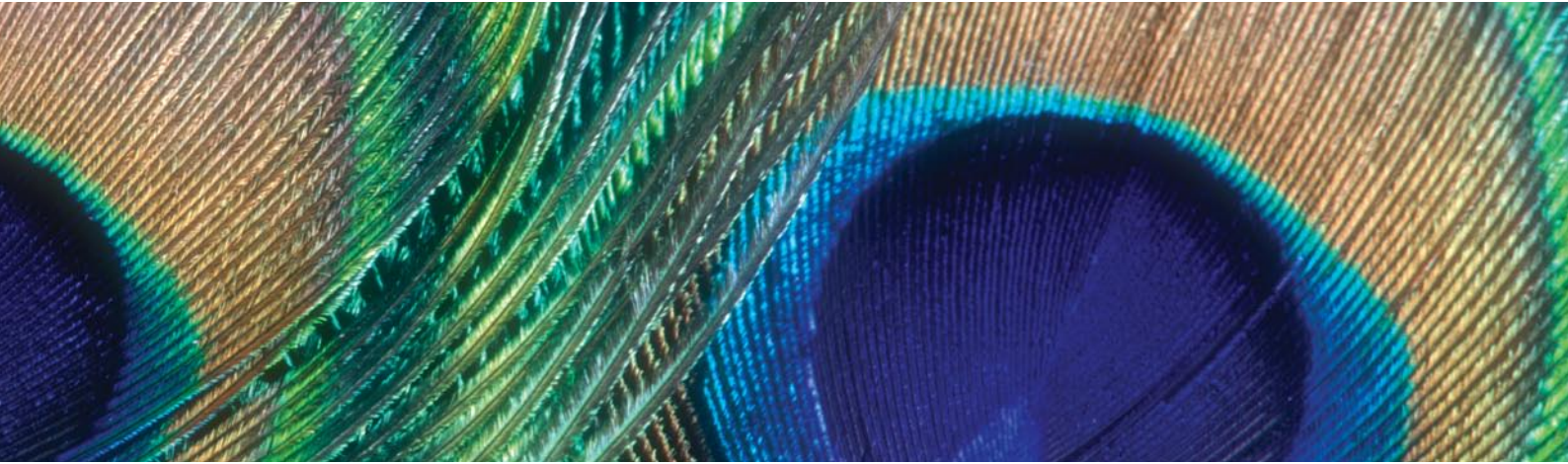


Private Banking

The Private Banking division doubled its profits with strong growth across loans, deposits and assets under management. Its ability to offer tailored private banking and wealth management solutions to clients means it is well positioned for future organic growth.

Retail Banking

2011 has been a milestone year for the development of Secure Trust Bank. It has delivered a strong underlying financial performance whilst putting in place the foundations for its ambitious growth plans.



ARBUTHNOT LATHAM
Private Bankers

Arbuthnot Latham provides a high quality private banking and wealth management service, consisting of four core elements:

Private Banking

Private banking comprises current accounts, deposit accounts, loans, overdrafts and foreign exchange. Each client deals with a dedicated Private Banker who is key to providing an individual service.

Wealth Planning

The wealth planning service is built on long-term relationships and bespoke financial strategies. The service is independent and fee, not commission based, with clients receiving a service covering estate and tax planning, pensions and wealth preservation and generation.

Investment Management

Our discretionary investment management service comprises asset management, developing tailored investment strategies to ensure that each client's specific investment objectives are met.

Gilliat Financial Solutions

Gilliat Financial Solutions designs, packages and distributes structured products to financial intermediaries.



Secure Trust Bank is an established UK retail bank. Its core business is to provide banking services including a range of lending solutions and deposits. It also provides fee-based current accounts to UK customers who may not be adequately served by other banks.

Motor Finance

A multi-channel offering through motor dealers and brokers. The hire purchase agreements are fixed rate, fixed term and secured mainly against used cars with finance term periods varying from 24 to 60 months with a maximum loan size of £15,000.

Retail Point of Sale Finance

Lending solutions for store and online retailers and an "e"-tailer proposition distributed through partnership with Pay4Later. Unsecured, fixed rate and fixed term loans with payments received monthly. Loans vary in term from six months to 48 months and range from £250 to £12,000.

Personal Unsecured Lending

Fixed rate, fixed term products with payments received monthly. Loan terms are between 12 months and 60 months with advances varying from £500 to £15,000.

Current Account

A current account with a prepaid card. The account charges a monthly fee of £12.50 but customers have the ability to earn rewards at participating retailers.

Savings

A combination of instant access accounts, notice deposits and deposit bonds with competitive interest rates

Chairman's Statement



Sometimes I believe we live in a parallel universe. After the successful sale of part of our investment in Secure Trust Bank (STB), Arbuthnot Banking Group (ABG) would have made a “profit” of £10 million in layman’s terms. However, the application of the accounting rules resulted in a loss of £7 million, as they do not recognise this gain as a profit. These same accounting rules previously allowed failed banks to show huge imaginary profits on which excessive bonuses were paid out. They also allowed the banks to revalue their own debt showing artificial profits as their credit ratings plunged. I can only live in hope that one day we will return to a saner world, where a spade is called a spade and where profits mean cash in the till.

In the real world, the past year has been a year of transformational changes for ABG. In November we saw the very successful flotation of STB on the AIM market, one of few listings in 2011 and the first by a bank in many years. We used the IPO to increase the capital base of STB in order to take advantage of the many business opportunities available in the present market place and to strengthen the Group balance sheet. Giving the Bank its own currency has allowed its management increased room for growth, while as majority shareholder ABG will continue to ensure that its principles of careful stewardship of the business will be maintained.

The opposite was true for Arbuthnot Securities (ASL). In the market place for small brokers we could see no improvement in sight and concluded that perhaps the environment may well have changed fundamentally. So we decided to cut our losses and to exit this business. We believe the deployment of our resources in the two Banks will bring better returns for our shareholders. We were pleased to find a good partner for ASL in Westhouse Holdings plc.

Arbuthnot Latham had its own fair share of change. While the business made very good progress and Gilliat has now become profitable, Arbuthnot Latham’s capable CEO, Dean Proctor, received an offer he could not refuse. Sadly this is not the only case of a young banking executive with an outstanding future, deciding that he has better economic prospects abroad. Unfortunately for our country, not only are an increasing number of highly mobile young and senior banking and financial services executives leaving the country, but few are coming back and even fewer foreign executives are joining us. This is a reversal of the previous trend and a serious problem. I believe there are two reasons for this:

1. With all the vilification being heaped upon them, it is no surprise that honest bankers – and they are the big majority - are feeling persecuted.

2. There is a lot of talk about fairness, but fairness should be about rewarding hard work and enterprise. A tax rate of 50% or more is not fair. Such a rate is anti-competitive and counterproductive. It damages incentives and undermines economic growth.

Which are the most economically successful countries in the world? Those with moderate or flat tax rates that encourage and reward hard work and entrepreneurship such as Hong Kong, Singapore, Switzerland, USA and not to forget the United Kingdom, when under Lady Thatcher's leadership.

There are many more issues and dangers that affect our business, but I will only mention three. Firstly, the Independent Commission on Banking Report, the Vickers Report. How the Government implements its recommendations is of great importance to Arbuthnot and the whole banking industry. I have given my initial thoughts in an article that was published, together with other views, by the CSFI. The article, which was written with the help of Dr. Atholl Turrell, is reprinted at the back of the Annual Report.

The second issue is the ongoing crisis within the Euro Zone, where politicians seem incapable – or unwilling – to resolve the matter decisively and prefer to procrastinate and postpone the inevitable outcome. Meanwhile, the weakened countries lurch towards default and economic ruin. It is clear that while this debacle continues, the impact on the UK economy and the banking sector can only be negative, albeit I am not as pessimistic as others and I believe with good financial management the UK could avoid the worst and recover quickly.

And thirdly, there is the issue of increasing regulation. As I have said many times, we don't need more regulation, but we could do with a better targeted regime. Since 90% of the prudential regulation now comes from Brussels, it is difficult for our own regulators to do much about it, however they could abstain from gold plating the European edicts.

Private Banking – Arbuthnot Latham & Co., Limited

The Private Banking business performed well, with pre-tax profit of £2.0 million (2010: £1.0 million).

Arbuthnot Latham continued to lend cautiously and maintained the quality of collateral held as security. As a result client loans grew by £27 million to £238 million, a 13% growth over 2010 with credit losses at less than 1% of the asset book.

Client deposits grew by £70 million in 2011 to £420 million, a 20% year on year increase. The resulting loan to deposit ratio closed the year below our target at 57%.

Arbuthnot Latham continues to focus on expanding its asset management and wealth planning offerings, with further investment in people and systems initiated in 2011. These initiatives, when fully implemented, will provide a strong foundation for future organic growth.

From a modest base, discretionary assets under management grew by 40% and fee income from wealth planning grew by 10%. This growth is a result of high net worth clients being attracted to the full wealth management and private banking proposition.

Gilliat Financial Solutions made its first annual profit of £0.2 million (2010: £0.6 million loss) as the business launched in July 2009 continued to build momentum transacting business with an increasing number of Financial Advisors and Intermediaries.

As reported above, Arbuthnot Latham's charismatic CEO, Dean Proctor, has left us. Our best wishes go with him. Fortunately,

we were able to find a strong successor in James Fleming. James joins us from Coutts where he had been a senior director.

Retail Banking – Secure Trust Bank PLC

Pre-tax profits of Secure Trust Bank, before IPO costs and group recharges, were £9.6 million (2010: £8.5 million). In isolation the growth of 13% is highly commendable. However, the underlying picture is stronger. The 2010 results were heavily influenced by the profits generated by the portfolios acquired from LV and Citi in 2009. The income benefit of these portfolios, which had a high profit margin, peaked in 2010 and reduced by over £4 million in 2011.

During the year the Bank's lending operations continued to generate very strong, controlled, organic growth. Overall new business lending volumes grew 51% to £136 million (2010: £90 million) which fuelled an increase of 73% in overall customer loans to £155 million (2010: £89 million)

The portfolios of books acquired in 2009 continue to be collected out in line with expectations, with the balance outstanding declining to £2.5 million at 31 December 2011 (2010: £10.7m).

The IPO has significantly raised STB's corporate profile and it has seen an increase in the scale, scope and range of opportunities being brought to it for consideration. There is a clear growth strategy and STB is working on a number of significant projects which will add considerable value to the business if completed.

Board Changes and Personnel

As a result of the sale of our Securities Business Neil Kirton and Atholl Turrell resigned from the Board on 29 December 2011 and 31 December 2011 respectively.

As already mentioned Dean Proctor resigned from the Board on 1 March 2012 to move overseas and was replaced on the same day by James Fleming.

I would like to thank the three directors who have left for the contributions that they have made to the Group.

These results once again reflect the continuing dedication and commitment of our employees who have done well in the current environment. On behalf of the Board I extend our thanks to all staff for their contributions made to the Group in 2011.

Dividend

The Board is proposing a final dividend of 13p, an increase of 1p on last year, making a total dividend of 24p (2011: 23p). If approved, the dividend will be paid on 18 May 2012 to shareholders on the register at close of business on 20 April 2012.

Outlook

Overall, 2011 was a transformational year for the Arbuthnot Banking Group PLC. The two banking businesses performed well and the Group ended the year on a firm foundation, regulatory capital increased by 27% to £55.7m and the total balance sheet by 36% to £769m and net asset value per share rose by 85p. At the same time high liquidity was maintained. The Group's overall position has strengthened considerably allowing it to continue to grow over the coming years as it exploits the opportunities that are arising, barring any macro-economic upheaval.

Henry Angest

Chairman & CEO

14 March 2012

Arbuthnot Latham & Co

Pre-tax profits for the Private Banking division doubled in the year to £2m (2010: £1m) and the underlying growth of the business was somewhat higher as these results include an additional £1m of credit provisions taken against two legacy accounts and a further decline in returns from our surplus funds, as we have held more money with the Bank of England rather than in the wholesale markets.

Total assets increased and for the first time stand at a level greater than half a billion pounds and assets under the Bank's direction are now in excess of one billion pounds.

The conditions for lending continued to be favourable during the year and the Bank was able to grow its loan portfolio by £27m to £238m while widening lending margins and maintaining the quality of collateral held. The loan to value of the overall book was 48% and retail deposits increased by £70m to £420m to close the year with a loan to deposit ratio of 57%. The returns earned on the surplus funds continued to decrease over the year as the decision was taken to hold more funds at the Bank of England, which given ongoing problems with the Euro Zone banks, was seen as the safer option rather than the wholesale markets. The credit losses experienced by the Bank remain under 1%.

The Bank continues to expand its asset management and wealth planning services and further investments in people and systems were made during the year. These initiatives are providing the foundation for future organic growth.

Arbuthnot Latham became the first UK bank to achieve chartered wealth planning status. This reflects the high quality of service offered and the chartered status of the individual wealth planners. The Bank is well placed to thrive as the advisory and investment management business environment continues to evolve leading up to and beyond the implementation of the FSA Retail Distribution Review (RDR) in January 2013. This recognition of the services provided has enabled the discretionary assets under management to grow from a modest base by 40% and wealth planning income to increase by 10%.

The structured notes distribution business, Gilliat Financial Solutions, delivered a full year profit of £0.2m (2010: loss of £0.6m) as it started to return the investment made by the Group since its launch in 2009. The profit was a result of significantly higher revenues as Gilliat was able to generate volumes in excess of £90m. Business is being done with an increasing number of Independent Financial Advisors (IFAs) and other intermediaries. This reflects the growing recognition of the brand within the retail distribution network.

Operating and other income

£20.3m

£16.9m 2010

Operating expenses

£16.0m

£14.9m 2010

Profit before tax

£2.0m

£1.0m 2010

Customer net margin

4.0%

4.0% 2010

Customer loans

£238.2m

£210.8m 2010

Customer deposits

£420.0m

£349.5m 2010

Total assets

£554.9

£417.9m 2010

Loan to deposit

57%

60% 2010



Secure Trust Bank

The pre-tax profits of Secure Trust Bank, before IPO costs and group recharges, were £9.6m (2010: £8.5m). In isolation the growth of 13% is commendable. However, this rather understates the stronger underlying picture. The 2010 results were heavily influenced by the profits generated by the portfolios acquired from LV and Citi in 2009. The income benefit of these portfolios, which had a high profit margin, peaked in 2010 and reduced by over £4m in 2011. These 'run off' profits have all been replaced by organically generated and sustainable new business.

Secure Trust Bank had anticipated creating a joint venture in the second half of the year and geared up its deposit balances to fund the expected initial portfolio purchase of around £50m. It was announced on 10 January 2012 that a structure could not be agreed that met regulatory requirements and which fell within Secure Trust Bank's risk appetite and that the joint venture would not proceed as anticipated. The combination of the cost of carrying the surplus deposits together with direct expenses incurred in setting up the joint venture reduced Secure Trust Bank's 2011 profit before tax by approximately £1m.

During the year Secure Trust Bank's lending operations continued to generate strong, controlled, organic growth. Overall, new business lending volumes grew 51% to £135.9m (2010: £90.2m) which led to an increase of 73% in overall balance sheet lending assets to £154.6m (2010: £89.5m)

Motor finance, a business which Secure Trust Bank entered cautiously during 2009, grew to a book of £63.4m at 31 December 2011 (2010: £31.3m). This business, which focuses on the near prime market segment, substantially expanded its network of brokers and dealers to the point where it now has national coverage and a fully independent sales force which services over 70% of the Top 20 UK car dealer groups.

Personal unsecured lending also evidenced strong growth with the 31 December 2011 balance sheet growing to £43.6m (2010: £22.4m). Secure Trust Bank has continued to broaden its distribution capabilities in this segment and entered into a number of significant new introducer relationships during the year.

Retail Point of Sale business saw balances at 31 December 2011 grow to £42.6m (2010: £21.6m)

The portfolios of books acquired in 2009 continued to be collected in line with expectations, with the balance outstanding declining to £2.5m at 31 December 2011 (2010: £10.7m).

There has been significant investment in Secure Trust Bank's operational infrastructure during 2011 which in particular has enhanced the competitiveness of the current account offering. Despite tempering the growth rate of this product, pending installation of the new platform, net customer numbers increased to 17,178 at the end of the year (2010: 9,576). Over 1,000 new customers are signing up each month and Secure Trust Bank continues to see substantial potential in this area.

As anticipated, OneBill customer numbers continue to decline over time. However, the attrition rates have been somewhat slower than expected which serves to highlight the attraction of this product. Work continues on the development of a next generation OneBill product and it is expected that customer trials will begin in the second half of 2012. The growth of other profit streams developed over the last three years will mean that this product will become progressively less significant to the profitability of the overall business.

Secure Trust Bank continues to see strong demand for all of its core products and envisages robust organic growth this year. The IPO has significantly increased the corporate profile and Secure Trust Bank has seen an increase in the scale, scope and range of opportunities being brought to it for consideration. It has a clear growth strategy and it is working on a number of significant projects which will add considerable value to the business if completed.

Secure Trust Bank was delighted to receive the Dealer Finance Provider 2012 award from the Institute of Transport Management in February in recognition of its increased importance to the motor industry at a time when other finance providers have been reducing their investment or exiting the market.

Operating income

£28.5m

£23.9m 2010

Operating expenses

£14.8m

£13.2m 2010

Profit before tax

£9.1m

£8.5m 2010

Net interest margin

14.0%

18.4% 2010

Customer loans – unsecured

£154.6m

£89.5m 2010

Customer deposits

£272.1m

£153.8m 2010

Customer numbers

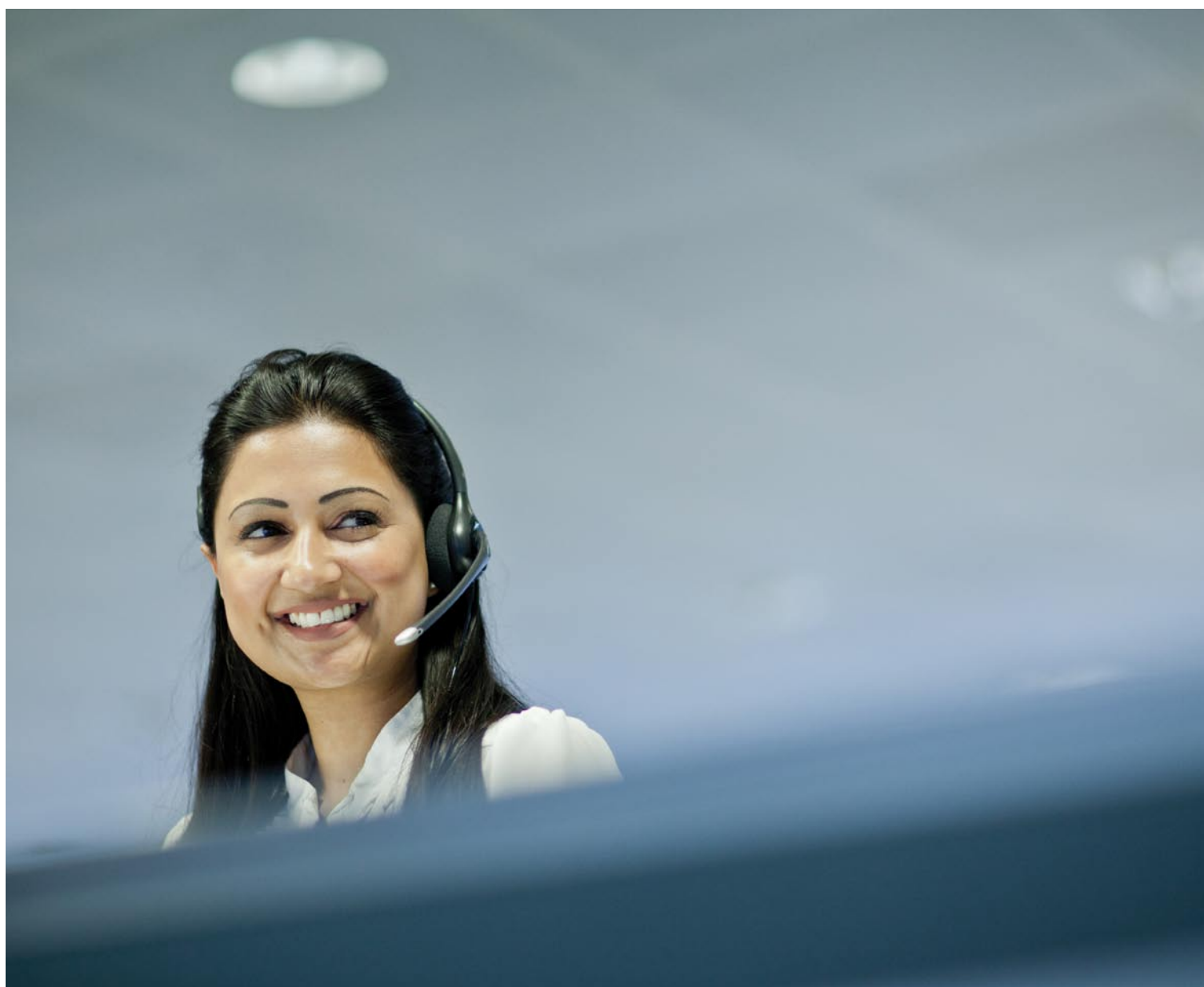
140,000

96,000 2010

Cost income ratio

0.53

0.47 2010



Financial Review

Arbuthnot Banking Group adopts a conservative approach to risk taking and seeks to maximise long term revenues and returns. Given its relative size, it is able to remain entrepreneurial and capable of taking advantage of market opportunities when they arise.

Following the decision to exit from the Investment Banking business, which has been designated as discontinued, it now provides a range of financial services to customers and clients in its two chosen niche markets of Private Banking (Arbuthnot Latham) and Retail Banking (Secure Trust Bank). The Group's revenues are derived from a combination of net interest income from lending, deposit-taking and money market activities, fees for services provided to customers and clients and commissions earned on the sale of financial instruments and products.

Highlights

Summarised Income Statement

	2011 £'000	2010 £'000
Net interest income	27,243	21,370
Net fee and commission income	18,327	16,538
Gains less losses from dealing in securities (Group)	(112)	(136)
Operating income	45,458	37,772
Other income	1,120	1,042
Operating expenses	(34,525)	(31,603)
Impairment losses on financial assets	(6,813)	(3,146)
Fair value movement derivatives	(124)	–
Profit on continuing operations before tax	5,116	4,065
Income tax	(1,817)	(1,238)
Profit on continuing operations after tax	3,299	2,827
Loss from discontinued operations after tax	(10,249)	894
(Loss) / profit after tax	(6,950)	3,721
Basic earnings per share (pence)	(33.3)	25.0

As noted in last year's financial review, the Group continued to experience two very different types of market conditions across its trading divisions. This led to two transformational decisions for the Group.

The lack of capacity in the lending markets continued as the larger banks continued their retrenchment. However, despite the uncertain economic conditions, the ability of our borrowers to repay their debts has been better than was expected. Given this market opportunity, and the fact that Secure Trust Bank had proven itself capable of exploiting these conditions, it was decided that the next step would be to accelerate its growth and a separate listing of this Bank would enable it to execute this strategy.

The market appetite for IPOs had fallen steadily during 2011, but the fact that we were able to complete a successful flotation in November, demonstrates that the market also strongly supported the strategy. The transaction generated a consolidated "gain on sale" of £17m, which has been recorded directly to reserves in accordance with the accounting rules.

For the Investment Bank, the corporate markets continued to be extremely difficult, primary income levels fell dramatically as the whole industry experienced a lack of appetite for fundraising activities. Also the levels of secondary commission incomes continued their

downward trend. As reported in the Interim Results, a restructuring programme was put in place in the third quarter. The results of this appeared to show no signs of improving the performance of the business and the forward looking projections showed no improvement in the medium term. As a result it was decided to exit the business and a successful sale of Arbuthnot Securities Ltd was agreed with Westhouse Holdings PLC on 18 November. The performance of the business and resultant costs to the Group are therefore reported as discontinued operations.

Overall the Group made a profit before tax from its continuing operations of £5.1m and when the cost of listing Secure Trust Bank (£0.5m) is excluded, these businesses increased by nearly 40%, which is in line with the growth levels that our banking businesses have been experiencing in recent years.

Operating income increased by 20% offset by expense growth of approximately 9% resulting in a positive organic operating leverage of 11%.

The Group is reporting a loss after tax of £7m for 2011. However, as mentioned earlier this does not include the gain on sale from the listing of Secure Trust Bank. The better measure of performance in the year would be the increase in net assets. These are shown in the Statement of Changes in Equity. This shows that the net assets of the Group increased from £34.1m to £47.0m, a 38% increase. Given this also equates to an equivalent increase in the Group Regulatory capital, the Group is now well positioned to grow in the future.

Balance Sheet Strength

Summarised Balance Sheet

	2011 £'000	2010 £'000
Assets		
Loans and advances to customers	392,789	300,252
Liquid assets	350,223	228,971
Other assets	26,304	35,887
Total assets	769,316	565,110
Liabilities		
Customer deposits	693,800	503,257
Other liabilities	28,545	27,705
Total liabilities	722,345	530,962
Equity	46,971	34,148
Total equity and liabilities	769,316	565,110

The total assets of the Group increased by 36% again led by the growth in our lending businesses and our continued conservative approach to maintaining adequate liquidity resources.

The Group's total assets broke through the half billion pound level for the first time in 2010 and during 2011 exceeded £750m remaining on a trajectory to exceed one billion pounds in the near future.

Customer deposits grew by 38% during the year to close at £693.8m. The Group remains entirely funded by retail deposits. The Group closed the year with a loan to deposit ratio of 56.6% (2010: 59.7%).

Segmental Analysis

The segmental analysis in Note 38 to the Consolidated Financial Statements of the Annual Report highlights the disclosures required under IFRS 8 'Operating Segments'. The operating segments are Private

Banking (Arbuthnot Latham), International Private Banking (Arbuthnot AG) and Retail Banking (Secure Trust Bank). Group costs and intercompany elimination journals are shown separately to reconcile back to the Group consolidated result. The analysis presented below, and in the business review, is prior to any consolidation adjustments to remove the impact of intergroup operating activities and also intergroup recharges and is a fair reflection of the way the Directors manage the Group.

Private Banking – Arbuthnot Latham

	2011 £'000	2010 £'000
Net interest income	10,594	9,380
Net fee and commission income	7,094	5,049
Operating income	17,688	14,429
Other income	2,631	2,491
Operating expenses	(16,025)	(14,896)
Impairment losses	(2,336)	(979)
Profit before tax	1,958	1,045

The profit before tax increased to £2m (2010: £1m) as the Private Bank continued to successfully implement its strategy of providing a full service banking and advisory product offering.

The lending opportunities presented to the Bank continued to be of high quality and at attractive yields. The advisory services and discretionary management increased its fee income by 32% as a result of an 40% increase in discretionary assets under management.

Profitability continues to be reduced as the interbank market returns remain low. This has also been affected by our decision to hold more funds at the Bank of England than necessary while uncertainty continues in the wider banking market as the financial crisis continues in the Euro Zone.

Impairment losses increased to £2.2m during the year due almost entirely to provisions taken against two legacy loans. Despite this increase the loss rate continues to be below 1% of the customer loan book and the credit quality of the remaining book remains high and well secured.

Gilliat Financial Solutions returned its first full year profit (£0.2m) during 2011 as it has continued to widen its reach within the Financial advisor and intermediary networks.

Assets	2011 £'000	2010 £'000
Advances	238,203	210,753
Liquid assets	292,151	182,512
Other assets (including Group companies)	24,581	24,588
Total assets	554,935	417,853
Liabilities		
Customer deposits	421,737	349,478
Other liabilities (including Group companies)	110,854	45,452
Total liabilities	532,591	394,930
Equity	22,344	22,923
Total equity and liabilities	554,935	417,853

Total assets increased by 33% to £554.9m (2010: £417.9m) with customer lending increasing by 13%. The loan to value on the portfolio remains at a healthy 48%.

The liabilities continued to follow the conservative policy on liquidity seeing an inflow of £70m of customer deposits representing a 20% increase from 2010. The loan to deposit ratio closed the year at 57%.

The Private Bank remains well capitalised with a total capital ratio of 13.3% (2010: 13.1%) and a core tier 1 ratio of 10.2% (2010: 11.1%).

International Private Banking – Arbuthnot AG

Costs associated with the Swiss Bank were £0.1m (2010: £0.1m) as the third party continued in its regulatory application to invest in the Swiss bank.

Retail Banking – Secure Trust Bank

	2011 £'000	2010 £'000
Net interest income	17,227	12,464
Net fee and commission income	11,233	11,489
Operating income	28,460	23,953
Other income	36	–
Operating expenses	(14,834)	(13,275)
Impairment losses	(4,601)	(2,167)
Profit before tax	9,061	8,511

Profit before tax is £9.1m (2010: £8.5m) however, after adding back the cost of listing the business, the adjusted profit before tax is £9.6m which represents a 13% increase during the year.

The profit would have been somewhat higher than reported. However the business incurred in excess of £1m of expenses principally being cost of holding surplus liquidity in readiness for concluding the lending joint venture that was indicated in the interim results for 2011. The business was unable to reach an agreement that satisfied both regulatory requirements and our conservative risk appetite, so the project was terminated. These surplus funds will be deployed by the business during 2012.

The growth in the year was again mainly led by the lending business with good growth across all the portfolios, which is in line with the plan to grow a diversified portfolio of lending books. The growth generated was also able to offset the declining contribution from the acquired portfolios. It is also important to note that the level of fees and commissions halted their downward trend in 2011 and has returned to an upward trajectory, recording income of £13.2m and reaching levels not seen since 2009. This is as a result of the current account revenues now offsetting the decline in revenues from OneBill. The current account closed the year with 17,178 open accounts (2010: 9,576) and OneBill ended the year with 28,698 (2010: 31,720).

Financial Review

Assets	2011 £'000	2010 £'000
Asset finance		
Motor vehicles	63,376	31,270
Cycles	13,784	8,984
Musical instruments	5,398	7,274
Personal computers	16,972	5,118
e-tailer	4,371	264
Other	2,083	102
	105,984	53,012
Personal lending	43,601	22,407
Other lending	2,520	3,074
Acquired portfolios	2,480	10,723
Liquid assets	56,018	45,144
Other assets (including Group companies)	97,332	42,647
Total assets	307,935	177,007
Liabilities		
Customer deposits	272,063	153,778
Other liabilities (including Group companies)	11,962	7,212
Total liabilities	284,025	160,990
Equity	23,910	16,017
Total equity and liabilities	307,935	177,007

During the year the asset finance business increased the overall portfolio size by 97% to end the year at £103.9m, mainly led by the motor vehicle portfolio which doubled in size. The personal computer business grew three fold and the business also launched its internet credit offering in conjunction with Pay4Later.

The personal loan portfolio increased by 95% to £43.6m. The acquired portfolios continued to be collected out as per expectations and closed the year with only £2.5m of balances remaining.

The customer deposit balances grew by 77% to £272.1m following the successful take up of the banks new fixed term bond offerings of 2, 3, 4 and 5 year maturities.

Discontinued operations (Investment Banking – Arbuthnot Securities)

	2011 £'000	2010 £'000
Net interest income	(144)	(232)
Net fee and commission income	6,510	12,755
Gains less losses from dealing in securities	149	4,456
Operating income	6,515	16,979
Other income	6	89
Operating expenses	(19,719)	(16,029)
(Loss) / profit before tax	(13,198)	1,039

The total impact on the Group's profitability from the discontinued operations was £13.2m, which comprises three items:

- 1) Operating losses totalled £7.9m. This decline was attributable to the significant reduction in fees earned on fundraising activities and the continued decline in secondary commissions. The business also incurred a £0.8m expense in restructuring the business in the third quarter.

- 2) As a result of agreeing the sale, Arbuthnot Securities has been recorded in the accounts at the lower of the consideration receivable and the net asset value. This results in a charge to profit & loss of £1.6m and effectively brings the predicted loss on sale into the 2011 results, despite the fact that the completion of the transaction did not take place until 20 January 2012.
- 3) As part of the process of discontinuing the business, the Group has taken impairment provisions of £3.7m, £3.1m of which results from the unwinding of the Long Term Incentive Plan that had been established for the employees of Arbuthnot Securities. The remaining amounts are against illiquid stocks and an outstanding receivable, both of these items were not transferred to Westhouse as part of the sale agreement.

Group & Other Costs

	2011 £'000	2010 £'000
Operating Income	(63)	(75)
Other income	–	227
Group costs	(4,056)	(4,039)
Group head office property costs	(1,164)	(1,020)
Subordinated loan stock interest	(573)	(483)
Total Group & other costs	(5,793)	(5,542)
Loss before tax	(5,856)	(5,390)

The net Group costs increased by 9% to £5.9m (2010: £5.4m). This was due to higher property costs, higher interest charges on the subordinated loan and one-off items included in other income in the prior year.

Capital

The Group's capital management policy is focused on optimising shareholder value over the long term. There is a clear focus on delivering organic growth and ensuring capital resources are sufficient to support planned levels of growth. The Board regularly reviews the capital position.

In accordance with the EU's Capital Requirements Directive (CRD) and the required parameters set out in the FSA Handbook (BIPRU 2.2), the Individual Capital Adequacy Assessment Process (ICAAP) is embedded in the risk management framework of the Group and is subject to ongoing updates and revisions when necessary. However, at a minimum, the ICAAP is updated annually as part of the business planning process. The ICAAP is a process that brings together the management framework (i.e. the policies, procedures, strategies, and systems that the Group has implemented to identify, manage and mitigate its risks) and the financial disciplines of business planning and capital management.

The Group's regulated entities are also the principal trading subsidiaries as detailed in Note 37.

Not all material risks can be mitigated by capital, but where capital is appropriate the Board has adopted a "Pillar I plus" approach to determine the level of capital the Group needs to hold. This method takes the Pillar I capital formula calculations (standardised approach for credit, market and operational risk) as a starting point, and then considers whether each of the calculations deliver a sufficient capital sum adequately to cover management's anticipated risks. Where the Board considered that the Pillar I calculations did not reflect the risk, an additional capital add-on in Pillar II is applied.

The Group's regulatory capital is divided into two tiers:

- Tier 1 comprises mainly shareholders' funds and non-controlling interest, after deducting goodwill and other intangible assets.
- Lower Tier 2 comprises qualifying subordinated loan capital and revaluation reserves. Lower Tier 2 capital cannot exceed 50% of tier 1 capital.

The ICAAP includes a summary of the capital required to mitigate the identified risks in its regulated entities and the amount of capital that the Group has available. The latest version of the Group ICAAP is currently in the process of being approved by the Board. All regulated entities have complied with all of the externally imposed capital requirements to which they are subject.

	2011 £'000
Core Tier 1 capital	46,831
Tier 1 capital after deductions	43,270
Tier 2	12,396
Total capital	55,666
Core Tier 1 capital ratio (Net Core Tier 1 capital/ Basel 2 RWAs*)	16.7%
Total Capital ratio (Capital/ Basel 2 RWAs*)	21.5%

* - Risk Weighted Assets (RWAs)

Risks and Uncertainties

The Group regards the monitoring and controlling of risks and uncertainties as a fundamental part of the management process. Consequently, senior management are involved in the development of risk management policies and in monitoring their application. A detailed description of risk management and their associated policies is set out in note 4 to the financial statements.

The principal risks inherent in the Group's business are credit, market, liquidity, operational and regulatory.

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. This risk exists mainly in Arbuthnot Latham & Co., Limited and Secure Trust Bank PLC, who currently have loan books of £238.2m and £154.6m respectively.

The lending portfolio in Arbuthnot Latham is extended to our Private Banking clients, the majority of which is secured against cash, property or other assets.

The portfolios within Secure Trust are extended to retail customers and are largely unsecured.

Credit risk is managed through the Credit Committees of each of the two banks with significant exposures also being approved by the Group Risk Committee.

Market risk arises in relation to movement in the interest rates, currencies and equity markets.

The Group's treasury function operates mainly to provide a service to clients and does not take significant unmatched positions in any market for its own account. Hence, the Group's exposure to adverse

movements in interest rates and currencies is limited to interest earnings on its free cash and interest rate re-pricing mismatches.

Liquidity risk is the risk that the Group cannot meet its liabilities as they fall due. The Group takes a conservative approach to managing its liquidity profile. It has placed no reliance on the wholesale lending markets and is entirely funded by retail customer deposits. The loan to deposit ratios are maintained at prudent levels. Following introduction of the new liquidity regime, which came into force on 1 October 2010, the Group now maintains liquidity asset buffers which comprise high quality, unencumbered assets such as Government Securities, which can be called upon to meet the Group's liabilities.

Operational risk is the risk that the Group may be exposed to financial losses from conducting its business. The largest exposure to this risk exists in Arbuthnot Latham as mis-selling risk via its wealth management advisory service and its structured product distribution business.

The Group maintains clear compliance guidelines and provides ongoing training to all staff. Periodic spot checks and internal audits are performed to ensure these guidelines are being maintained. The Group also has insurance policies in place to cover any claims that may arise.

The Group is also exposed to operational risks from its Information Technology and Operations platforms. There are additional internal controls in these processes that are designed to protect the Group from these risks. The Group's overall approach to managing internal control and financial reporting is described in the Corporate Governance section of the Annual Report.

Regulatory risk is the risk that the Group will have insufficient capital resources to support the business or does not comply with regulatory requirements. The Group adopts a conservative approach to managing the capital of the Group. The principal regulated entities maintain capital ratios in excess of the minimum level set by the regulator. Capital requirements are forecast as part of the annual budgeting process and these are regularly monitored. Annually the Group Board assesses the robustness of the capital requirements as part of the Individual Capital Adequacy Assessment Process (ICAAP) where stringent stress tests are performed to ensure that capital resources are adequate over a future three year horizon.

Dividend

The Board proposes a final dividend of 13 pence per share to be paid on 18 May 2012, giving a total dividend for the year of 24 pence (2010: 23 pence) per share.

Going Concern

After making appropriate enquiries which assessed strategy, profitability, funding, risk management (see Note 4) and capital resources (see Note 5), the directors are satisfied that the Company and the Group have adequate resources to continue in operation for the foreseeable future. The financial statements are, therefore, prepared on the going concern basis.

James Cobb

Group Finance Director

14 March 2012

Board of Directors



Henry Angest

Chairman and Chief Executive of the Group and Chairman of Secure Trust Bank PLC, Arbuthnot Latham & Co., Limited and Arbuthnot Securities Limited. He is a past Master of the Worshipful Company of International Bankers. Previously he was an International Executive with The Dow Chemical Company and Dow Banking Corporation in Switzerland, USA, Brazil, Hong Kong and the UK. He has a law degree from University of Basel and is an Hon. Fellow of UHI (University of the Highlands and Islands).



James Cobb ACA

James Cobb joined the Board on 1 November 2008 as Group Finance Director. He was previously Deputy Chief Financial Officer and Controller of Citigroup's Global Consumer Group in Europe, Middle East and Africa and qualified as a Chartered Accountant with Price Waterhouse.



James Fleming

James Fleming joined the Board on 1 March 2012 as Chief Executive Officer of Arbuthnot Latham & Co., Limited. He joined from Coutts & Co where he held the position of Head of International Private Banking and more recently was Managing Director of the UK Entrepreneurs, Landowners and Inpatriates businesses. Prior to Coutts, James was Managing Director of SG Hambros UK. He has over 25 years experience of private banking.



Andrew Salmon ACA

Appointed a director on 8 March 2004. He joined the Company in 1997 and is Chief Operating Officer and Head of Business Development. He was previously a director of Hambros Bank Limited and qualified as a Chartered Accountant with KPMG.



Robert Wickham

Deputy Chairman and senior independent non-executive director. He was formerly on the Management Board of Bank of Scotland. He is also an independent non-executive director of Arbuthnot Latham & Co., Limited.



Jeremy Robin Kaye FCIS

Secretary.



Ruth Lea

Independent non-executive director since 1 November 2005 and Economic Adviser to the Group. She was previously the Director of Global Vision, Director of the Centre for Policy Studies, Head of the Policy Unit at the Institute of Directors, Economics Editor at ITN, Chief UK Economist at Lehman Brothers and Chief Economist at Mitsubishi Bank. She also spent 16 years in the Civil Service in the Treasury, the Department of Trade and Industry, the Central Statistical Office and the Civil Service College.



Paul Lynam

Paul Lynam joined the Board on 13 September 2010 as Chief Executive of Secure Trust Bank PLC. Prior to his appointment, Paul spent 22 years in a variety of roles with RBS and NatWest. These included Managing Director, Banking; Chief Executive, UK Business Banking and Managing Director, Lombard North Central PLC. Paul holds degree level Banking and Corporate Treasury qualifications.



Sir Christopher Meyer

Independent non-executive director since 1 October 2007. He retired as Chairman of the Press Complaints Commission on 30 March 2009. He had a distinguished diplomatic career, in 1997 he was appointed as Ambassador to Germany and from 1997 – 2003 he was Ambassador to the USA. Between 1994 and 1996, he was Press Secretary to Prime Minister John Major. He is also on the International Advisory Board of British American Business Inc. and Chairman of the Advisory Board of Pagefield.

Group Directors' Report

The Directors submit their annual report and the audited consolidated financial statements for the year ended 31 December 2011.

Principal Activities and Review

The principal activities of the Group are banking and financial services. A business review in accordance with Section 417 of the Companies Act 2006 forming part of this report is set out on pages 6 to 13.

Results and Dividends

The results for the year are shown on page 24. The loss after tax for the year of £7 million (2010: profit after tax of £3.7 million) is included in reserves.

The Directors recommend the payment of a final dividend of 13 pence on the ordinary shares which, together with the interim dividend of 11 pence paid on 2 November 2011, represents a total dividend for the year of 24 pence (2010: 23 pence). A scrip dividend alternative was offered on the interim dividend but is not being offered in respect of the final dividend for 2011. The final dividend, if approved by members at the Annual General Meeting, will be paid on 18 May 2012 to shareholders on the register at close of business on 20 April 2012.

Information on the listing on the Alternative Investment Market of shares in Secure Trust Bank PLC with the reduction in the Company's shareholding to 75.5% and the sale of Arbuthnot Securities Limited are set out in the business review.

At the same time as posting the Annual Report there has been separately issued a letter from the Chairman accompanying the Notice of the Annual General Meeting. This notice includes a special resolution, which will be moved in relation to the proposed cancellation of the share premium account.

Share Capital

On 10 January 2012 the Company repurchased 5,000 ordinary shares at 328p per share and on 12 January 2012 a further 5,000 ordinary shares at 355p, such shares being held as Treasury Shares.

At the Annual General Meeting shareholders will be asked to approve two Special Resolutions; the authority granted by each of them will expire at the conclusion of the Annual General Meeting in 2013.

The first continues the authority of the Directors to issue shares in nominal value equal to 5% of the existing share capital for cash, otherwise than to existing shareholders pro rata to their holdings. The Directors have no present intention of issuing any shares and will not issue shares which would effectively change the control of the Company without the prior approval of shareholders in General Meeting.

The second renews the authority of the Directors to make market purchases of shares not exceeding 10% of the existing issued share capital. The Directors will keep the position under review in order to maximise the Company's resources in the best interests of shareholders.

Substantial Shareholders

The Company was aware at 13 March 2012 of the following substantial holdings in the ordinary shares of the Company, other than those held by one director shown below:

Holder	Ordinary Shares	%
Prudential plc	712,929	4.7
Mr. R Paston	529,130	3.5

Directors

H Angest	Chairman & CEO
R J J Wickham	Deputy Chairman
J R Cobb	Finance Director
J W Fleming	
Ms. R J Lea	
P A Lynam	
Sir Christopher Meyer	
A A Salmon	Chief Operating Officer

Apart from Mr. N.W. Kirton who resigned from the Board on 29 December 2011 and Dr. A.D. Turrell who resigned from the Board on 31 December 2011, all directors other than Mr. J.W. Fleming who was appointed a director on 1 March 2012 served throughout the year. Mr. D.M. Proctor, who served as a director throughout 2011, resigned from the Board on 1 March 2012.

Mr. Fleming retires under Article 75 of the Articles of Association and, being eligible, offers himself for election. Mr. Fleming has a service agreement with a subsidiary company terminable on twelve months' notice.

Ms. R. J. Lea and Mr. R.J.J. Wickham retire under Article 78 of the Articles of Association and, being eligible, offer themselves for re-election. Each of these directors is non-executive and they do not have service agreements.

According to the information kept under Section 3 of the Disclosure and Transparency Rules 2006, the interests of directors and their families in the ordinary 1p shares of the Company at the dates shown were, and the percentage of the current issued share capital held is, as follows:

Beneficial Interests	1 January 2011	31 December 2011	14 March 2011	%
H Angest	7,917,862	8,186,901	8,186,901	53.6
P A Lynam	10,000	10,000	10,000	0.1
A A Salmon	50,000	51,699	51,699	0.3
R J J Wickham	3,600	3,600	3,600	—

On 21 May 2008 Mr. Salmon was granted an option to subscribe between May 2011 and May 2015 for 100,000 ordinary 1p shares in the Company at 337.5p.

On 5 November 2008 Mr. Cobb was granted an option to subscribe between November 2011 and November 2015 for 50,000 ordinary 1p shares in the Company at 320p.

Dr. Turrell, a former director of the Company, has an option to subscribe for 50,000 ordinary 1p shares in the Company at 380p, exercisable until 31 December 2012.

On 2 November 2011 Mr. Lynam and Mr. Salmon were each granted options to subscribe for 141,666 ordinary 40p shares in Secure Trust Bank PLC at 720p between 2 November 2014 and 1 November 2021, and a further 141,667 shares at 720p between 2 November 2016 and 1 November 2021.

Apart from the interests disclosed above, no director was interested at any time in the year in the share capital of Group companies.

No director, either during or at the end of the financial year, was materially interested in any contract with the Company or any of its subsidiaries, which was significant in relation to the Group's business. At 31 December 2011 one director had a loan from Arbuthnot Latham & Co., Limited amounting to £2,337,000, on normal commercial terms as disclosed in note 36 to the financial statements. At 31 December 2011 two directors had deposits with Secure Trust Bank PLC amounting to £212,000 and four directors had deposits with Arbuthnot Latham & Co., Limited amounting to £1,061,000, all on normal commercial terms as disclosed in note 36 to the financial statements.

The Company maintains insurance to provide liability cover for directors and officers of the Company.

Board Committees

The report of the Remuneration Committee on pages 20 to 21 will be the subject of an Ordinary Resolution at the Annual General Meeting.

Information on the Audit, Nomination, Risk and Donations Committees is included in the Corporate Governance section of the Annual Report on page 18 to 19.

Employees

The Company gives due consideration to the employment of disabled persons and is an equal opportunities employer. It also regularly provides employees with information on matters of concern to them, consults on decisions likely to affect their interests and encourages their involvement in the performance of the Company through share participation and in other ways.

Supplier Payment Policy

The Company's policy is to make payment in line with terms agreed with individual suppliers, payment being effected on average within 30 days of invoice.

Forbearance

The Group has always looked to support customers who are in financial difficulty. We seek to engage in early communication with borrowers experiencing difficulty in meeting their repayments, to obtain their commitment to maintaining or re-establishing their contractual payment plan. We consider forbearance options on a case by case basis in line with best practice and they are subject to regular monitoring and review.

Charitable Donations

The Company made charitable donations of £71,000 during the year (2010: £55,000).

Political Donations

The Company made a political donation of £15,000 to the Conservative Party and £20,000 to the No2AV campaign during the year (2010: political donations £25,000).

Status

The Company is not a close company as defined in the Income and Corporation Taxes Act 1988.

Auditors

A resolution to reappoint KPMG Audit Plc as auditors of the Company will be proposed at the forthcoming Annual General Meeting at a fee to be agreed in due course by the Directors.

The Directors have disclosed to the auditors to the best of their knowledge and belief all relevant information necessary to assist the auditors in the preparation of their report.

By order of the Board

J R Kaye

Secretary

14 March 2012

Corporate Governance

AIM companies are not required to comply with The Combined Code. Nevertheless, the Board endorses the principles of openness, integrity and accountability which underlie good corporate governance and intends to take into account the provisions of The Combined Code in so far as they are appropriate to the Group's size and circumstances. Moreover, the Group contains subsidiaries authorised to undertake regulated business under the Financial Services and Markets Act 2000 and regulated by the Financial Services Authority, including two which are authorised deposit taking businesses. Accordingly, the Group operates to the high standards of corporate accountability and regulatory compliance appropriate for such businesses.

Directors

The Group is led and controlled by an effective Board which comprises five executive directors and three non-executive directors.

The senior independent non-executive director is Robert Wickham, who in addition is Deputy Chairman. Although Mr. Wickham has served on the Board for eighteen years from the date of his first election, he displays independence in both character and judgement and there are no other relationships or circumstances which could affect his judgement. Accordingly, the Board considers him to be independent.

The Board

The Board meets regularly throughout the year. Substantive agenda items have briefing papers, which are circulated in a timely manner before each meeting. The Board is satisfied that it is supplied with all the information that it requires and requests, in a form and of a quality to enable it to discharge its duties. In addition to ongoing matters concerning the strategy and management of the Company and of the Group, the Board has determined certain items which are reserved for decision by itself. These matters include the acquisition and disposal of other than minor businesses, the issue of capital by any Group company and any transaction by a subsidiary company that cannot be made within its own resources, or that is not in the normal course of its business.

The Company Secretary is responsible for ensuring that Board processes and procedures are appropriately followed and support effective decision making. All directors have access to the Company Secretary's advice and services and there is an agreed procedure for directors to obtain independent professional advice in the course of their duties, if necessary, at the Company's expense.

The Board has delegated certain of its responsibilities to Committees. All Committees have written terms of reference.

Audit Committee

Membership of the Audit Committee is limited to non-executive directors and comprises Ruth Lea (as Chairman), Sir Christopher Meyer and Robert Wickham.

The Audit Committee provides a forum for discussing with the Group's external auditors their report on the annual accounts, reviewing the scope, results and effectiveness of the internal audit work programme and considering any other matters which might have a financial impact on the Company, including the Group's arrangements by which staff may, in confidence, raise concerns about possible improprieties in matters of financial reporting or other matters. The Audit Committee's responsibilities include reviewing the Group's system of internal control and the process for evaluating and monitoring risk. The Committee also reviews the appointment, terms of engagement and objectivity of the external auditors, including the level of non-audit services provided, and ensures that there is an appropriate audit relationship.

Remuneration Committee

Information on the Remuneration Committee and details of the Directors' remuneration are set out in the separate Remuneration Report.

Nomination Committee

The Nomination Committee is chaired by Henry Angest and its other members are Robert Wickham and Ruth Lea. Before a Board appointment is made the skills, knowledge and experience required for a particular appointment are evaluated.

Risk Committee

The Risk Committee is chaired by Henry Angest and its other members are James Cobb, James Fleming, John Reed (non-executive of Arbuthnot Latham), Andrew Salmon and Robert Wickham. The role of the Risk Committee is to approve specific risk policies for Group subsidiaries and significant individual credit or other exposures.

Donations Committee

The Donations Committee is chaired by Henry Angest and its other members are Robert Wickham and Ruth Lea. The Committee considers any political donation or expenditure as defined within the Political Parties, Elections and Referendums Act 2000.

Shareholder Communications

The Company maintains a regular dialogue with its shareholders and makes full use of the Annual General Meeting and any other General Meetings to communicate with investors.

The Company aims to present a balanced and understandable assessment in all its reports to shareholders, its regulators and the wider public. Key announcements and other information can be found at: www.arbuthnotgroup.com.

Internal Control and Financial Reporting

The Board of directors has overall responsibility for the Group's system of internal control and for reviewing its effectiveness. Such a system is designed to manage rather than eliminate risk of failure to achieve business objectives and can only provide reasonable but not absolute assurance against the risk of material misstatement or loss.

The Directors and senior management of the Group have formally adopted a Group Risk and Controls Policy which sets out the Board's attitude to risk and internal control. Key risks identified by the Directors are formally reviewed and assessed at least once a year by the Board, in addition to which key business risks are identified, evaluated and managed by operating management on an ongoing basis by means of procedures such as physical controls, credit and other authorisation limits and segregation of duties. The Board also receives regular reports on any risk matters that need to be brought to its attention. Significant risks identified in connection with the development of new activities are subject to consideration by the Board. There are well-established budgeting procedures in place and reports are presented regularly to the Board detailing the results of each principal business unit, variances against budget and prior year, and other performance data.

The effectiveness of the internal control system is reviewed regularly by the Board and the Audit Committee, which also receives reports of reviews undertaken by the internal audit function which was outsourced to Ernst & Young. The Audit Committee also receives reports from the external auditors, KPMG Audit Plc, which include details of internal control matters that they have identified. Certain aspects of the system of internal control are also subject to regulatory supervision, the results of which are monitored closely by the Board.

Going Concern

After making appropriate enquiries which assessed strategy, profitability, funding and capital resources, the Directors are satisfied that the Company and the Group have adequate resources to continue in operation for the foreseeable future. The financial statements are, therefore, prepared on the going concern basis.

Statement of Directors' Responsibilities

The Directors are responsible for preparing the Annual Report and the financial statements in accordance with applicable law and regulations. Company law requires the Directors to prepare Group and Parent Company financial statements for each financial year. As required by the AIM Rules of the London Stock Exchange they are required to prepare the Group financial statements in accordance with IFRSs as adopted by the EU and applicable law and have elected to prepare the Parent Company financial statements on the same basis.

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 Group and Parent Company and of their profit or loss for that period. In preparing each of the Group and Parent Company financial statements, the Directors are required to:

- select suitable accounting policies and then apply them consistently;
- make judgments and estimates that are reasonable and prudent;
- state whether they have been prepared in accordance with IFRSs as adopted by the EU; and
- prepare the financial statements on the going concern basis unless it is inappropriate to presume that the Group and the Parent Company will continue in business.

The Directors are responsible for keeping adequate accounting records that are sufficient to show and explain the Parent Company's transactions and disclose with reasonable accuracy at any time the financial position of the Parent Company and enable them to ensure that its financial statements comply with the Companies Act 2006. They have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group 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.

Statement of Disclosure of Information to Auditors

The directors confirm that:

- so far as each director is aware, there is no relevant audit information of which the Company's auditors are unaware; and
- the Directors have taken all the steps they ought to have taken as directors to make themselves aware of any relevant audit information and to establish that the Company's auditors are aware of that information.

Remuneration Report

Remuneration Committee

Membership of the Remuneration Committee is limited to non-executive directors together with Henry Angest as Chairman. The present members of the Committee are Henry Angest, Robert Wickham and Ruth Lea.

The Committee has responsibility for producing recommendations on the overall remuneration policy for directors and for setting the remuneration of individual directors, both for review by the Board. Members of the Committee do not vote on their own remuneration.

Remuneration Policy

The Remuneration Committee determines the remuneration of individual directors having regard to the size and nature of the business; the importance of attracting, retaining and motivating management of the appropriate calibre without paying more than is necessary for this purpose; remuneration data for comparable positions; the need to align the interests of executives with those of shareholders; and an appropriate balance between current remuneration and longer term performance-related rewards. The remuneration package can comprise a combination of basic annual salary and benefits (including pension), a discretionary annual bonus award related to the Committee's assessment of the contribution made by the executive during the year and longer term incentives, including executive share options. Pension benefits take the form of annual contributions paid by the Company to individual money purchase schemes. The Remuneration Committee reviews salary levels each year based on the performance of the Group during the preceding financial period. This review does not necessarily lead to increases in salary levels. During 2011 the Group implemented all the provisions required under the FSA Remuneration Code. Accordingly the Group and its subsidiaries are all considered to be Tier 3 institutions.

Directors' Service Contracts

Henry Angest, James Fleming, Paul Lynam and Andrew Salmon each have service contracts terminable at any time on 12 months' notice in writing by either party. James Cobb has a service contract terminable at any time on 6 months' notice in writing by either party.

Share Option and Long Term Incentive Schemes

This part of the remuneration report is audited information.

In May 2005, the Company extended its Unapproved Executive Share Option Scheme for a further period of 10 years.

The Company has an ESOP ("the Arbuthnot ESOP Trust") under which trustees may purchase shares in the Company to satisfy the exercise of share options by employees including executive directors.

At the date of this remuneration report, the only outstanding options to directors under the Unapproved Executive Share Option Scheme are those in relation to 100,000 shares for Andrew Salmon and 50,000 shares for James Cobb. 150,500 shares are held in the Arbuthnot ESOP Trust.

Under the Unapproved Executive Share Option Scheme of the Company's subsidiary, Secure Trust Bank PLC, established in November 2011, P Lynam and A Salmon were each granted options over 283,333 shares in that company.

Directors' Emoluments

This part of the remuneration report is audited information.

	2011 £'000	2010 £'000
Fees (including benefits in kind)	180	185
Salary payments (including benefits in kind)	2,808	2,395
Loss of office	100	552
Pension contributions	160	153
	3,248	3,285

	Salary £000	Bonus £000	Benefits £000	Pension £000	Fees £000	Loss of office £000	Total 2011 £000	Total 2010 £000
H Angest	360	–	55	–	–	–	415	444
JR Cobb	226	100	16	35	–	–	377	402
GA Jennison (to 10/05/10)	–	–	–	–	–	–	–	642
NW Kirton (to 29/12/11)	225	70	28	35	–	–	358	418
PA Lynam (from 13/09/10)	233	400	17	35	–	–	685	82
DM Proctor	221	–	17	20	–	–	258	302
AA Salmon	315	300	22	35	–	–	672	607
AD Turrell (to 31/12/11)	203	–	–	–	–	100	303	203
Ms RJ Lea	–	–	–	–	85	–	85	79
Sir Christopher Meyer	–	–	–	–	45	–	45	45
Sir Michael Peat (to 11/03/10)	–	–	–	–	–	–	–	11
RJJW Wickham	–	–	–	–	50	–	50	50
	1,783	870	155	160	180	100	3,248	3,285

Details of any shares or options held by directors are presented on pages 16 and 17.

The emoluments of the Chairman were £415,000 (2010: £444,000). The emoluments of the highest paid director were £685,000 (2010: £642,000) including pension contributions of £35,000 (2010: £nil).

Mr. R J J Wickham is a director of Calando Finance Limited which received an annual fee of £50,000 (2010: £50,000) in respect of his services to the Group.

These amounts are included in the above figures.

Retirement benefits are accruing under money purchase schemes for five directors who served during 2011 (2010: six directors).

Henry Angest

Chairman of the Remuneration Committee

14 March 2012

Independent Auditor's Report

to the members of Arbuthnot Banking Group PLC

We have audited the financial statements of Arbuthnot Banking Group PLC for the year ended 31 December 2011 set out on pages 24 to 69. The financial reporting framework that has been applied in their preparation is applicable law and International Financial Reporting Standards (IFRSs) as adopted by the EU and, as regards the Parent Company financial statements, as applied in accordance with the provisions of the Companies Act 2006.

In addition to our audit of the financial statements, the directors have engaged us to audit the information in the Directors' Remuneration Report that is described as having been audited, which the directors have decided to prepare (in addition to that required to be prepared) as if the Company were required to comply with the requirements of Schedule 8 to the Companies Act 2006 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008 (SI 2008 No. 410).

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 and, in respect of the separate opinion in relation to the Directors' Remuneration Report and reporting on corporate governance, on terms that have been agreed. 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, in respect of the separate opinion in relation to the Directors' Remuneration Report, those matters that we have agreed to state to them in our 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.

Respective responsibilities of directors and auditors

As explained more fully in the Directors' Responsibilities Statement set out on page 19, the directors are responsible for the preparation of the financial statements and for being satisfied that they give a true and fair view. Our responsibility is to audit, and express an opinion on, the financial statements in accordance with applicable law and International Standards on Auditing (UK and Ireland). Those standards require us to comply with the Auditing Practices Board's (APB's) Ethical Standards for Auditors.

Scope of the audit of the financial statements

A description of the scope of an audit of financial statements is provided on the APB's web-site at www.frc.org.uk/apb/scope/private.cfm.

Opinion on financial statements

In our opinion:

- the financial statements give a true and fair view of the state of the Group's and of the Parent Company's affairs as at 31 December 2011 and of the Group's loss for the year then ended;
- the Group financial statements have been properly prepared in accordance with IFRSs as adopted by the EU;
- the Parent Company financial statements have been properly prepared in accordance with IFRSs as adopted by the EU and as applied in accordance with the provisions of the Companies Act 2006; and
- the financial statements have been prepared in accordance with the requirements of the Companies Act 2006.

In our opinion:

- the part of the Directors' Remuneration Report which we were engaged to audit has been properly prepared in accordance with Schedule 8 to the Companies Act 2006 The Large and Medium-sized Companies and Groups (Accounts and Reports) Regulations 2008, as if those requirements were to apply to the Company; and
- the information given in the Directors' Report for the financial year for which the financial statements are prepared is consistent with the financial statements.

Matters on which we are required to report by exception

We have nothing to report in respect of the following:

Under the Companies Act 2006 and under the terms of our engagement we are required to report to you if, in our opinion:

- adequate accounting records have not been kept by the Parent Company, or returns adequate for our audit have not been received from branches not visited by us; or
- the parent company financial statements and the part of the Directors' Remuneration Report which we were engaged to audit 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.

Ian A Dewar (Senior Statutory Auditor)

for and on behalf of KPMG Audit Plc, Statutory Auditor
Chartered Accountants

15 Canada Square
London
E14 5GL
14 March 2012

Consolidated Statement of Comprehensive Income

	Note	Year ended 31 December 2011 £000	Year ended 31 December 2010 £000
Interest and similar income		39,233	29,325
Interest expense and similar charges		(11,990)	(7,955)
Net interest income		27,243	21,370
Fee and commission income	6	20,087	16,902
Fee and commission expense		(1,760)	(364)
Net fee and commission income		18,327	16,538
Gains less losses from dealing in securities		(112)	(136)
Operating income		45,458	37,772
Net impairment loss on financial assets	7	(6,813)	(3,146)
Fair value movement on derivatives		(124)	–
Other income	8	1,120	1,042
Operating expenses	10	(34,525)	(31,603)
Profit before income tax from continuing operations		5,116	4,065
Income tax expense	12	(1,817)	(1,238)
Profit after income tax from continuing operations		3,299	2,827
Loss from discontinued operations after tax	9	(10,249)	894
(Loss)/profit for the year		(6,950)	3,721
Foreign currency translation reserve		(12)	(300)
Revaluation reserve			
– Adjustment		–	(112)
– Amount transferred to profit and loss		(2)	–
Cash flow hedging reserve			
– Effective portion of changes in fair value		(333)	–
– Amount transferred to profit and loss		4	–
Available-for-sale reserve		(142)	142
Other comprehensive income for the period, net of income tax		(485)	(270)
Total comprehensive income for the period		(7,435)	3,451
(Loss)/profit attributable to:			
Equity holders of the Company		(5,014)	3,747
Non-controlling interests		(1,936)	(26)
		(6,950)	3,721
Total comprehensive income attributable to:			
Equity holders of the Company		(5,499)	3,477
Non-controlling interests		(1,936)	(26)
		(7,435)	3,451
Earnings per share for profit attributable to the equity holders of the Company during the year (expressed in pence per share):			
– basic and fully diluted	13	(33.3)	25.0

Consolidated Statement of Financial Position

	Note	At 31 December	
		2011 £000	2010 £000
ASSETS			
Cash	14	243,183	73,772
Derivative financial instruments	25	951	–
Loans and advances to banks	15	66,961	12,080
Loans and advances to customers	17	392,789	300,252
Trading securities – long positions	16	–	3,232
Debt securities held-to-maturity	19	40,079	143,119
Assets classified as held for sale	9	3,674	–
Current tax asset		457	–
Other assets	23	8,645	17,948
Financial investments	20	3,076	4,957
Intangible assets	21	3,561	2,915
Property, plant and equipment	22	5,214	5,903
Deferred tax asset	29	726	932
Total assets		769,316	565,110
EQUITY AND LIABILITIES			
Equity attributable to owners of the parent			
Share capital	31	153	150
Share premium account	31	21,085	21,085
Retained earnings	32	21,571	12,142
Other reserves	32	(1,836)	(1,347)
Non-controlling interests		5,998	2,118
Total equity		46,971	34,148
LIABILITIES			
Deposits from banks	24	8	3,706
Trading securities – short positions	16	–	775
Derivative financial instruments	25	–	184
Deposits from customers	26	693,800	503,257
Liabilities relating to assets classified as held for sale	9	1,291	–
Current tax liability		–	751
Other liabilities	27	14,893	9,533
Deferred tax liability	29	97	126
Debt securities in issue	28	12,256	12,630
Total liabilities		722,345	530,962
Total equity and liabilities		769,316	565,110

The financial statements on pages 24 to 69 were approved and authorised for issue by the Board of directors on 14 March 2012 and were signed on behalf by:

H Angest
Director

JR Cobb
Director

Registered Number: 1954085

The notes on pages 32 to 69 are an integral part of these consolidated financial statements

Company Statement of Financial Position

	Note	At 31 December	
		2011 £000	2010 £000
ASSETS			
Current assets			
Due from subsidiary undertakings		15,848	7,795
Financial investments	20	218	330
Other debtors		1,175	2,386
Non-current assets			
Shares in subsidiary undertakings	37	25,233	28,633
Intangible assets	21	28	36
Property, plant and equipment	22	127	88
Due from subsidiary undertakings		9,000	7,750
Total assets		51,629	47,018
EQUITY AND LIABILITIES			
Equity			
Share capital	31	153	150
Share premium account	31	21,085	21,085
Other reserves	32	(1,077)	(1,077)
Retained earnings	32	8,517	415
Total equity		28,678	20,573
LIABILITIES			
Current liabilities			
Deposits from banks		–	2,869
Due to subsidiary undertakings		6,020	10,097
Accruals		4,675	849
Non-current liabilities			
Debt securities in issue	28	12,256	12,630
Total liabilities		22,951	26,445
Total equity and liabilities		51,629	47,018

The Company has elected to take the exemption under section 408 of the Companies Act 2006 not to present the Parent Company profit and loss account. The profit for the Parent Company for the year is presented in the Statement of Changes in Equity.

The financial statements on pages 24 to 69 were approved and authorised for issue by the Board of directors on 14 March 2012 and were signed on behalf by:

H Angest
Director

JR Cobb
Director

Consolidated Statement of Changes in Equity

	Attributable to equity holders of the Group										
	Share capital £000	Share premium account £000	Foreign currency translation reserve £000	Revaluation reserve £000	Capital redemption reserve £000	Available- for-sale reserve £000	Cash flow hedging reserve £000	Treasury shares £000	Retained earnings £000	Non- controlling interests £000	Total £000
Balance at 1 January 2011	150	21,085	(558)	146	20	142	–	(1,097)	12,142	2,118	34,148
Total comprehensive income for the period											
Loss for 2011	–	–	–	–	–	–	–	–	(5,014)	(1,936)	(6,950)
Other comprehensive income, net of income tax											
Foreign currency translation reserve	–	–	(12)	–	–	–	–	–	–	–	(12)
Revaluation reserve											
– Adjustment	–	–	–	(4)	–	–	–	–	4	–	–
– Amount transferred to profit and loss	–	–	–	(2)	–	–	–	–	–	–	(2)
Cash flow hedging reserve											
– Effective portion of changes in fair value	–	–	–	–	–	–	(333)	–	–	–	(333)
– Amount transferred to profit and loss	–	–	–	–	–	–	4	–	–	–	4
Available-for-sale reserve	–	–	–	–	–	(142)	–	–	–	–	(142)
Total other comprehensive income	–	–	(12)	(6)	–	(142)	(329)	–	4	–	(485)
Total comprehensive income for the period	–	–	(12)	(6)	–	(142)	(329)	–	(5,010)	(1,936)	(7,435)
Transactions with owners, recorded directly in equity											
Contributions by and distributions to owners											
Charge for share based payments	–	–	–	–	–	–	–	–	–	70	70
Sale of Secure Trust Bank shares	–	–	–	–	–	–	–	–	16,899	5,746	22,645
Final dividend relating to 2010	–	–	–	–	–	–	–	–	(1,754)	–	(1,754)
Interim dividend relating to 2011	–	–	–	–	–	–	–	–	(1,608)	–	(1,608)
New share capital subscribed	3	902	–	–	–	–	–	–	–	–	905
Transfer to retained earnings in lieu of cash dividends	–	(902)	–	–	–	–	–	–	902	–	–
Total contributions by and distributions to owners	3	–	–	–	–	–	–	–	14,439	5,816	20,258
Balance at 31 December 2011	153	21,085	(570)	140	20	–	(329)	(1,097)	21,571	5,998	46,971

Consolidated Statement of Changes in Equity continued

	Attributable to equity holders of the Group									Total £000
	Share capital £000	Share premium account £000	Foreign currency translation reserve £000	Revaluation reserve £000	Capital redemption reserve £000	Available- for-sale reserve £000	Treasury shares £000	Retained earnings £000	Non- controlling interests £000	
Balance at 1 January 2010	150	21,085	(258)	258	20	–	(940)	11,684	2,144	34,143
Total comprehensive income for the period										
Profit/(loss) for 2010	–	–	–	–	–	–	–	3,747	(26)	3,721
Other comprehensive income, net of income tax										
Foreign currency translation reserve	–	–	(300)	–	–	–	–	–	–	(300)
Revaluation reserve										
– Adjustment	–	–	–	(112)	–	–	–	–	–	(112)
Available-for-sale reserve	–	–	–	–	–	142	–	–	–	142
Total other comprehensive income	–	–	(300)	(112)	–	142	–	–	–	(270)
Total comprehensive income for the period	–	–	(300)	(112)	–	142	–	3,747	(26)	3,451
Transactions with owners, recorded directly in equity										
Contributions by and distributions to owners										
Purchase of own shares	–	–	–	–	–	–	(157)	–	–	(157)
Final dividend relating to 2009	–	–	–	–	–	–	–	(1,681)	–	(1,681)
Interim dividend relating to 2010	–	–	–	–	–	–	–	(1,608)	–	(1,608)
Total contributions by and distributions to owners	–	–	–	–	–	–	(157)	(3,289)	–	(3,446)
Balance at 31 December 2010	150	21,085	(558)	146	20	142	(1,097)	12,142	2,118	34,148

Company Statement of Changes in Equity

	Attributable to equity holders of the Company					Total £000
	Share capital £000	Share premium account £000	Capital redemption reserve £000	Treasury shares £000	Retained earnings £000	
Balance at 1 January 2010	150	21,085	20	(940)	1,862	22,177
Total comprehensive income for the period	–	–	–	–	1,842	1,842
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Purchase of own shares	–	–	–	(157)	–	(157)
Final dividend relating to 2009	–	–	–	–	(1,681)	(1,681)
Interim dividend relating to 2010	–	–	–	–	(1,608)	(1,608)
Total contributions by and distributions to owners	–	–	–	(157)	(3,289)	(3,446)
Balance at 1 January 2011	150	21,085	20	(1,097)	415	20,573
Total comprehensive income for the period	–	–	–	–	10,562	10,562
Transactions with owners, recorded directly in equity						
Contributions by and distributions to owners						
Final dividend relating to 2010	–	–	–	–	(1,754)	(1,754)
Interim dividend relating to 2011	–	–	–	–	(1,608)	(1,608)
New share capital subscribed	3	902	–	–	–	905
Transfer to retained earnings in lieu of cash dividends	–	(902)	–	–	902	–
Total contributions by and distributions to owners	–	–	–	–	(2,460)	(2,457)
Balance at 31 December 2011	153	21,085	20	(1,097)	8,517	28,678

Consolidated Statement of Cash Flow

Note	Year ended 31 December 2011 £000	Year ended 31 December 2010 £000
Cash flows from operating activities		
Interest and similar income received	39,337	27,612
Interest and similar charges paid	(11,494)	(8,189)
Fees and commissions received	24,837	30,310
Net trading and other income	1,263	5,451
Cash payments to employees and suppliers	(59,287)	(46,913)
Taxation (paid)/received	101	(1,539)
Cash flows from operating (losses)/profits before changes in operating assets and liabilities	(5,243)	6,732
Changes in operating assets and liabilities:		
– net decrease/(increase) in trading securities	2,457	(757)
– net (increase)/decrease in derivative financial instruments	(1,135)	420
– net increase in loans and advances to customers	(94,655)	(72,425)
– net decrease in other assets	5,629	806
– net (decrease)/increase in deposits from banks	(3,698)	820
– net increase in amounts due to customers	190,543	117,258
– net increase/(decrease) in other liabilities	6,651	(3,684)
Net cash inflow from operating activities	100,549	49,170
Cash flows from investing activities		
Acquisition of financial investments	(113)	(605)
Disposal of financial investments	1,740	450
Purchase of computer software	21	(426)
Purchase of property, plant and equipment	22	(286)
Proceeds from sale of property, plant and equipment	33	1,673
Purchases of debt securities	(174,337)	(452,576)
Proceeds from redemption of debt securities	277,441	437,054
Net cash from investing activities	103,555	(14,716)
Cash flows from financing activities		
Purchase of treasury shares	–	(157)
Dividends paid	(2,457)	(3,289)
Proceeds from sale and issue of Secure Trust Bank shares	22,645	–
Net cash used in financing activities	20,188	(3,446)
Net increase in cash and cash equivalents	224,292	31,008
Cash and cash equivalents at 1 January	85,852	54,844
Cash and cash equivalents at 31 December	310,144	85,852

Company Statement of Cash Flows

Note	Year ended 31 December 2011 £000	Year ended 31 December 2010 £000
Cash flows from operating activities		
Dividends received from subsidiaries	8,500	4,150
Interest and similar income received	283	342
Interest and similar charges paid	(820)	(778)
Net trading and other income	13,734	2,921
Cash payments to employees and suppliers	(9,149)	(5,949)
Taxation received	958	775
Cash flows from operating profits before changes in operating assets and liabilities	13,506	1,461
Changes in operating assets and liabilities:		
– net (increase)/decrease in group company balances	(4,140)	2,764
– net decrease/(increase) in other assets	1,211	(683)
– net increase in other liabilities	3,826	219
Net cash inflow from operating activities	14,403	3,761
Cash flows from investing activities		
Increase in loans to subsidiary companies	(2,000)	–
Repayment of loans to subsidiary companies	750	–
Increase investment in subsidiary	(1,800)	(9)
Disposal of share in subsidiaries, net of cash and cash equivalents disposed	1,897	–
Disposal of financial investments	112	135
Purchase of computer software	–	(40)
Purchase of property, plant and equipment	(46)	(17)
Net cash from investing activities	(1,087)	69
Cash flows from financing activities		
Purchase of treasury shares	–	(157)
Dividends paid	(2,457)	(3,289)
Net cash used in financing activities	(2,457)	(3,446)
Net increase in cash and cash equivalents	10,859	384
Cash and cash equivalents at 1 January	2,470	2,086
Cash and cash equivalents at 31 December	13,329	2,470

Principal Accounting Policies

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

1.1. Reporting entity

Arbuthnot Banking Group PLC is a company domiciled in United Kingdom. The registered address of the Arbuthnot Banking Group PLC is One Arleston Way, Solihull B90 4LH. The consolidated financial statements of the Arbuthnot Banking Group PLC as at and for the year ended 31 December 2011 comprise the Arbuthnot Banking Group PLC and its subsidiaries (together referred to as the “Group” and individually as “subsidiaries”). The Company is primarily involved in banking and financial services.

1.2. Basis of presentation

The Group’s consolidated financial statements and the Company’s financial statements have been prepared in accordance with International Financial Reporting Standards (IFRSs as adopted and endorsed by the EU) and the Companies Act 2006 applicable to companies reporting under IFRS. They have been prepared under the historical cost convention, as modified by the revaluation of land and buildings, available-for-sale financial assets, and financial assets and financial liabilities at fair value through profit or loss.

The preparation of financial statements in conformity with IFRS requires the use of certain critical accounting estimates. It also requires management to exercise its judgement in the process of applying the Group’s accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note 2.

The Group’s business activities and financial position, the factors likely to affect its future development and performance, and its objectives and policies in managing the financial risks to which it is exposed and its capital are discussed in the Financial Review. The Directors have assessed, in the light of current and anticipated economic conditions, the Group’s ability to continue as a going concern. The Directors confirm they are satisfied that the Company and the Group have adequate resources to continue in business for the foreseeable future. For this reason, they continue to adopt the ‘going concern’ basis for preparing accounts.

(a) Standards, interpretations and amendments effective in 2011 – relevant to the Group

- IFRS 2 (Revised), ‘Share-based payments’. The revised standard clarifies the scope and accounting for group cash-settled share-based payments in the separate financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment transaction.
- IFRS 3 (Revised), ‘Business combinations’. The revised standard continues to apply the acquisition method to business combinations, however, all payments to purchase a business are to be recorded at fair value at the acquisition date, with contingent payments classified as debt subsequently re-measured through the Statement of Comprehensive Income. There is a choice on an acquisition-by-acquisition basis to measure the non-controlling interest in the acquiree either at fair value or at the non-controlling interest’s proportionate share of the acquiree’s net assets. All acquisition-related costs should be expensed.
- IAS 24 (Revised), ‘Related party disclosures’ (effective from 1 January 2011 – early adopted). The revised standard includes an exemption from the disclosure requirements for related party transactions between “state controlled” entities and includes a revised definition for related parties.
- IAS 27 (Revised), ‘Consolidated and separate financial statements’. The revised standard requires the effects of all transactions with non-controlling interests to be recorded in equity if there is no change in control. Any remaining interest in an investee is re-measured to fair value in determining the gain or loss recognised in profit or loss where control over the investee is lost.
- Improvements to IFRSs. Sets out minor amendments to IFRS standards as part of annual improvements process.

The above changes did not have any material impact on the financial statements.

(b) Standards, interpretations and amendments to existing standards that are not yet effective and have not been early adopted by the Group

The following standards, interpretations and amendments to existing standards have been published and are mandatory for the Group’s accounting periods beginning on or after 1 January 2012 or later periods, but the Group has not early adopted them:

- IFRS 7 (Revised), ‘Disclosures – Transfers of Financial Assets’ (effective from 1 July 2011). The revised standard requires additional disclosures for transfers of financial assets and where there are a disproportionate amount of transactions undertaken around the period end. The revised standard will not have any material impact on the Group’s financial accounts.
- IFRS 7 (Revised), ‘Disclosures – Offsetting Financial Assets and Financial Liabilities’ (effective 1 January 2013). The revised standard amend the required disclosures to include information that will enable users of an entity’s financial statements to evaluate the effect or potential effect of netting arrangements, including rights of set-off associated with the entity’s recognised financial assets and recognised financial liabilities, on the entity’s financial position.*

1.2. Basis of presentation continued

- IFRS 10, 'Consolidated Financial Statements' and IAS 27 (Revised), 'Separate Financial Statements' (effective 1 January 2013). IFRS 10 supersedes IAS 27 and SIC-12, and provides a single model to be applied in the control analysis for all investees. There are some minor clarifications in IAS27, and the requirements of IAS 28 and IAS 31 have been incorporated into IAS 27.*
- IFRS 11, 'Joint Arrangements' (effective 1 January 2013). This standard replaces the existing accounting for subsidiaries and joint ventures (now joint arrangements) and removes the choice of equity or proportionate accounting for jointly controlled entities, as was the case under IAS 31.*
- IFRS 12, 'Disclosure of Interests in Other Entities' (effective 1 January 2013). This standard replaces the existing accounting for subsidiaries and joint ventures (now joint arrangements) and contains the disclosure requirements for entities that have interests in subsidiaries, joint arrangements, associates and/or unconsolidated structured entities.*
- IFRS 13, 'Fair Value Measurement' (effective 1 January 2013). This standard replaces the existing guidance on fair value measurement in different IFRSs with a single definition of fair value, a framework for measuring fair values and disclosures about fair value measurements.*
- IAS 32 (Revised), 'Offsetting Financial Assets and Financial Liabilities' (effective 1 January 2014). This standard was amended to clarify the offsetting criteria, specifically when an entity currently has a legal right of set off; and when gross settlement is equivalent to net settlement.*
- IFRS 9, 'Financial instruments' (effective from 1 January 2015). This standard deals with the classification and measurement of financial assets and will replace IAS 39. The requirements of this standard represent a significant change from the existing requirements in IAS 39. The standard contains two primary measurement categories for financial assets: amortised cost and fair value. The standard eliminates the existing IAS 39 categories of 'held to maturity', 'available for sale' and 'loans and receivables'. The potential effect of this standard is currently being evaluated but it is expected to have a pervasive impact on the Group's financial statements, due to the nature of the Group's operations.*

* – *These standards have not yet been endorsed by the EU.*

1.3. Consolidation

(a) Subsidiaries

Subsidiaries are all entities (including special purpose entities) over which the Group has the power to govern the financial and operating policies, generally accompanying a shareholding of more than one-half of the voting rights. The existence and effect of potential voting rights that are currently exercisable or convertible are considered when assessing whether the Group controls another entity. Subsidiaries are fully consolidated from the date on which control is transferred to the Group. They are de-consolidated from the date that control ceases.

The purchase method of accounting is used to account for the acquisition of subsidiaries by the Group. The cost of an acquisition is measured as the fair value of the assets given, equity instruments issued and liabilities incurred or assumed at the date of exchange, plus costs directly attributable to the acquisition. Identifiable assets acquired and liabilities and contingent liabilities assumed in a business combination are measured initially at their fair values at the acquisition date, irrespective of the extent of any non-controlling interest. The excess of the cost of acquisition over the fair value of the Group's shares of the identifiable net assets acquired is recorded as goodwill. If the cost of acquisition is less than the fair value of the net assets of the subsidiary acquired, the difference is recognised directly in the Statement of Comprehensive Income.

Inter-company transactions, balances and unrealised gains on transactions between Group companies are eliminated. Unrealised losses are also eliminated. Accounting policies of subsidiaries have been changed where necessary to ensure consistency with the policies adopted by the Group.

(b) Special purpose entities

Special purpose entities (SPEs) are entities that are created to accomplish a narrow and well-defined objective such as the securitisation of particular assets, or the execution of a specific borrowing or lending transaction. SPEs are consolidated when the substance of the relationship between the Group and the entity and the evaluation of the Group's exposure to the risks and rewards of the SPE indicates control. The following circumstances may indicate control by the Group and would therefore require consolidation of the SPE:

- in substance, the activities of the SPE are being conducted on behalf of the entity according to its specific business needs so that the entity obtains benefits from the SPE's operation;
- in substance, the entity has the decision-making powers to obtain the majority of the benefits of the activities of the SPE or, by setting up an 'autopilot' mechanism, the entity has delegated these decision-making powers;
- in substance, the entity has rights to obtain the majority of the benefits of the SPE and therefore may be exposed to risks incident to the activities of the SPE; or
- in substance, the entity retains the majority of the residual or ownership risks related to the SPE or its assets in order to obtain benefits from its activities.

Principal Accounting Policies continued

1.3. Consolidation continued

The assessment of whether the Group has control over an SPE is carried out at inception and the initial assessment is only reconsidered at a later date if there were any changes to the structure or terms of the SPE, or there were additional transactions between the Group and the SPE.

(c) Transactions and non-controlling interests

Changes in ownership interest in a subsidiary that do not result in the loss of control are accounted for as equity transactions and no gain or loss is recognised.

1.4. Segment reporting

Operating segments are reported in a manner consistent with the internal reporting provided to the Group Board. The Group Board, which is responsible for allocating resources and assessing performance of the operating segments, has been identified as the chief operating decision maker. All transactions between segments are conducted on an arm's length basis. Income and expenses directly associated with each segment are included in determining segment performance. There are three main operating segments:

- Retail Banking
- International Private Banking
- UK Private Banking

1.5. Foreign currency translation

(a) Functional and presentational currency

Items included in the financial statements of each of the Group's entities are measured using the currency of the primary economic environment in which the entity operates ('the functional currency'). The consolidated financial statements are presented in pounds sterling, which is the Company's functional and the Group's presentational currency.

(b) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the dates of the transactions or valuation where items are remeasured. Foreign exchange gains and losses resulting from the settlement of such transactions and from the translation at year-end exchange rates of monetary assets and liabilities denominated in foreign currencies are recognised in the Statement of Comprehensive Income.

(c) Group companies

The results and financial position of all the Group entities (none of which has the currency of a hyperinflationary economy) that have a functional currency different from the presentational currency are translated into the presentation currency as follows:

- assets and liabilities for each Statement of Financial Position presented are translated at the closing rate at the date of that Statement of Financial Position;
- income and expenses for each Statement of Comprehensive Income are translated at average exchange rates (unless this average is not a reasonable approximation of the cumulative effect of the rates prevailing on the transaction dates, in which case income and expenses are translated at the rate on the dates of the transactions); and
- all resulting exchange differences are recognised as a separate component of equity.

On consolidation, exchange differences arising from the translation of the net investment in foreign operations, and of borrowings and other currency instruments designated as hedges of such investments, are taken to shareholders' equity. When a foreign operation is partially disposed of or sold, exchange differences that were recorded in equity are recognised in the Statement of Comprehensive Income as part of the gain or loss on sale.

Goodwill and fair value adjustments arising on the acquisition of a foreign entity are treated as assets and liabilities of the foreign entity and translated at the closing rate.

1.6. Interest income and expense

Interest income and expense are recognised in the Statement of Comprehensive Income for all instruments measured at amortised cost using the effective interest method.

The effective interest method calculates the amortised cost of a financial asset or a financial liability and allocates the interest income or interest expense over the relevant period. The effective interest rate is the rate that discounts estimated future cash payments or receipts through the expected life of the financial instrument or, when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability. When calculating the effective interest rate, the Group takes into account all contractual terms of the financial instrument but does not consider future credit losses. The calculation includes all fees paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs and all other premiums or discounts.

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, interest income is recognised using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.

1.7. Fee and commission income

Fees and commissions which are not considered integral to the effective interest rate are generally recognised on an accrual basis when the service has been provided. Loan commitment fees are deferred and recognised as an adjustment to the effective interest rate on the loan.

Commission and fees arising from negotiating, or participating in the negotiation of, a transaction for a third party – such as the issue or the acquisition of shares or other securities or the purchase or sale of businesses – are recognised on completion of the underlying transaction. Asset and other management, advisory and service fees are recognised based on the applicable service contracts, usually on a time apportioned basis. The same principle is applied for financial planning and insurance services that are continuously provided over an extended period of time. Commissions arising from the sale of structured products are recognised at the point of sale as there are no further services provided or due.

1.8. Gains less losses arising from dealing in securities

This includes the net gains arising from both buying and selling securities and from positions held in securities, including related interest income and dividends, recognised on trade-date – the date on which the Group commits to purchase or sell the asset.

1.9. Financial assets and financial liabilities

The Group classifies its financial assets and financial liabilities in the following categories: financial assets and financial liabilities at fair value through profit or loss; loans and receivables; held-to-maturity investments; available-for-sale financial assets and other financial liabilities. Management determines the classification of its investments at initial recognition. A financial asset or financial liability is measured initially at fair value. At inception transaction costs that are directly attributable to its acquisition or issue, for an item not at fair value through profit or loss, is added to the fair value of the financial asset and deducted from the fair value of the financial liability.

(a) Financial assets and financial liabilities at fair value through profit or loss

This category comprises listed securities and derivative financial instruments. Derivative financial instruments utilised by the Group include embedded derivatives and derivatives used for hedging purposes. Financial assets and liabilities at fair value through profit or loss are initially recognised on trade-date – the date on which the Group becomes a party to the contractual provisions of the instrument. Subsequent measurement of financial assets and financial liabilities held in this category are carried at fair value through profit or loss.

(b) Loans and receivables

Loans and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market. They arise when the Group provides money, goods or services directly to a debtor with no intention of trading the receivable. Loans are recognised when cash is advanced to the borrowers. Loans and receivables are carried at amortised cost using the effective interest method.

(c) Held-to-maturity

Held-to-maturity investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Group's management has the positive intention and ability to hold to maturity. Held-to-maturity investments are carried at amortised cost using the effective interest method.

(d) Available-for-sale

Available-for-sale investments are those intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, exchange rates or equity prices. Included in available-for-sale are equity investments in special purpose vehicles set up to acquire and enhance the value of commercial properties and equity investments in unquoted vehicles. These investments are of a medium term nature. There is no open market for these assets and there are no available-for-sale debt securities. Unquoted equity securities whose fair value cannot reliably be measured are carried at cost. All other available-for-sale investments are carried at fair value. Fair value changes on the equity securities are recognised in other comprehensive income (fair value reserve) until the investment is sold or impaired. Once sold or impaired the cumulative gains or losses previously recognised in other comprehensive income is reclassified to profit or loss.

(e) Other financial liabilities

Other financial liabilities are non-derivative financial liabilities with fixed or determinable payments. Other financial liabilities are recognised when cash is received from the depositors. Other financial liabilities are carried at amortised cost using the effective interest method. The fair value of other liabilities repayable on demand is assumed to be the amount payable on demand at the Statement of Financial Position date.

Derecognition

Financial assets are derecognised when the rights to receive cash flows from the financial assets have expired or where the Group has transferred substantially all risks and rewards of ownership. Any interest in transferred financial assets that qualify for derecognition that is created or retained by the Group is recognised as a separate asset or liability in the Statement of Financial Position. In transactions which the Group neither retains nor transfers substantially all the risks and rewards of ownership of a financial asset and it retains control over the asset, the Group continues to recognise the asset to the extent of its continuing involvement, determined by the extent to which it is exposed to changes in the value of the transferred asset. There have not been any instances where assets have only been partially derecognised.

The Group derecognises a financial liability when its contractual obligations are discharged or cancelled or expire.

Principal Accounting Policies continued

1.9. Financial assets and financial liabilities continued

Amortised cost measurement

The amortised cost of a financial asset or financial liability is the amount at which the financial asset or financial liability is measured at initial recognition, minus principal payments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount recognised and the maturity amount, minus any reduction for impairment.

Fair value measurement

Fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction on the measurement date. The fair value of assets and liabilities traded in active markets are based on current bid and offer prices respectively. If the market is not active the Group establishes a fair value by using appropriate valuation techniques. These include the use of recent arm's length transactions, reference to other instruments that are substantially the same for which market observable prices exist, net present value and discounted cash flow analysis.

1.10. Derivative financial instruments and hedge accounting

All derivatives are recognised at their fair value. Fair values are obtained from quoted market prices in active markets, including recent arm's length transactions or using valuation techniques such as discounted cash flow models. Derivatives are shown in the Statement of Financial Position as assets when their fair value is positive and as liabilities when their fair value is negative.

(a) Fair value hedges

The Group assesses at each Statement of Financial Position date changes in the fair value of derivatives are recognised immediately in the Statement of Comprehensive Income, together with the changes in fair value of the hedged assets or liabilities.

If a hedging relationship no longer meets the criteria for hedge accounting, the carrying amount of the hedged item is amortised over the residual period to maturity, as part of the newly calculated effective interest rate. However, if the hedged item has been derecognised, it is immediately released to the Statement of Comprehensive Income.

(b) Cash flow hedges

These cash flow hedges are used to hedge against fluctuations in future cash flows from interest rate movements on variable rate customer deposits. On initial purchase the derivative is valued at fair value and then the effective portion of the change in the fair value of the hedging instrument is recognised in equity (cash flow hedging reserve) until the gain or loss on the hedged item is realised, when it is amortised; the ineffective portion of the hedging instrument is recognised in the Statement of Comprehensive Income immediately.

If a hedging derivative expires or is sold, terminated, or exchanged, or the hedge no longer meets the criteria for cash flow hedge accounting, or the hedge designation is revoked, then hedge accounting is discontinued prospectively. In a discontinued hedge of a forecast transaction the cumulative amount recognised in other comprehensive income from the period when the hedge was effective is reclassified from equity to profit or loss as a reclassification adjustment when the forecast transaction occurs and affects profit or loss. If the forecast transaction is no longer expected to occur, then the balance in other comprehensive income is reclassified immediately to profit or loss as a reclassification adjustment.

Hedge effectiveness testing

On initial designation of the hedge, the Group formally documents the relationship between the hedging instruments and the hedged items, including the risk management objective and strategy in undertaking the hedge, together with the method that will be used to assess the effectiveness of the hedging relationship. The Group makes an assessment, both at the inception of the hedge relationship as well as on an ongoing basis, as to whether the hedging instruments are expected to be highly effective in offsetting the changes in the fair value or cash flows of the respective hedged items during the period for which the hedge is designated, and whether the actual results of each hedge are within a range of 80-125%. The Group makes an assessment for a cash flow hedge of a forecast transaction, as to whether the forecast transaction is highly probable to occur and presents an exposure to variations in cash flows that could ultimately affect profit or loss.

(c) Embedded derivatives

Embedded derivatives arise from contracts ('hybrid contracts') containing both a derivative (the 'embedded derivative') and a non-derivative (the 'host contract'). Where the economic characteristics and risks of the embedded derivatives are not closely related to those of the host contract, and the host contract is not at fair value through profit or loss, the embedded derivative is bifurcated and reported at fair value and gains or losses are recognised in the Statement of Comprehensive Income.

1.11. Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the Statement of Financial Position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis, or realise the asset and settle the liability simultaneously.

1.12. Impairment of financial assets

(a) Assets carried at amortised cost

On an ongoing basis the Group assesses whether there is objective evidence that a financial asset or group of financial assets is impaired. Objective evidence is the occurrence of a loss event, after the initial recognition of the asset, that impact on the estimated future cash flows of the financial asset or group of financial assets, and can be reliably estimated.

The criteria that the Group uses to determine that there is objective evidence of an impairment loss include, but are not limited to, the following:

- Delinquency in contractual payments of principal or interest;
- Cash flow difficulties experienced by the borrower;
- Initiation of bankruptcy proceedings;
- Deterioration in the value of collateral;
- Deterioration of the borrower's competitive position;

If there is objective evidence that an impairment loss on loans and receivables or held-to-maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced through the use of an allowance account and the amount of the loss is recognised in the Statement of Comprehensive Income. If a loan or held-to maturity investment has a variable interest rate, the discount rate for measuring any impairment loss is the current effective interest rate determined under the contract. When a loan is uncollectible, it is written off against the related provision for loan impairment. Such loans are written off after all the necessary procedures have been completed and the amount of the loss has been determined. Subsequent recoveries of amounts previously written off decrease the amount of the provision for loan impairment in the Statement of Comprehensive Income.

(b) Assets classified as available for sale

The Group assesses at each Statement of Financial Position date whether there is objective evidence that a financial asset or a group of financial assets is impaired. In the case of equity investments classified as available-for-sale, a significant or prolonged decline in the fair value of the security below its cost is considered as an indicator that the securities are impaired. If any such evidence exists for available-for-sale financial assets, the cumulative loss – measured as the difference between the acquisition cost and the current fair value, less any impairment loss on that financial asset previously recognised in profit or loss – is removed from equity and recognised in the Statement of Comprehensive Income. Impairment losses recognised in the Statement of Comprehensive Income on equity instruments are not reversed through the Statement of Comprehensive Income.

(c) Renegotiated loans

Loans that are either subject to collective impairment assessment or individually significant and whose terms have been renegotiated are no longer considered to be past due but are treated as new loans.

1.13. Intangible assets

(a) Goodwill

Goodwill represents the excess of the cost of an acquisition over the fair value of the Group's share of the net identifiable assets of the acquired subsidiary at the date of acquisition. Goodwill on acquisitions of subsidiaries is included in 'intangible assets'. Gains and losses on the disposal of an entity include the carrying amount of goodwill relating to the entity sold.

The Group reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place and carry goodwill at cost less accumulated impairment losses. Assets are grouped together into the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets (the "cash-generating unit" or "CGU"). For impairment testing purposes goodwill cannot be allocated to a CGU that is greater than a reported operating segment. CGUs to which goodwill has been allocated are aggregated so that the level at which impairment is tested reflects the lowest level at which goodwill is monitored for internal reporting purposes. Goodwill acquired in a business combination is allocated to groups of CGUs that are expected to benefit from the synergies of the combination.

The recoverable amount of an asset or CGU is the greater of its value in use and its fair value less costs to sell. There are currently two CGU's with goodwill attached to it; the core Arbutnot Latham CGU and the Music Finance CGU.

Management considers the value in use for the core Arbutnot Latham CGU to be the discounted cash flows over 5 years with a terminal value (2010: 5 years with a terminal value). The 5 year plan with a terminal value is considered to be appropriate as the goodwill relates to an ongoing well established business and not underlying assets with finite lives. The terminal value is calculated by applying a discounted perpetual growth model to the profit expected in 2014 as per the approved 3 year plan. A growth rate of 5% (2010: 8%) was used for income and 4% (2010: 9%) for expenditure from 2012 to 2014 (these rates were the best estimate of future forecasted performance), while a 4% (2010: 4%) percent growth rate for income and expenditure (a more conservative approach was taken for latter years as these were not budgeted for in detail as per the three year plan approved by the Board of Directors) was used for cash flows after the approved three year plan.

Principal Accounting Policies continued

1.13. Intangible assets continued

Management considers the value in use for the Music Finance CGU to be the discounted cash flows over 5 years (2010: 5 years). Income and expenditure were kept flat (2010: 0%) over the 5 year period.

Cash flows were discounted at a pre-tax rate of 12% (2010: 12%) to their net present value. The discount rate of 12% is considered to be appropriate after evaluating current market assessments of the time value of money and the risks specific to the assets or CGUs. Currently the value in use and fair value less costs to sell far exceeds the carrying value and as such no sensitivity analysis was done.

Impairment losses are recognised in profit and loss if the carrying amounts exceed the recoverable amounts.

(b) Computer software

Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software. These costs are amortised on the basis of the expected useful lives (three to five years).

Costs associated with developing or maintaining computer software programs are recognised as an expense as incurred.

1.14. Property, plant and equipment

Land and buildings comprise mainly branches and offices and are stated at the latest valuation with subsequent additions at cost less depreciation. Plant and equipment is stated at historical cost less depreciation. Historical cost includes expenditure that is directly attributable to the acquisition of the items.

Land is not depreciated. Depreciation on other assets is calculated using the straight-line method to allocate their cost to their residual values over their estimated useful lives, applying the following annual rates, which are subject to regular review:

Freehold buildings	50 years
Office equipment	6 to 20 years
Computer equipment	3 to 5 years
Motor vehicles	4 years

Gains and losses on disposals are determined by comparing proceeds with carrying amount. These are included in the Statement of Comprehensive Income. Depreciation on revalued freehold buildings is calculated using the straight-line method over the remaining useful life. Revaluation of assets and any subsequent disposals are addressed through the revaluation reserve and any changes are transferred to retained earnings.

1.15. Leases

(a) As a lessor

Assets leased to customers under agreements which transfer substantially all the risks and rewards of ownership, with or without ultimate legal title, are classified as finance leases. When assets are held subject to finance leases, the present value of the lease payments is recognised as a receivable. The difference between the gross receivable and the present value of the receivable is recognised as unearned finance income. Lease income is recognised over the term of the lease using the net investment method, which reflects a constant periodic rate of return.

Assets leased to customers under agreements which do not transfer substantially all the risks and rewards of ownership are classified as operating leases. When assets are held subject to operating leases, the underlying assets are held at cost less accumulated depreciation. The assets are depreciated down to their estimated residual values on a straight line basis over the lease term. Lease rental income is recognised on a straight line basis over the lease term.

(b) As a lessee

Rentals made under operating leases are recognised in the Statement of Comprehensive Income on a straight line basis over the term of the lease.

1.16. Cash and cash equivalents

For the purposes of the Statement of Cash Flows, cash and cash equivalents comprises cash on hand and demand deposits, and cash equivalents comprise highly liquid investments that are convertible into cash with an insignificant risk of changes in value with a maturity of three months or less at the date of acquisition, including certain loans and advances to banks and building societies and short-term highly liquid debt securities.

1.17. Employee benefits

(a) Post-retirement obligations

The Group contributes to a defined contribution scheme and to individual defined contribution schemes for the benefit of certain employees. The schemes are funded through payments to insurance companies or trustee-administered funds at the contribution rates agreed with individual employees.

1.17. Employee benefits continued

The Group has no further payment obligations once the contributions have been paid. The contributions are recognised as an employee benefit expense when they are due. Prepaid contributions are recognised as an asset to the extent that a cash refund or a reduction in the future payments is available.

There are no post-retirement benefits other than pensions.

(b) Share-based compensation

As set out in note 33, in 2008 and 2009 the Group awarded share options to two current and one former director under an equity settled share-based compensation plan. No options were awarded in 2010. In 2011 share options were granted to employees in Secure Trust Bank PLC. Detail on the share options granted to Group directors are set out in note 33. The fair value for the grant of the options is recognised as an expense. The total amount to be expensed over the vesting period is determined by reference to the fair value of the options granted. At each Statement of Financial Position date, the Group revises its estimates of the number of options that are expected to vest and recognises the impact of the revision to original estimates, if any, in the Statement of Comprehensive Income, with a corresponding adjustment to equity.

The proceeds received net of any directly attributable transaction costs are credited to share capital (nominal value) and share premium when the options are exercised.

1.18. Taxation

Current income tax which is payable on taxable profits is recognised as an expense in the period in which the profits arise. Income tax recoverable on tax allowable losses is recognised as an asset only to the extent that it is regarded as recoverable by offset against current or future taxable profits.

Deferred tax is provided in full on temporary differences arising between the tax bases of assets and liabilities and their carrying amounts in the consolidated financial statements. However, deferred tax is not accounted for if it arises from the initial recognition of goodwill, the initial recognition of an asset or liability in a transaction other than a business combination that at the time of the transaction affects neither accounting nor taxable profit or loss, and differences relating to investments in subsidiaries to the extent that they probably will not reverse in the foreseeable future. Deferred tax is determined using tax rates (and laws) that have been enacted or substantively enacted by the Statement of Financial Position date and are expected to apply when the related deferred tax asset is realised or the deferred tax liability is settled.

Deferred tax assets are recognised where it is probable that future taxable profits will be available against which the temporary differences can be utilised.

1.19. Issued debt and equity securities

Issued financial instruments or their components are classified as liabilities where the contractual arrangement results in the Group having a present obligation to either deliver cash or another financial asset to the holder, to exchange financial instruments on terms that are potentially unfavourable. Issued financial instruments, or their components, are classified as equity where they meet the definition of equity and confer on the holder a residual interest in the assets of the Company. The components of issued financial instruments that contain both liability and equity elements are accounted for separately with the equity component being assigned the residual amount after deducting from the instrument as a whole the amount separately determined as the fair value of the liability component.

Financial liabilities, other than trading liabilities at fair value, are carried at amortised cost using the effective interest method as set out in policy 1.6. Equity instruments, including share capital, are initially recognised at net proceeds, after deducting transaction costs and any related income tax. Dividend and other payments to equity holders are deducted from equity, net of any related tax.

1.20. Share capital

(a) Share issue costs

Incremental costs directly attributable to the issue of new shares or options or the acquisition of a business by Arbutnot Banking Group or its subsidiaries, are shown in equity as a deduction, net of tax, from the proceeds.

(b) Dividends on ordinary shares

Dividends on ordinary shares are recognised in equity in the period in which they are approved.

(c) Share buybacks

Where any Group company purchases the Company's equity share capital (treasury shares), the consideration paid, including any directly attributable incremental costs (net of income taxes) is deducted from equity attributable to the Company's equity holders until the shares are cancelled or reissued.

Principal Accounting Policies continued

1.21. Fiduciary activities

The Group commonly acts as trustees and in other fiduciary capacities that result in the holding or placing of assets on behalf of individuals, trusts, retirement benefit plans and other institutions. These assets and income arising thereon are excluded from these financial statements, as they are not assets of the Group.

1.22. Financial guarantee contracts

Financial guarantees represent undertakings that the Group will meet a customer's obligation to third parties if the customer fails to do so. Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. The Group is theoretically exposed to loss in an amount equal to the total guarantees or unused commitments, however, the likely amount of loss is expected to be significantly less; most commitments to extend credit are contingent upon customers maintaining specific credit standards. Liabilities under financial guarantee contracts are initially recorded at their fair value, and the initial fair value is amortised over the life of the financial guarantee. Subsequently, the financial guarantee liabilities are measured at the higher of the initial fair value, less cumulative amortisation, and the best estimate of the expenditure to settle obligations.

1.23. Forbearance

Forbearance is available to support customers who are in financial difficulty and help them re-establish their contractual payment plan. The main option offered by the Group is an arrangement to clear outstanding arrears. If the forbearance request is granted the account is monitored in accordance with the Group's policy and procedures.

All debts however retain the customer's normal contractual payment due dates. Arrears tracking and the allowance for impairment is based on the original contractual due dates for both the secured and unsecured lending channels.

Notes to the Consolidated Financial Statements

2. Critical accounting estimates and judgements in applying accounting policies

The Group makes estimates and assumptions that affect the reported amounts of assets and liabilities within the next financial year. Estimates and judgements are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

2.1. Estimation uncertainty

Credit losses

The Group reviews its loan portfolios and held-to-maturity investments to assess impairment at least on a half-yearly basis. The basis for evaluating impairment losses is described in accounting policy 1.12. Where financial assets are individually evaluated for impairment, management uses their best estimates in calculating the net present value of future cash flows. Management has to make judgements on the financial position of the counterparty and the net realisable value of collateral, in determining the expected future cash flows.

In determining whether an impairment loss should be recorded in the Statement of Comprehensive Income, the Group makes judgements as to whether there is any observable data indicating that there is a measurable decrease in the estimated future cash flows from a portfolio of loans or held-to-maturity investments with similar credit characteristics, before the decrease can be identified with an individual loan in that portfolio. This evidence may include observable data indicating that there has been an adverse change in the payment status of borrowers in a group, or national or local economic conditions that correlate with defaults on assets in the Group. Management uses estimates based on historical loss experience for assets with credit risk characteristics and objective evidence of impairment similar to those in the portfolio when scheduling its future cash flows. The methodology and assumptions used for estimating both the amount and timing of future cash flows are reviewed regularly to reduce any differences between loss estimates and actual loss experience.

Goodwill impairment

The accounting policy for goodwill is described in note 1.13 (a). The Company reviews the goodwill for impairment at least annually or when events or changes in economic circumstances indicate that impairment may have taken place. Significant management judgements are made in estimations, to evaluate whether an impairment of goodwill is necessary. Impairment testing is done at CGU level and the following two items, with judgements surrounding them, have a significant impact on the estimations used in determining the necessity of an impairment charge:

- Future cash flows – Cash flow forecasts reflect managements view of future business forecasts at the time of the assessment. A detailed three year budget is done every year and management also uses judgement in applying a growth rate. The accuracy of future cash flows is subject to a high degree of uncertainty in volatile market conditions. During such conditions, management would do impairment testing more frequently than annually to ensure that the assumptions applied are still valid in the current market conditions.
- Discount rate – Management also apply judgement in determining the discount rate used to discount future expected cash flows. The discount rate is derived from the cost of capital for each CGU.

At the time of the impairment testing, if the future expected cash flows decline and/or the cost of capital has increased, then the recoverable amount will reduce.

Taxation

The Group is subject to direct and indirect taxation in a number of jurisdictions. There may be some transactions and calculations for which the ultimate tax determination has an element of uncertainty during the ordinary course of business. The Group recognises liabilities based on estimates of the quantum of taxes that may be due. Where the final tax determination is different from the amounts that were initially recorded, such differences will impact the income tax and deferred tax expense in the year in which the determination is made.

2.2. Judgements

Impairment of equity securities

A significant or prolonged decline in the fair value of an equity security is objective evidence of impairment. The Group regards a decline of more than 20 percent in fair value as “significant” and a decline in the quoted market price that persists for nine months or longer as “prolonged”.

Valuation of financial instruments

Fair values of financial assets and financial liabilities that are traded in active markets are based on quoted market prices. If the market is not active the Group establishes a fair value by using appropriate valuation techniques. These include the use of recent arm’s length transactions, reference to other instruments that are substantially the same for which market observable prices exist, net present value and discounted cash flow analysis. The objective of valuation techniques is to determine the fair value of the financial instrument at the reporting date as the price that would have been agreed between active market participants in an arm’s length transaction.

Notes to the Consolidated Financial Statements continued

2.2. Judgements continued

The Group measures fair value using the following fair value hierarchy that reflects the significance of the inputs used in making measurements:

- Level 1: Quoted prices in active markets for identical assets or liabilities
- Level 2: Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3: inputs for the asset or liability that are not based on observable market data (unobservable inputs).

The consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads, assist in the judgement as to whether a market is active. If in the opinion of management, a significant proportion of the instrument's carrying amount is driven by unobservable inputs, the instrument in its entirety is classified as valued using significant unobservable inputs. 'Unobservable' in this context means that there is little or no current market data available from which to determine the level at which an arm's length transaction would be likely to occur. It generally does not mean that there is no market data available at all upon which to base a determination of fair value (consensus pricing data may, for example, be used).

The tables below analyses financial instruments measured at fair value by the level in the fair value hierarchy into which the measurement is categorised:

	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
At 31 December 2011				
Derivative financial instruments	–	951	–	951
Financial investments	330	–	2,746	3,076
	330	951	2,746	4,027
At 31 December 2010				
Trading securities – long positions	3,232	–	–	3,232
Financial investments	2,070	–	2,887	4,957
	5,302	–	2,887	8,189
Trading securities – short positions	775	–	–	775
Derivative financial instruments	–	184	–	184
	775	184	–	959

There were no significant transfers between level 1 and level 2 during the year.

The following table reconciles the movement in level 3 financial instruments during the year:

	2011 £000	2010 £000
Movement in level 3		
At 1 January	2,887	3,524
Purchases	–	130
Disposals	–	(450)
Losses recognised in the profit and loss	(141)	(317)
At 31 December	2,746	2,887

3. Maturity analysis of assets and liabilities

The table below shows the maturity analysis of assets and liabilities as at 31 December 2011:

At 31 December 2011	Due within one year £000	Due after more than one year £000	Total £000
ASSETS			
Cash	243,183	–	243,183
Derivative financial instruments	892	59	951
Loans and advances to banks	66,961	–	66,961
Loans and advances to customers	257,033	135,756	392,789
Debt securities held-to-maturity	30,573	9,506	40,079
Assets classified as held for sale	3,674	–	3,674
Current tax asset	457	–	457
Other assets	6,311	2,334	8,645
Financial investments	–	3,076	3,076
Intangible assets	–	3,561	3,561
Property, plant and equipment	–	5,214	5,214
Deferred tax asset	–	726	726
Total assets	609,084	160,232	769,316
LIABILITIES			
Deposits from banks	8	–	8
Deposits from customers	616,531	77,269	693,800
Liabilities relating to assets classified as held for sale	1,291	–	1,291
Other liabilities	11,838	3,055	14,893
Deferred tax liability	–	97	97
Debt securities in issue	–	12,256	12,256
Total liabilities	629,668	92,677	722,345

Notes to the Consolidated Financial Statements continued

3. Maturity analysis of assets and liabilities continued

The table below shows the maturity analysis of assets and liabilities as at 31 December 2010:

At 31 December 2010	Due within one year £000	Due after more than one year £000	Total £000
ASSETS			
Cash	73,772	–	73,772
Loans and advances to banks	12,080	–	12,080
Loans and advances to customers	211,063	89,189	300,252
Trading securities – long positions	3,232	–	3,232
Debt securities held-to-maturity	127,114	16,005	143,119
Other assets	14,284	3,664	17,948
Financial investments	–	4,957	4,957
Intangible assets	–	2,915	2,915
Property, plant and equipment	–	5,903	5,903
Deferred tax asset	–	932	932
Total assets	441,545	123,565	565,110
LIABILITIES			
Deposits from banks	3,706	–	3,706
Trading securities – short positions	775	–	775
Derivative financial instruments	184	–	184
Deposits from customers	496,964	6,293	503,257
Current tax liability	751	–	751
Other liabilities	9,387	146	9,533
Deferred tax liability	–	126	126
Debt securities in issue	–	12,630	12,630
Total liabilities	511,767	19,195	530,962

4. Financial risk management

Strategy

By their nature, the Group's activities are principally related to the use of financial instruments. The Directors and senior management of the Group have formally adopted a Group Risk and Controls Policy which sets out the Board's attitude to risk and internal controls. Key risks identified by the Directors are formally reviewed and assessed at least once a year by the Board, in addition to which key business risks are identified, evaluated and managed by operating management on an ongoing basis by means of procedures such as physical controls, credit and other authorisation limits and segregation of duties. The Board also receives regular reports on any risk matters that need to be brought to its attention. Significant risks identified in connection with the development of new activities are subject to consideration by the Board. There are budgeting procedures in place and reports are presented regularly to the Board detailing the results of each principal business unit, variances against budget and prior year, and other performance data.

The principal non-operational risks inherent in the Group's business are credit, market and liquidity risks.

(a) Credit risk

The Company and Group take on exposure to credit risk, which is the risk that a counterparty will be unable to pay amounts in full when due. Impairment provisions are provided for losses that have been incurred at the balance sheet date. Significant changes in the economy, or in the health of a particular industry segment that represents a concentration in the Company and Group's portfolio, could result in losses that are different from those provided for at the balance sheet date. Credit risk is managed through the Credit Committees of the banking subsidiaries, with significant exposures also being approved by the Group Risk Committee.

The Company and Group structure the levels of credit risk it undertakes by placing limits on the amount of risk accepted in relation to one borrower or groups of borrowers. Such risks are monitored on a revolving basis and subject to an annual or more frequent review. The limits are approved periodically by the Board of Directors and actual exposures against limits are monitored daily.

Exposure to credit risk is managed through regular analysis of the ability of borrowers and potential borrowers to meet interest and capital repayment obligations and by changing these lending limits where appropriate. Exposure to credit risk is also managed in part by obtaining collateral and corporate and personal guarantees.

4. Financial risk management continued

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of collateral to secure advances, which is common practice. The principal collateral types for loans and advances include, but are not limited to:

- Charges over residential and commercial properties;
- Charges over business assets such as premises, inventory and accounts receivable;
- Charges over financial instruments such as debt securities and equities;
- Personal guarantees; and
- Charges over other chattels

Upon initial recognition of loans and advances, the fair value of collateral is based on valuation techniques commonly used for the corresponding assets. In order to minimise any potential credit loss the Group will seek additional collateral from the counterparty as soon as impairment indicators are noticed for the relevant individual loans and advances. Repossessed collateral, not readily convertible into cash, is made available for sale in an orderly fashion, with the proceeds used to reduce or repay the outstanding indebtedness. Where excess funds are available after the debt has been repaid, they are available either for other secured lenders with lower priority or are returned to the customer.

Commitments to extend credit represent unused portions of authorisations to extend credit in the form of loans, guarantees or letters of credit. With respect to credit risk on commitments to extend credit, the Group is potentially exposed to loss in an amount equal to the total unused commitments. However, the likely amount of loss is less than the total unused commitments, as most commitments to extend credit are contingent upon customers maintaining specific credit standards.

The Group's maximum exposure to credit risk before collateral held or other credit enhancements is as follows:

	2011 £000	2010 £000
Credit risk exposures relating to on-balance sheet assets are as follows:		
Cash	243,183	73,772
Derivative financial instruments	951	–
Loans and advances to banks	66,961	12,080
Loans and advances to customers – Arbuthnot Latham	238,204	210,753
Loan and advances to customers – Secure Trust Bank	154,585	89,501
Trading securities – long positions	–	3,232
Debt securities held-to-maturity	40,079	143,119
Financial investments	3,076	4,957
Other assets	3,108	8,727
Credit risk exposures relating to off-balance sheet assets are as follows:		
Guarantees	803	485
Loan commitments and other credit related liabilities	21,841	23,469
At 31 December	772,791	570,095

The Company's maximum exposure to credit risk before collateral held or other credit enhancements is as follows:

	2011 £000	2010 £000
Credit risk exposures relating to on-balance sheet assets are as follows:		
Due from subsidiary undertakings	24,848	15,545
Financial investments	218	330
Other debtors	1,175	2,386
Credit risk exposures relating to off-balance sheet assets are as follows:		
Guarantees	2,500	2,500
At 31 December	28,741	20,761

The above table represents the maximum credit risk exposure (net of impairment) to the Group and Company at 31 December 2011 and 2010 without taking account of any collateral held or other credit enhancements attached. For on-balance-sheet assets, the exposures are based on the net carrying amounts as reported in the Statement of Financial Position.

Notes to the Consolidated Financial Statements continued

4. Financial risk management continued

The table below represents an analysis of the loan to values of the property book for the Group:

Loan to value	31 December 2011		31 December 2010	
	Loan Balance £000	Collateral £000	Loan Balance £000	Collateral £000
Less than 60%	105,907	309,328	103,320	284,285
60% – 80%	62,259	89,972	47,642	65,821
80% – 100%	21,013	23,572	12,060	13,578
Greater than 100%	25,551	21,596	15,081	11,357
Total	214,730	444,468	178,103	375,041

Concentration risk

The Group is well diversified in the UK, being exposed to retail banking and private banking. Management assesses the potential concentration risk from a number of areas including:

- geographical concentration
- product concentration; and
- high value residential properties

Due to the well diversified nature of the Group and the significant collateral held against the loan book, the Directors do not consider there to be a potential material exposure arising from concentration risk.

(b) Operational risk (unaudited)

The Group's objective is to manage operational risk so as to balance the avoidance of financial losses and damage to the Group's reputation with overall cost effectiveness and to avoid control procedures that restrict initiatives and creativity. Operational risk arises from all of the Group's operations.

The primary responsibility for the development and implementation of controls to address operational risk is assigned to the senior management within each subsidiary.

Compliance with Group standards is supported by a programme of periodic reviews undertaken by Internal Audit. The results of the Internal Audit reviews are discussed with the Company's senior management, with summaries submitted to the Arbuthnot Banking Group Audit Committee.

(c) Market risk

Price risk

The Company and Group is exposed to equity securities price risk because of investments held by the Group and classified on the Consolidated Statement of Financial Position either as available-for-sale or at fair value through the profit and loss. The Group is not exposed to commodity price risk. To manage its price risk arising from investments in equity securities, the Group diversifies its portfolio. Diversification of the portfolio is done in accordance with the limits set by the Group.

Based upon the financial investment exposure (in Note 20), a stress test scenario of a 10% (2010: 10%) decline in market prices, with all other things being equal, would result in a £22,000 (2010: £33,000) decrease in the Group's income and a decrease of £272,000 (2010: £364,000) in the Group's equity. The Group consider a 10% stress test scenario appropriate after taking the current values and historic data into account.

Based upon the financial investment exposure given in Note 20, a stress test scenario of a 10% (2010: 10%) decline in market prices, with all other things being equal, would result in a £22,000 (2010: £33,000) decrease in the Company's income and a decrease of £16,000 (2010: £24,000) in the Company's equity.

4. Financial risk management continued

Currency risk

The Company and Group takes on exposure to the effects of fluctuations in the prevailing foreign currency exchange rates on its financial position and cash flows. The Board sets limits on the level of exposure for both overnight and intra-day positions, which are monitored daily. The table below summarises the Group's exposure to foreign currency exchange rate risk at 31 December 2011. Included in the table below are the Group's assets and liabilities at carrying amounts, categorised by currency.

At 31 December 2011	GBP (£) £000	USD (\$) £000	Euro (€) £000	Other £000	Total £000
ASSETS					
Cash	242,981	140	61	1	243,183
Derivative financial instruments	951	–	–	–	951
Loans and advances to banks	59,431	4,899	578	2,053	66,961
Loans and advances to customers	338,574	4,502	47,271	2,442	392,789
Debt securities held-to-maturity	40,079	–	–	–	40,079
Other assets	8,643	2	–	–	8,645
Financial investments	330	–	2,746	–	3,076
	690,989	9,543	50,656	4,496	755,684
LIABILITIES					
Deposits from banks	8	–	–	–	8
Deposits from customers	663,653	9,821	18,271	2,055	693,800
Other liabilities	14,891	–	–	–	14,891
Debt securities in issue	–	–	12,256	–	12,256
	678,552	9,821	30,527	2,055	720,955
Net on-balance sheet position	12,437	(278)	20,129	2,441	34,729
Credit commitments	22,290	20	334	–	22,644

The table below summarise the Group's exposure to foreign currency exchange risk at 31 December 2010:

At 31 December 2010	GBP (£) £000	USD (\$) £000	Euro (€) £000	Other £000	Total £000
ASSETS					
Cash	73,667	32	73	–	73,772
Loans and advances to banks	5,188	4,945	427	1,520	12,080
Loans and advances to customers	258,486	5,090	36,676	–	300,252
Trading securities – long positions	3,220	12	–	–	3,232
Debt securities held-to-maturity	143,119	–	–	–	143,119
Other assets	17,943	4	1	–	17,948
Financial investments	1,999	71	2,887	–	4,957
	503,622	10,154	40,064	1,520	555,360
LIABILITIES					
Deposits from banks	1,812	10	13	1,871	3,706
Trading securities – short positions	775	–	–	–	775
Derivative financial instruments	184	–	–	–	184
Deposits from customers	484,904	9,947	6,873	1,533	503,257
Other liabilities	9,533	–	–	–	9,533
Debt securities in issue	–	–	12,630	–	12,630
	497,208	9,957	19,516	3,404	530,085
Net on-balance sheet position	6,414	197	20,548	(1,884)	25,275
Credit commitments	23,600	20	334	–	23,954

Notes to the Consolidated Financial Statements continued

4. Financial risk management continued

A 10% strengthening of the pound against the US dollar would lead to a £16,000 (2010: £20,000) decrease in Group profits and equity, while a 10% weakening of the pound against the US dollar would lead to the same increase in Group profits and equity. Similarly a 10% strengthening of the pound against the Euro would lead to a £8,000 (2010: £48,000) decrease in Group profits and equity, while a 10% weakening of the pound against the Euro would lead to the same increase in Group profits and equity. The above results are after taking into account the effect of derivative financial instruments (see Note 25), which covers most of the net exposure in each currency.

The table below summarise the Company's exposure to foreign currency exchange rate risk at 31 December 2011:

At 31 December 2011	GBP (£) £000	Euro (€) £000	CHF £000	Total £000
ASSETS				
Due from subsidiary undertakings	9,693	12,713	2,442	24,848
Financial investments	218	–	–	218
Other debtors	637	–	–	637
Shares in subsidiary undertakings	25,233	–	–	25,233
	35,781	12,713	2,442	50,936
LIABILITIES				
Due to subsidiary undertakings	6,020	–	–	6,020
Debt securities in issue	–	12,256	–	12,256
	6,020	12,256	–	18,276
Net on-balance sheet position	29,761	457	2,442	32,660

The table below summarise the Company's exposure to foreign currency exchange rate risk at 31 December 2010:

At 31 December 2010	GBP (£) £000	Euro (€) £000	CHF £000	Total £000
ASSETS				
Due from subsidiary undertakings	124	13,025	2,396	15,545
Financial investments	330	–	–	330
Other debtors	601	–	–	601
Shares in subsidiary undertakings	28,633	–	–	28,633
	29,688	13,025	2,396	45,109
LIABILITIES				
Deposits from banks	1,004	–	1,865	2,869
Due to subsidiary undertakings	10,097	–	–	10,097
Debt securities in issue	–	12,630	–	12,630
	11,101	12,630	1,865	25,596
Net on-balance sheet position	18,587	395	531	19,513

A 10% strengthening of the pound against the Euro would lead to £18,000 (2010: £11,000) decrease in the Company profits and equity, conversely a 10% weakening of the pound against the Euro would lead to the same increase in the Company profits and equity. A 10% strengthening of the pound against the Swiss Franc would lead to £38,000 (2010: £53,000) decrease in the Company profits and equity, conversely a 10% weakening of the pound against the Swiss Franc would lead to the same increase in the Company profits and equity. The above results are after taking into account the effect of derivative financial instruments (see Note 25), which covers most of the net Swiss Franc exposure.

4. Financial risk management continued

Interest rate risk

Interest rate risk is the potential adverse impact on the Company and Group's future cash flows from changes in interest rates; and arises from the differing interest rate risk characteristics of the Company and Group's assets and liabilities. In particular, fixed rate savings and borrowing products expose the Group to the risk that a change in interest rates could cause either a reduction in interest income or an increase in interest expense relative to variable rate interest flows. The Group seeks to "match" interest rate risk on either side of the Statement of Financial Position. However, this is not a perfect match and interest rate risk is present on: Money market transactions of a fixed rate nature, fixed rate loans and fixed rate savings accounts. There is interest rate mismatch in Arbutnot Latham and Secure Trust Bank. This is monitored on a daily basis in conjunction with liquidity and capital. The interest rate mismatch is daily monitored, throughout the maturity bandings of the book on a parallel scenario for 50, 100 and 200 basis points movement. The Group consider the 50, 100 and 200 basis points movement to be appropriate for scenario testing given the current economic outlook and industry expectations. This typically results in a pre-tax mismatch of £0.3m to £1.1m (2010: £0.6m to £2.4m) for the Group, with the same impact to equity pre-tax. The Company has no fixed rate exposures, but a upward change of 50 basis points on variable rates would increase pre-tax profits and equity by £4,000 (2010: reduce pre-tax profits and equity by £1,000).

(d) Liquidity risk

The new Liquidity regime came into force on the 1 October 2010. The FSA requires a firm to maintain at all times liquidity resources which are adequate, both as to amount and quality, to ensure that there is no significant risk that its liabilities cannot be met as they fall due. There is also a requirement that a firm ensures its liquidity resources contain an adequate buffer of high quality, unencumbered assets (i.e. Government securities in the liquidity asset buffer); and it maintains a prudent funding profile. The liquid assets buffer is a pool of highly liquid assets that can be called upon to create sufficient liquidity to meet liabilities on demand, particularly in a period of liquidity stress. The liquidity resources outside the buffer must either be marketable assets with a demonstrable secondary market that the firm can access, or a credit facility that can be activated in times of stress.

The banking entities both prepared and approved their Individual Liquidity Assessment (ILA). The liquidity buffers required by the ILA have all been put in place and maintained since. Liquidity resources outside of the buffer are made up of certificates of deposit and fixed rate notes (debt securities). The Company and Group also maintain long-term committed bank facilities.

The table below analyses the contractual undiscounted cash flows for the Group into relevant maturity groupings at 31 December 2011:

At 31 December 2011	Carrying amount £000	Gross nominal inflow/ (outflow) £000	Not more than 3 months £000	More than 3 months but less than 1 year £000	More than 1 year but less than 5 years £000	More than 5 years £000
Non-derivative liabilities						
Deposits from banks	8	(8)	(8)	–	–	–
Deposits from customers	693,800	(707,428)	(344,558)	(275,998)	(86,872)	–
Liabilities relating to assets classified as held for sale	1,291	(1,291)	(1,291)	–	–	–
Other liabilities	14,893	(15,056)	(14,821)	(109)	(126)	–
Debt securities in issue	12,256	(15,054)	(140)	(420)	(2,238)	(12,256)
Issued financial guarantee contracts		(803)	(803)	–	–	–
Unrecognised loan commitments		(21,841)	(21,841)	–	–	–
	722,248	(761,481)	(383,462)	(276,527)	(89,236)	(12,256)

Notes to the Consolidated Financial Statements continued

4. Financial risk management continued

The table below analyses the contractual undiscounted cash flows for the Group into relevant maturity groupings at 31 December 2010:

	Carrying amount £000	Gross nominal inflow/ (outflow) £000	Not more than 3 months £000	More than 3 months but less than 1 year £000	More than 1 year but less than 5 years £000	More than 5 years £000
At 31 December 2010						
Non-derivative liabilities						
Deposits from banks	3,706	(3,710)	(3,710)	–	–	–
Trading securities – short positions	775	(775)	(775)	–	–	–
Deposits from customers	503,257	(503,671)	(323,077)	(174,267)	(6,327)	–
Other liabilities	9,533	(8,294)	(8,039)	(109)	(146)	–
Debt securities in issue	12,630	(15,143)	(126)	(377)	(2,010)	(12,630)
Issued financial guarantee contracts		(485)	(485)	–	–	–
Unrecognised loan commitments		(23,469)	(23,469)	–	–	–
	529,901	(555,547)	(359,681)	(174,753)	(8,483)	(12,630)
Derivative liabilities						
Risk management:	184	–	–	–	–	–
– Inflows		20,073	20,073	–	–	–
– Outflows		(20,257)	(20,257)	–	–	–
	184	(184)	(184)	–	–	–

The table below analyses the contractual undiscounted cash flows for the Company into relevant maturity groupings at 31 December 2011:

	Carrying amount £000	Gross nominal inflow/ (outflow) £000	Not more than 3 months £000	More than 3 months but less than 1 year £000	More than 1 year but less than 5 years £000	More than 5 years £000
At 31 December 2011						
Non-derivative liabilities						
Due to subsidiary undertakings	6,020	(6,020)	(6,020)	–	–	–
Accruals	4,675	(4,675)	–	(4,675)	–	–
Debt securities in issue	12,256	(15,054)	(140)	(420)	(2,238)	(12,256)
Issued financial guarantee contracts		(2,500)	(2,500)	–	–	–
	22,951	(28,249)	(8,660)	(5,095)	(2,238)	(12,256)

The table below analyses the contractual undiscounted cash flows for the Company into relevant maturity groupings at 31 December 2010:

	Carrying amount £000	Gross nominal inflow/ (outflow) £000	Not more than 3 months £000	More than 3 months but less than 1 year £000	More than 1 year but less than 5 years £000	More than 5 years £000
At 31 December 2010						
Non-derivative liabilities						
Deposits from banks	2,869	(2,869)	(2,869)	–	–	–
Due to subsidiary undertakings	10,097	(10,097)	(10,097)	–	–	–
Accruals	849	(848)	–	(848)	–	–
Debt securities in issue	12,630	(15,143)	(126)	(377)	(2,010)	(12,630)
Issued financial guarantee contracts		(2,500)	(2,500)	–	–	–
	26,445	(31,457)	(15,592)	(1,225)	(2,010)	(12,630)

The maturities of assets and liabilities and the ability to replace, at an acceptable cost, interest-bearing liabilities as they mature are important factors in assessing the liquidity of the Group and its exposure to changes in interest rates and exchange rates.

4. Financial risk management continued

Fiduciary activities

The Group provides trustee, investment management and advisory services to third parties, which involve the Group making allocation and purchase and sale decisions in relation to a wide range of financial instruments. Those assets that are held in a fiduciary capacity are not included in these financial statements. These services give rise to the risk that the Group may be accused of maladministration or underperformance. At the balance sheet date, the Group had investment management accounts amounting to approximately £315m (2010: £225m). Additionally the Group provides investment advisory services.

(e) Financial assets and liabilities

The tables below sets out the Group's financial assets and financial liabilities into the respective classifications:

	Trading £000	Held-to- maturity £000	Loans and receivables £000	Available- for-sale £000	Other amortised cost £000	Total carrying amount £000	Fair value £000
At 31 December 2011							
Cash	–	–	243,183	–	–	243,183	243,183
Derivative financial instruments	951	–	–	–	–	951	951
Loans and advances to banks	–	–	66,961	–	–	66,961	66,961
Loans and advances to customers	–	–	392,789	–	–	392,789	392,789
Debt securities held-to-maturity	–	40,079	–	–	–	40,079	40,079
Financial investments	218	–	–	2,858	–	3,076	3,076
	1,169	40,079	702,933	2,858	–	747,039	747,039
Deposits from banks	–	–	–	–	8	8	8
Deposits from customers	–	–	–	–	693,800	693,800	693,800
Debt securities in issue	–	–	–	–	12,256	12,256	12,256
	–	–	–	–	706,064	706,064	706,064
At 31 December 2010							
Cash	–	–	73,772	–	–	73,772	73,772
Loans and advances to banks	–	–	12,080	–	–	12,080	12,080
Loans and advances to customers	–	–	300,252	–	–	300,252	300,252
Trading securities – long positions	3,232	–	–	–	–	3,232	3,232
Debt securities held-to-maturity	–	143,119	–	–	–	143,119	143,119
Financial investments	330	–	–	4,627	–	4,957	4,957
	3,562	143,119	386,104	4,627	–	537,412	537,412
Deposits from banks	–	–	–	–	3,706	3,706	3,706
Trading securities – short positions	775	–	–	–	–	775	775
Derivative financial instruments	184	–	–	–	–	184	184
Deposits from customers	–	–	–	–	503,257	503,257	503,257
Debt securities in issue	–	–	–	–	12,630	12,630	12,630
	959	–	–	–	519,593	520,552	520,552

Notes to the Consolidated Financial Statements continued

5. Capital management

The Group's capital management policy is focused on optimising shareholder value. There is a clear focus on delivering organic growth and ensuring capital resources are sufficient to support planned levels of growth. The Board regularly reviews the capital position.

In accordance with the EU's Capital Requirements Directive (CRD) and the required parameters set out in the FSA Handbook (BIPRU 2.2), the Individual Capital Assessment Process (ICAAP) is embedded in the risk management framework of the Group and is subject to ongoing updates and revisions when necessary. However, at a minimum, the ICAAP is updated annually as part of the business planning process. The ICAAP is a process that brings together management framework (i.e. the policies, procedures, strategies, and systems that the Group has implemented to identify, manage and mitigate its risks) and the financial disciplines of business planning and capital management. The Group's regulated entities are also the principal trading subsidiaries as detailed in Note 37.

Not all material risks can be mitigated by capital, but where capital is appropriate the Board has adopted a "Pillar 1 plus" approach to determine the level of capital the Group needs to hold. This method takes the Pillar 1 capital formula calculations (standardised approach for credit, market and operational risk) as a starting point, and then considers whether each of the calculations delivers a sufficient capital sum adequately to cover managements' anticipated risks. Where the Board considered that the Pillar 1 calculations did not reflect the risk, an additional capital add-on in Pillar 2 is applied, as per the Individual Capital Guidance (ICG) issued by the FSA.

The Group's regulatory capital is divided into two tiers:

- Tier 1 comprises mainly shareholders' funds, non-controlling interests, after deducting goodwill and other intangible assets.
- Lower Tier 2 comprises qualifying subordinated loan capital and revaluation reserves. Lower Tier 2 capital cannot exceed 50% of tier 1 capital.

The following table shows the regulatory capital resources as managed by the Group:

	2011 £000	2010 £000
Tier 1		
Share capital	153	150
Share premium account	21,085	21,085
Retained earnings	21,571	12,142
Other reserves	(1,976)	(1,493)
Non-controlling interests	5,998	2,118
Goodwill	(1,991)	(1,991)
Other deductions	(1,570)	(924)
Total tier 1 capital	43,270	31,087
Tier 2		
Revaluation reserve	140	146
Debt securities in issue	12,256	12,630
Total tier 2 capital	12,396	12,776
Total tier 1 & tier 2 capital	55,666	43,863

The ICAAP includes a summary of the capital required to mitigate the identified risks in its regulated entities and the amount of capital that the Group has available. The latest version of the Group ICAAP is in the process of being approved by the Board. The FSA sets ICG for each UK bank calibrated by references to its Capital Resources Requirement, broadly equivalent to 8 percent of risk weighted assets and thus representing the capital required under Pillar 1 of the Basel II framework. The ICAAP is a key input into the FSA's ICG setting process, which addresses the requirements of Pillar 2 of the Basel II framework. The FSA's approach is to monitor the available capital resources in relation to the ICG requirement. Each entity maintains an extra internal buffer and capital ratios are reviewed on a monthly basis to ensure that external requirements are adhered to. All regulated entities have complied with all of the externally imposed capital requirements to which they are subject.

Pillar 3 complements the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). Its aim is to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on a firm's capital, risk exposures and risk assessment processes. Our Pillar 3 disclosures for the year ended 31 December 2011 are published as a separate document on the Group website under Investor Relations (Announcements & Shareholder Info).

6. Fee and commission income

	2011 £000	2010 £000
Fee and commission income		
Trust and other fiduciary fee income	3,237	2,219
Other fee income	16,850	14,683
	20,087	16,902

7. Net impairment loss on financial assets

	2011 £000	2010 £000
Impairment losses on loans and advances to customers (Note 18)	6,688	3,146
Impairment losses on available-for-sale investments	125	–
	6,813	3,146

8. Other income

Other income mainly consist of a contribution of £1.1m (2010: £0.8m) towards the cost of the Swiss entity received from a possible investor.

9. Discontinued operations

On 18 November 2011, the Group entered into a conditional contract to sell its Investment Banking Division, Arbuthnot Securities Ltd, to Westhouse Holdings PLC (“Westhouse”) subject to regulatory approval. Westhouse agreed to buy Arbuthnot Securities together with its outstanding subordinated loan of £1.5m for a total of £1.9m. Also refer to note 40 for post balance sheet events.

	Year ended 31 December 2011 £000	Year ended 31 December 2010 £000
Interest and similar income	3	2
Interest expense and similar charges	(147)	(234)
Net interest income	(144)	(232)
Fee and commission income	6,783	12,949
Fee and commission expense	(273)	(194)
Net fee and commission income	6,510	12,755
Gains less losses from dealing in securities	149	4,456
Operating income	6,515	16,979
Other income	6	89
Impairment of LTIP loans, illiquid stocks and outstanding receivable	(3,716)	–
Adjustment of carrying value to fair value less costs to sell	(1,556)	–
Operating expenses	(14,447)	(16,029)
(Loss)/profit before income tax	(13,198)	1,039
Income tax credit/(expense)	2,949	(145)
(Loss)/profit after income tax	(10,249)	894

Assets classified as held for sale

	2011 £000
Loans and advances to banks	241
Trading securities – long positions	206
Other assets	1,674
Intangible assets	17
Property, plant and equipment	36
Deferred tax asset	1,500
	3,674

Notes to the Consolidated Financial Statements continued

9. Discontinued operations continued

Liabilities relating to assets classified as held for sale

	2011 £000
Trading securities – short positions	46
Other liabilities	1,245
	1,291

10. Operating profit on ordinary activities before tax

	2011 £000	2010 £000
Operating expenses comprise:		
Staff costs, including Directors:		
Wages and salaries	16,259	16,000
Social security costs	1,839	1,698
Pension costs	800	791
Amortisation of computer software (Note 21)	324	403
Depreciation (Note 22)	736	1,193
Profit on disposals of property, plant and equipment	(3)	–
Financial Services Compensation Scheme Levy	157	30
Charitable donations	126	55
Operating lease rentals	2,079	2,370
Restructuring costs	–	262
Other administrative expenses	12,208	8,801
Total operating expenses	34,525	31,603

The auditors' remuneration for the audit of the Company's accounts was £75,000 (2010: £75,000) and fees payable for the audit of the accounts of subsidiaries of the Company was £216,000 (2010: £216,000). Remuneration of the auditors for non-audit services was: services related to taxation £184,000 (2010: £163,000) and all other services £703,000 (2010: £70,000).

11. Average number of employees

	2011	2010
Retail banking	229	201
Private banking	132	125
Group	18	17
	379	343

12. Income tax expense

	2011 £000	2010 £000
United Kingdom corporation tax at 26.5% (2010: 28%)		
Current taxation		
Corporation tax charge – current year	1,700	1,514
Corporation tax charge – adjustments in respect of prior years	(99)	(201)
	1,601	1,313
Deferred taxation		
Origination and reversal of temporary differences	3	(166)
Adjustments in respect of prior years	213	91
	216	(75)
Income tax expense	1,817	1,238
Tax reconciliation		
Profit before tax	5,116	4,065
Tax at 26.5% (2010: 28%)	1,356	1,153
Permanent differences	278	190
Tax rate change	69	5
Prior period adjustments	114	(110)
Corporation tax charge for the year	1,817	1,238

13. Earnings per ordinary share*Basic and fully diluted*

Earnings per ordinary share are calculated on the net basis by dividing the loss attributable to equity holders of the Company of £5,014,000 (2010: profit of £3,747,000) by the weighted average number of ordinary shares 15,046,364 (2010: 14,999,619) in issue during the year. There is no difference between basic and fully diluted earnings per ordinary share.

14. Cash

	2011 £000	2010 £000
Cash in hand included in cash and cash equivalents (Note 35)	243,183	73,772

In 2010 a reserve account was opened at the Bank of England (BoE) to comply with the new Liquidity regime that came into force on 1 October 2010. Surplus funds are now mainly held in the BoE reserve account, with the remainder held in certificates of deposit, fixed rate notes and money market deposits in highly rated banks (the majority held in UK clearing banks). The Group took the prudent approach of moving the majority of excess funds to the BoE reserve account, after the recent down grade of UK banks and the instability in the Euro Zone.

15. Loans and advances to banks

	2011 £000	2010 £000
Placements with banks included in cash and cash equivalents (Note 35)	66,961	12,080

Notes to the Consolidated Financial Statements continued

15. Loans and advances to banks continued

The table below presents an analysis of loans and advances to banks by rating agency designation as at 31 December, based on Moody's long term ratings:

	2011 £000	2010 £000
Aaa	52,936	–
Aa1	581	–
Aa2	–	4,633
Aa3	10,575	7,447
A1	2,257	–
A2	612	–
	66,961	12,080

None of the loans and advances to banks is either past due or impaired.

16. Trading securities, all held at fair value through profit and loss

	2011 £000	2010 £000
<i>Unlisted equity securities:</i>		
Long positions	–	65
<i>Listed equity securities:</i>		
Long positions	–	3,167
Short positions	–	(775)

The following table shows the Group's trading book exposure to market price risk for the year ended 31 December 2011:

	Highest exposure £000	Lowest exposure £000	Average exposure £000	Exposure as at 31 December £000
Equities:				
Long	5,685	288	2,479	206
Short	(1,668)	(21)	(433)	(46)

At year end these exposures were transferred to assets classified as held for sale.

The following table shows the Group's trading book exposure to market price risk for the year ended 31 December 2010:

	Highest exposure £000	Lowest exposure £000	Average exposure £000	Exposure as at 31 December £000
Equities:				
Long	4,807	1,734	3,311	3,232
Short	(2,247)	(137)	(987)	(775)

17. Loans and advances to customers

	2011 £000	2010 £000
Gross loans and advances	404,039	309,448
Less: allowances for impairment on loans and advances (Note 18)	(11,250)	(9,196)
	392,789	300,252

For a maturity profile of loans and advances to customers, refer to Note 4.

17. Loans and advances to customers continued

	2011 £000	2010 £000
Loans and advances to customers include finance lease receivables as follows:		
Gross investment in finance lease receivables:		
– No later than 1 year	12,857	3,386
– Later than 1 year and no later than 5 years	10,663	5,348
– Later than 5 years	–	2
	23,520	8,736
Unearned future finance income on finance leases	(6,518)	(3,407)
Net investment in finance leases	17,002	5,329
The net investment in finance leases may be analysed as follows:		
– No later than 1 year	8,395	1,485
– Later than 1 year and no later than 5 years	8,607	3,842
– Later than 5 years	–	2
	17,002	5,329

	2011 £000	2010 £000
Loans and advances to customers can be further summarised as follows:		
Neither past due nor impaired	371,884	282,737
Past due but not impaired	19,263	11,980
Impaired	12,892	14,731
Gross	404,039	309,448
Less: allowance for impairment	(11,250)	(9,196)
Net	392,789	300,252

(a) Loans and advances past due but not impaired

	2011 £000	2010 £000
Gross amounts of loans and advances to customers that were past due but not impaired were as follows:		
Past due up to 30 days	10,217	6,860
Past due 30 – 60 days	5,272	1,416
Past due 60 – 90 days	942	668
Over 90 days	2,832	3,036
Total	19,263	11,980

Loans and advances normally fall into this category when there is a delay in either the sale of the underlying collateral or the completion of formalities to extend the credit facilities for a further period. Management have no material concerns regarding the quality of the collateral that secures the lending.

(b) Loans and advances renegotiated

Restructuring activities include external payment arrangements, modification and deferral of payments. Following restructuring, a previously overdue customer account is reset to a normal status and managed together with other similar accounts. Restructuring policies and practices are based on indicators or criteria which, in the judgement of management, indicate that payment will most likely continue. These policies are kept under continuous review. Renegotiated loans that would otherwise be past due or impaired totalled £nil (2010: £nil).

(c) Collateral held

An analysis of loans and advances to customers past due or impaired by reference to the fair value of the underlying collateral is as follows:

	2011 £000	2010 £000
Past due but not impaired	18,764	16,065
Impaired	5,735	1,403
Fair value of collateral held	24,499	17,468

Collateral is shown at fair value less costs to sell. The fair value of the collateral held is £24,499,000 against £17,698,000 secured loans, giving an average loan-to-value of 72% (2010: 34%).

Notes to the Consolidated Financial Statements continued

17. Loans and advances to customers continued

The gross amount of individually impaired loans and advances to customers before taking into account the cash flows from collateral held is £12,892,000 (2010: £14,731,000).

Interest income on loans classified as impaired totalled £745,000 (2010: £1,919,000).

18. Allowances for impairment of loans and advances

A reconciliation of the allowance account for losses on loans and advances by class is as follows:	2011 £000	2010 £000
At 1 January	9,196	7,301
Impairment losses	7,367	3,146
Loans written off during the year as uncollectible	(4,634)	(1,251)
Amounts recovered during the year	(679)	–
At 31 December	11,250	9,196

A further analysis of allowances for impairment of loans and advances is as follows:	2011 £000	2010 £000
Loans and advances to customers – Arbuthnot Latham	2,386	1,398
Loan and advances to customers – unsecured – Secure Trust Bank	8,864	7,798
At 31 December	11,250	9,196

19. Debt securities held-to-maturity

Debt securities represent certificates of deposit. The Group's intention is to hold them to maturity and, therefore, they are stated in the Statement of Financial Position at amortised cost. Amounts include £nil (2010: £nil) with a maturity, when placed, of 3 months or less included in cash and cash equivalents (Note 35).

The movement in debt securities held to maturity may be summarised as follows:	2011 £000	2010 £000
At 1 January	143,119	127,597
Additions	174,401	452,576
Redemptions	(277,441)	(437,054)
At 31 December	40,079	143,119

The table below presents an analysis of debt securities by rating agency designation at 31 December, based on Moody's long term ratings:

	2011 £000	2010 £000
Aaa	15,291	4,005
Aa2	4,510	13,018
Aa3	11,775	126,096
A1	8,503	–
	40,079	143,119

None of the debt securities held-to-maturity are either past due or impaired.

20. Financial investments

Group:	2011 £000	2010 £000
Financial investments comprise:		
– Securities (at fair value through profit and loss)	218	330
– Securities (available-for-sale)	2,858	4,627
Total financial investments	3,076	4,957

Unlisted securities

The Group has made equity investments in unlisted special purpose vehicles set up to acquire and enhance the value of commercial properties. These investments are of a medium term nature. There is no open market for these investments therefore the Group has valued them using appropriate valuation methodologies, which include net asset valuations and discounted future cash flows.

20. Financial investments continued

The Directors intend to dispose of these assets when a suitable buyer has been identified and when the Directors believe that the underlying assets have reached their maximum value.

Company	2011 £000	2010 £000
Financial investments comprise:		
– Listed securities (at fair value through profit and loss)	218	330

21. Intangible assets

Goodwill Group	2011 £000	2010 £000
Opening net book amount	1,991	1,991
Closing net book amount	1,991	1,991

**Computer software
Group**

Cost	£000
At 1 January 2010	3,725
Additions	426
At 31 December 2010	4,151
Additions	1,004
Disposals	(177)
Transfer to assets classified as held for sale	(58)
At 31 December 2011	4,920

Accumulated amortisation

At 1 January 2010	(2,810)
Amortisation charge	(417)
At 31 December 2010	(3,227)
Amortisation charge	(333)
Disposals	177
Transfer to assets classified as held for sale	33
At 31 December 2011	(3,350)

Net book amount

At 31 December 2010	924
At 31 December 2011	1,570

Total intangible assets	2011 £000	2010 £000
Goodwill	1,991	1,991
Computer software	1,570	924
Net book amount at 31 December	3,561	2,915

Refer to note 1.13 (a) for assumptions used in the impairment review of goodwill.

Notes to the Consolidated Financial Statements continued

22. Property, plant and equipment

Group	Freehold land and buildings £000	Computer and other equipment £000	Operating leases £000	Motor vehicles £000	Total £000
Cost or valuation					
At 1 January 2010	4,850	11,494	2,095	328	18,767
Additions	–	286	–	–	286
Disposals	–	(2)	(2,095)	(118)	(2,215)
At 31 December 2010	4,850	11,778	–	210	16,838
Additions	–	205	–	–	205
Disposals	–	(609)	–	(210)	(819)
Transfer to assets classified as held for sale	–	(200)	–	–	(200)
At 31 December 2011	4,850	11,174	–	–	16,024
Accumulated depreciation					
At 1 January 2010	(529)	(8,997)	(468)	(221)	(10,215)
Depreciation charge	(78)	(1,154)	–	(30)	(1,262)
Disposals	–	–	468	74	542
At 31 December 2010	(607)	(10,151)	–	(177)	(10,935)
Depreciation charge	(78)	(731)	–	–	(809)
Disposals	–	609	–	177	786
Transfer to assets classified as held for sale	–	148	–	–	148
At 31 December 2011	(685)	(10,125)	–	–	(10,810)
Net book amount					
At 31 December 2010	4,243	1,627	–	33	5,903
At 31 December 2011	4,165	1,049	–	–	5,214

The Group's freehold property at 1 Arleston Way, Solihull, B90 4LH, was valued on 17 December 2008 by an Independent external valuer, who is a Fellow of the Royal Institute of Chartered Surveyors. The Valuation was in accordance with the requirements of the RICS Valuation Standards 6th Edition and the International Valuation Standards. The Valuation of the property was on the basis and assumption it is an Owner/Occupied property, valued to Market Value assuming that the property will be sold as part of the continuing business. The Valuer's opinion of Market Value was primarily derived using comparable recent market transactions on arms-length terms. The Directors have assessed the value at year end through comparison to current rental yields on similar properties in the area and do not believe that the fair value of freehold property is materially different from the carrying value. All freehold land and buildings are occupied and used by Group companies. The carrying value of freehold land not depreciated is £0.5 million (2010: £0.5 million).

The historical cost of freehold property included at valuation is as follows:

	2011 £000	2010 £000
Cost	4,792	4,792
Accumulated depreciation	(1,057)	(967)
Net book amount	3,735	3,825

Motor vehicles include the following amounts where the Group is a lessee under a finance lease:

	2011 £000	2010 £000
Cost – capitalised finance leases	–	306
Accumulated depreciation	–	(199)
Net book amount	–	107

22. Property, plant and equipment continued

Company	Computer and other equipment £000
Cost or valuation	
At 1 January 2010	126
Additions	17
At 31 December 2010	143
Additions	46
At 31 December 2011	189
Accumulated depreciation	
At 1 January 2010	(48)
Depreciation charge	(7)
At 31 December 2010	(55)
Depreciation charge	(7)
At 31 December 2011	(62)
Net book amount	
At 31 December 2010	88
At 31 December 2011	127

23. Other assets

	2011 £000	2010 £000
Trade receivables	3,108	8,727
Repossessed collateral – held-for-sale	2,334	2,205
Prepayments and accrued income	3,203	7,016
	8,645	17,948

24. Deposits from banks

	2011 £000	2010 £000
Deposits from other banks	8	3,706

For a maturity profile of deposits from banks, refer to Note 4.

25. Derivative financial instruments

	2011			2010		
	Contract/ notional amount	Fair value assets	Fair value liabilities	Contract/ notional amount	Fair value assets	Fair value liabilities
Currency swaps	20,840	325	–	20,073	–	184
Interest rate caps	40,000	59	–	–	–	–
Structured notes	691	567	–	–	–	–
	61,531	951	–	20,073	–	184

The principal derivatives used by the Group are exchange rate contracts and cash flow hedges. Exchange rate related contracts include currency swaps and cash flow hedges include interest rate caps.

A forward foreign exchange contract is an agreement to buy or sell a specified amount of foreign currency on a specified future date at an agreed rate. Currency swaps generally involve the exchange of interest payment obligations denominated in different currencies; exchange of principal can be notional or actual. The currency swaps are settled net and therefore the fair value is small in comparison to the contract/notional amount.

Notes to the Consolidated Financial Statements continued

25. Derivative financial instruments continued

An interest rate cap is a option contract which puts an upper limit on a floating exchange rate. The writer of the cap has to pay the holder of the cap the difference between the floating rate and the reference rate when that reference rate is breached. The holder pays a premium for the cap.

Also included in derivative financial instruments are structured notes. These notes contain embedded derivatives (embedded options to buy and sell indicies) and non-derivative host contracts (discounted bonds). Both the host and embedded derivatives are presented net within derivative financial instruments.

The Company only uses investment graded banks for derivative financial instruments.

The table below presents an analysis of derivative financial instruments contract/notional amounts by rating agency designation at 31 December, based on Moody's long term ratings:

	2011 £000	2010 £000
Aa3	21,531	20,073
A1	40,000	–
	61,531	20,073

26. Deposits from customers

	2011 £000	2010 £000
Current/demand accounts	202,843	179,209
Term deposits	490,957	324,048
	693,800	503,257

Included in customer accounts are deposits of £8,578,000 (2010: £10,035,000) held as collateral for loans and advances. The fair value of these deposits approximates the carrying value.

For a maturity profile of deposits from customers, refer to Note 4.

27. Other liabilities

	2011 £000	2010 £000
Trade payables	7,069	1,835
Finance lease liabilities	–	25
Accruals and deferred income	7,824	7,673
	14,893	9,533

The Financial Services Compensation Scheme ('FSCS') has provided compensation to consumers following the collapse of a number of deposit takers. The compensation paid out to consumers is currently funded through loans from the Bank of England and HM Treasury.

At 31 December 2011, the Group had accrued £355,000 (2010: £353,000) in respect of the levy, based on the bank's estimated share of total market protected deposits.

27. Other liabilities continued*a.) Finance lease liabilities*

Lease liabilities are effectively secured as the rights to the leased asset revert to the lessor in the event of default.

	2011 £000	2010 £000
Gross finance lease liabilities – minimum lease payments		
Within 1 year	–	26
	–	26
Future finance charges on finance leases	–	(1)
Present value of finance lease liabilities	–	25
The present value of finance lease liabilities is as follows:		
Within 1 year	–	25
	–	25

28. Debt securities in issue

	2011 £000	2010 £000
Subordinated loan notes 2035	12,256	12,630

The subordinated loan notes 2035 were issued on 7 November 2005 and are denominated in Euros. The principal amount outstanding at 31 December 2011 was €15,000,000 (2010: €15,000,000). The notes carry interest at 3% over the interbank rate for three month deposits in euros and are repayable at par in August 2035 unless redeemed or repurchased earlier by the Company.

The contractual undiscounted amount that will be required to be paid at maturity of the above debt securities is €15,000,000.

Given the fact that the Group has never been subject to a published credit rating by any of the relevant agencies and the notes in issue are not quoted, it is not considered possible to approximate a fair value for these notes.

29. Deferred taxation

The deferred tax asset comprises:

	2011 £000	2010 £000
Unrealised surplus on revaluation of freehold property	(97)	(126)
Accelerated capital allowances and other short-term timing differences	607	870
Movement in fair value of derivatives	110	–
Tax losses	2,098	62
Transfer to assets classified as held for sale	(2,089)	–
Deferred tax asset	629	806
At 1 January	806	302
Revaluation reserve	–	(70)
Available-for-sale securities	55	(55)
Movement in fair value of derivatives	110	–
Profit and loss account – accelerated capital allowances and other short-term timing differences	(217)	35
Profit and loss account – tax losses	1,964	594
Transfer to assets classified as held for sale	(2,089)	–
Deferred tax asset at 31 December	629	806

The above balance is made up as follows:

	2011 £000	2010 £000
Deferred tax assets within the Group	726	932
Deferred tax liabilities within the Group	(97)	(126)
	629	806

Notes to the Consolidated Financial Statements continued

29. Deferred taxation continued

Deferred tax assets are recognised for tax losses to the extent that the realisation of the related tax benefit through future taxable profits is probable.

During the year the Government substantively enacted a reduction in UK corporation tax rate to 26% with effect from 1 April 2011 and to 25% with effect from 1 April 2012. This will reduce the Group's future current tax charge accordingly. Deferred tax has been calculated at the corporation tax rates applicable to the financial years in which it is expected that the assets will be realised or the liabilities settled, being 25%.

On the 23 March 2011 the Government announced its intention to further reduce the UK corporation tax rate to 23% by April 2014. It has not yet been possible to quantify the full anticipated effect of the announced further 2% reduction, although this will further reduce the Group's future current tax charge and reduce the Group's deferred tax balances accordingly.

30. Contingent liabilities and commitments

Capital commitments

At 31 December 2011, the Group had capital commitments of £nil (2010: £nil) in respect of equipment purchases.

Credit commitments

The contractual amounts of the Group's off-balance sheet financial instruments that commit it to extend credit to customers are as follows:

	2011 £000	2010 £000
Guarantees and other contingent liabilities	803	485
Commitments to extend credit:		
– Original term to maturity of one year or less	21,841	23,469
	22,644	23,954

Operating lease commitments

Where a Group company is the lessee, the future aggregate lease payments under non-cancellable operating leases are as follows:

	2011 £000	2010 £000
Expiring:		
Within 1 year	1,877	1,798
Later than 1 year and no later than 5 years	5,324	151
Later than 5 years	43	57
	7,244	2,006

Other commitments

At 31 December 2011 a commitment exists to make further payments with regard to the Financial Compensation Scheme Levy for 2011 and thereafter. Due to uncertainties regarding the calculation of the levy and the Group's share thereof, the Directors consider this cost to be unquantifiable.

31. Share capital

	Number of shares	Ordinary share capital £000	Share premium £000
At 1 January 2011	14,999,619	150	21,085
Rights issue	279,703	3	–
At 31 December 2011	15,279,322	153	21,085

During the year there was a rights issue of 279,703 shares, as shares were issued as part of a scrip dividend alternative (2010: no change in share capital). All issued shares are fully paid.

At 31 December 2011 the Company held 380,274 shares (2010: 380,274) in treasury.

32. Reserves and retained earnings

Group	2011 £000	2010 £000
Foreign currency translation reserve	(570)	(558)
Revaluation reserve	140	146
Capital redemption reserve	20	20
Available-for-sale reserve	–	142
Cash flow hedging reserve	(329)	–
Treasury shares	(1,097)	(1,097)
Retained earnings	21,571	12,142
Total reserves at 31 December	19,735	10,795

The revaluation reserve represents the unrealised change in the fair value of properties.

The foreign exchange translation reserve represents the cumulative gains and losses on the retranslation of the Group's and the Company's net investment in foreign operations, net of the effects of economic hedging.

The capital redemption reserve represents a reserve created after the Company purchased its own shares which resulted in a reduction of share capital.

Company	2011 £000	2010 £000
Capital redemption reserve	20	20
Treasury shares	(1,097)	(1,097)
Retained earnings	8,517	415
Total reserves as 31 December	7,440	(662)

33. Share-based payment options

At 31 December 2011, the Company had the following equity settled share-based payment awards outstanding:

- On 21 May 2008 Mr. Salmon was granted an option to subscribe for 100,000 ordinary 1p shares in the Company between May 2011 and May 2015 at 337.5p. The fair value of the option at grant date was £nil.
- On 5 November 2008 Mr. Cobb was granted an option to subscribe for 50,000 ordinary 1p shares in the Company between November 2011 and November 2015 at 320p. The fair value of the option at grant date was £nil.
- On 22 December 2009 Dr. Turrell was granted an option to subscribe for 50,000 ordinary 1p shares in the Company at 380p which may be executed in December 2012. The fair value of the option at grant date was £nil.

On 17 October 2011, the Secure Trust Bank Group established a Share Option Scheme that entitles key management personnel and senior employees of Secure Trust Bank to purchase shares in that company. All options are non-transferable and there are no cash settlement alternatives.

Options are forfeited if they remain unexercised after a period of more than 10 years from the date of grant. If the participant ceases to be employed by the Group by reason of injury, disability, ill-health or redundancy; or because his employing company ceases to be a shareholder of the Group; or because his employing business is being transferred out of the Group, his option may be exercised within 6 months after such cessation. In the event of the death of a participant, the personal representatives of a participant may exercise an option, to the extent exercisable at the date of death, within 6 months after the death of the participant.

On cessation of employment for any other reason (or when a participant serves, or has been served with, notice of termination of such employment), the option will lapse although the Remuneration Committee has discretion to allow the exercise of the option for a period not exceeding 6 months from the date of such cessation.

In such circumstances, the performance conditions may be modified or waived as the Remuneration Committee, acting fairly and reasonably and taking due consideration of the circumstances, thinks fit. The number of shares which can be acquired on exercise will be pro-rated on a time elapsed basis, unless the Remuneration Committee, acting fairly and reasonably and taking due consideration of the circumstances, decides otherwise. In determining whether to exercise its discretion in these respects, the Remuneration Committee must satisfy itself that the early exercise of an option does not constitute a reward for failure.

Notes to the Consolidated Financial Statements continued

33. Share-based payment options continued

On 2 November 2011 934,998 share options were granted at an exercise price of 720p per share. Half of the share options are exercisable on 2 November 2014 with the remainder exercisable on 2 November 2016. At the grant date these share options had a fair value of £1,580,147. The movement within reserves during the year was £70,000 (2010: £nil). Of the share options granted on 2 November 2011, the following were to Group directors:

- Mr. Lynam was granted an option to subscribe for 141,666 ordinary 40p shares in Secure Trust Bank PLC at 720p between 2 November 2014 and 1 November 2021 and a further 141,667 shares at 720p between 2 November 2016 and 1 November 2021.
- Mr. Salmon was granted an option to subscribe for 141,666 ordinary 40p shares in Secure Trust Bank PLC at 720p between 2 November 2014 and 1 November 2021 and a further 141,667 shares at 720p between 2 November 2016 and 1 November 2021.

Subsequent to the year end the Secure Trust Bank Group Share Option Scheme was altered to allow cash rather than equity settlement.

34. Dividends per share

Final dividends are not accounted for until they have been approved at the Annual General Meeting. At the meeting on 16 May 2012, a dividend in respect of 2011 of 13 pence per share (2010: actual dividend 12 pence per share) amounting to a total of £1.94m (2010: actual £1.75m) is to be proposed. The financial statements for the year ended 31 December 2011 do not reflect the final dividend which will be accounted for in shareholders' equity as an appropriation of retained profits in the year ending 31 December 2012.

35. Cash and cash equivalents

For the purposes of the Statement of Cash Flows, cash and cash equivalents comprises of the following balances with less than three months maturity from the date of acquisition.

	2011 £000	2010 £000
Cash (Note 14)	243,183	73,772
Loans and advances to banks (Note 15)	66,961	12,080
	310,144	85,852

36. Related-party transactions

Related parties of the Company and Group include subsidiaries, Key Management Personnel, close family members of Key Management Personnel and entities which are controlled, jointly controlled or significantly influenced, or for which significant voting power is held, by Key Management Personnel or their close family members.

Other than the directors' remuneration, payment of dividends and transactions with subsidiaries, there were no related party transactions within the Parent Company. A number of banking transactions are entered into with related parties in the normal course of business on normal commercial terms. These include loans and deposits. Except for the directors' disclosures, there were no other Key Management Personnel disclosures; therefore the tables below relate to directors.

	Directors	
	2011 £000	2010 £000
Loans		
Loans outstanding at 1 January	2,952	2,936
Loans advanced during the year	98	17
Loan repayments during the year	(673)	(1)
Loans outstanding at 31 December	2,377	2,952
Interest income earned	167	143

The loans to directors are secured on property or shares and bear interest at rates linked to base rate. No provisions have been recognised in respect of loans given to related parties (2010: £nil). Details of directors' remuneration are given in the Remuneration Report. The Directors do not believe that any other key management disclosures are required.

36. Related-party transactions continued

	2011 £000	Directors 2010 £000
Deposits		
Deposits at 1 January	2,468	1,880
Deposits placed during the year	4,021	1,265
Deposits repaid during the year	(5,216)	(677)
Deposits at 31 December	1,273	2,468
Interest expense on deposits	134	90

Details of principal subsidiaries are given in Note 37. Transactions and balances with subsidiaries are shown below:

	2011		Subsidiaries		2010	
	Highest balance during the year £000	Balance at 31 December £000	Highest balance during the year £000	Balance at 31 December £000	Highest balance during the year £000	Balance at 31 December £000
ASSETS						
Due from subsidiary undertakings	27,072	24,848	15,545	15,545		
Shares in subsidiary undertakings	25,233	25,233	28,633	28,633		
Total assets	52,305	50,081	44,178	44,178		
LIABILITIES						
Due to subsidiary undertakings	12,263	6,020	10,243	10,097		
Total liabilities	12,263	6,020	10,243	10,097		
Issued guarantee contracts	2,500	2,500	2,500	2,500		

The disclosure of the year-end balance and the highest balance during the year is considered the most meaningful information to represent the transactions during the year. The above transactions arose during the normal course of business and are on substantially the same terms as for comparable transactions with third-parties.

37. Shares in subsidiary undertakings

	Shares at cost £000	Impairment provisions £000	Net £000
Arbuthnot Banking Group PLC:			
At 1 January 2010	31,603	(2,979)	28,624
Adjustment	9	–	9
At 31 December 2010	31,612	(2,979)	28,633
Allotment of shares in Arbuthnot Securities Limited	1,800	–	1,800
Impairment of investment in Arbuthnot Securities Limited	–	(3,303)	(3,303)
Sale of shares in Secure Trust Bank PLC	(1,897)	–	(1,897)
At 31 December 2011	31,515	(6,282)	25,233
		2011 £000	2010 £000
Subsidiary undertakings:			
Banks		22,589	24,486
Other		2,644	4,147
Total		25,233	28,633

Notes to the Consolidated Financial Statements continued

37. Shares in subsidiary undertakings continued

The principal subsidiary undertakings of Arbuthnot Banking Group PLC at 31 December 2011 were:

	Country of incorporation	Interest %	Principal activity
Secure Trust Bank PLC	UK	75.5	Retail banking
Arbuthnot Latham & Co., Limited	UK	100	Private banking
Arbuthnot AG	Switzerland	100	Private banking
Arbuthnot Securities Limited (discontinued)	UK	78.7	Investment banking

(i) All the above subsidiary undertakings are included in the consolidated financial statements and have an accounting reference date of 31 December.

(ii) All the above interests relate wholly to ordinary shares.

38. Operating segments

The Group is organised into three main operating segments, arranged over three separate companies with each having its own specialised banking service, as disclosed below:

- 1) Retail banking – incorporating household cash management, personal lending and banking and insurance services.
- 2) UK Private banking – incorporating private banking and wealth management.
- 3) International Private banking – incorporating private banking and wealth management outside the UK.

Transactions between the operating segments are on normal commercial terms. Centrally incurred expenses are charged to operating segments on an appropriate pro-rata basis. Segment assets and liabilities comprise operating assets and liabilities, being the majority of the balance sheet.

	Discontinued operations		Continuing operations			Total £000	Group Total £000
	Investment banking £000	Retail banking £000	UK Private banking £000	International Private banking £000	Group (reconciling items) £000		
Year ended 31 December 2011							
Interest revenue	3	22,836	16,405	–	296	39,537	
Inter-segment revenue	–	(11)	(139)	–	(154)	(304)	
Interest revenue from external customers	3	22,825	16,266	–	142	39,233	
Fee and commission income	6,783	12,662	7,425	–	–	20,087	
Revenue from external customers	6,786	35,487	23,691	–	142	59,320	
Interest expense	(147)	(5,609)	(5,811)	(54)	57	(11,417)	
Subordinated loan note interest	–	–	–	–	(573)	(573)	
Segment operating income	6,515	28,460	17,688	(54)	(636)	45,458	
Impairment losses	–	(4,601)	(2,212)	–	–	(6,813)	
Segment profit/(loss) before tax	(13,198)	9,061	1,958	(47)	(5,856)	5,116	
Income tax (expense)/income	2,949	(2,241)	448	–	(24)	(1,817)	
Segment profit/(loss) after tax	(10,249)	6,820	2,406	(47)	(5,880)	3,299	(6,950)
Segment total assets	7,859	307,935	554,935	85	(101,498)	761,457	769,316
Segment total liabilities	2,791	284,025	532,591	2,542	(99,604)	719,554	722,345
Other segment items:							
Capital expenditure	(9)	(140)	(1,013)	–	(47)	(1,200)	(1,209)
Depreciation and amortisation	(76)	(606)	(440)	(5)	(15)	(1,066)	(1,142)

The “Group” segment above includes the parent entity and all intercompany eliminations and fulfils the requirement of IFRS8.28.

38. Operating segments continued

	Discontinued operations		Continuing operations			Total £000	Group Total £000
	Investment banking £000	Retail banking £000	UK Private banking £000	International Private banking £000	Group (reconciling items) £000		
Year ended 31 December 2011							
Interest revenue	2	15,883	13,750	–	356	29,989	
Inter-segment revenue	–	–	(315)	–	(349)	(664)	
Interest revenue from external customers	2	15,883	13,435	–	7	29,325	
Fee and commission income	12,949	11,489	5,413	–	–	16,902	
Revenue from external customers	12,951	27,372	18,848	–	7	46,227	
Interest expense	(234)	(3,419)	(4,370)	–	317	(7,472)	
Subordinated loan note interest	–	–	–	–	(483)	(483)	
Segment operating income	16,979	23,953	14,429	–	(610)	37,772	
Impairment losses	–	(2,167)	(979)	–	–	(3,146)	
Segment profit/(loss) before tax	1,039	8,511	1,045	(100)	(5,391)	4,065	
Income tax (expense)/income	(145)	(2,005)	(49)	–	816	(1,238)	
Segment profit/(loss) after tax	894	6,506	996	(100)	(4,575)	2,827	3,721
Segment total assets	12,045	181,026	417,618	4	(45,583)	553,065	565,110
Segment total liabilities	5,659	165,110	394,713	2,408	(36,928)	525,303	530,962
Other segment items:							
Capital expenditure	(82)	(301)	(272)	–	(57)	(630)	(712)
Depreciation and amortisation	(83)	(961)	(551)	(74)	(10)	(1,596)	(1,679)

Segment profit is shown prior to any intra-group eliminations.

Other than the International private banking operations which are in Switzerland, all the Group's other operations are conducted wholly within the United Kingdom and geographical information is therefore not presented.

39. Ultimate controlling party

The Company regards Henry Angest, the Group Chairman and Chief Executive Officer, who has a beneficial interest in 53.6% of the issued share capital of the Company, as the ultimate controlling party. Details of his remuneration are given in the Remuneration Report and Note 36 of the consolidated financial statements includes related party transactions with Mr Angest.

40. Events after the balance sheet date

Regulatory approval was received for the sale of Arbuthnot Securities on 17 January 2012 and the sale completed on 20 January 2012. Also refer to note 9. Except for the sale of Arbuthnot Securities, there were no other material post balance sheet events.

Five Year Summary

In the table below, all the figures are presented in accordance with IFRS.

	2007 £000	2008 £000	2009 £000	2010 £000	2011 £000
Profit/(Loss) before tax *	8,579	(2,150)	5,050	5,104	5,116
Earnings per share					
Basic (p) **	23.8	3.5	23.4	25.0	(33.3)
Dividends per share (p)	33.0	21.0	22.0	23.0	24.0
Net asset value per share (p)	283.2	229.4	227.6	227.7	312.2

* The profit before tax for 2011 is shown as the continuing operations results. The previous years have not been restated but the contribution of the discontinued operation can be seen in the segmental analysis for those historical years.

** The earnings per share includes the effect of discontinued operations in 2011.

Response to Independent Commission on Banking Report

Where Vickers is Wrong

(Ring-Fencing doesn't solve the problem of "too big to fail")

The main feature of the Vickers Report which distinguishes it from attempts being made elsewhere to reform the banking system is its proposed introduction of ring-fencing for the retail activities of complex banking groups. Politicians of all parties, and even some more knowledgeable commentators, have been falling over themselves to embrace the Report. We are more sceptical.

Ring-Fencing

We believe that ring-fencing won't solve the problem of "too big to fail" because it is based on two premises which we believe to be flawed. If we are right, Vickers won't help prevent a repeat of the banking collapse of 2008-09. These premises are as follows:-

Premise 1

That the banking crisis was caused by excessive risk-taking in the banks, especially investment banks. Whilst there was clearly – with the benefit of hindsight – excessive risk-taking, you can't say that this caused the banking crisis without explaining why banks suddenly started taking excessive risks. They did so, we would argue, precisely because they did not think the risks excessive. They considered them to be sensible and well-judged. For the most part, the banks taking these decisions did so within corporate governance structures which complied fully with practice. Institutional shareholders put pressure on management to deliver growth – not just in profits, but also in revenues and market share. Regulators and rating agencies were comfortable with the risks being taken. Why? In answering that question, perhaps we will come clearer to understanding what caused the crisis and what needs to be done to ensure it doesn't happen again.

Fifteen years of uninterrupted growth, with low inflation and cheap borrowing, had created the illusion that politicians and central bankers had somehow found the way to break the cycle. There would be "no more boom and bust". An intellectual climate had been created in which debt levels – personal, corporate or sovereign – were discounted as a risk, asset bubbles viewed as genuine wealth creation and default or business failure regarded as remote contingencies most likely to be associated with fraud or catastrophic management failure. As the economy overheated, politicians were happy to take credit for the apparent economic miracle which their "wise policies" seemed to be producing.

In truth, they and the officials that they appointed (regulators, central bankers and others) bear a heavy responsibility for what happened. Instead of stoking up bullish sentiment with complacent remarks on how well the economy was growing and how much better off the population was getting, politicians entrusted with power should have used it more maturely and responsibly.

They should have paid heed to the warning signals which were flashing – particularly debt levels and the real estate asset bubble. How different things might have been if politicians had been more interested in governing responsibly and less fixated on satisfying personal ambition. No wonder they were so keen to fix responsibility for the whole debacle on the bankers!

How is this relevant to Vickers? Simply this – four major UK banking collapses in 2007-09 (Northern Rock, Bradford & Bingley, Alliance and Leicester and HBos) took place within the ring-fence. They were not caused by a rogue trader or by the proliferation of opaque, complex products in the business mix. They were caused by a persistent, institutionalised misreading of risk, which permeated everywhere in the intellectual climate which we have described above. If our politicians, central bankers and regulators are as complacent in the future as they were in the years leading up to 2007/8, there is nothing in Vickers to prevent the same thing happening again. What is needed is the practical judgement to spot problems as they develop and the political will to act to cool down overheating markets, even if that is electorally unpopular. As we saw, that proved to be too much to ask in 2007/08.

Premise 2

That governments can allow investment banking businesses to fail. This is a highly dubious premise which Vickers takes as given without attempting to justify it. In fact, all the weight of evidence is against this idea. Lehman had no retail business, yet its collapse proved disastrous for the global banking system. Admittedly, many of its counterparties were banks with a retail component but the fact remains that the interconnectedness to the financial system of investment banks and their products is profound and complicated, and goes well beyond counterparty relations with other investment banks outside the ring-fence. Investment banks have connections to the underwriters of credit insurance for their products. Those insurance underwriters have often a systemic status within the financial system, and are often also underwriting products sold to the retail market. Investment banks' connections extend also to industrial corporations of various kinds through derivatives and cash flow management products which they run to manage risk. The last financial crisis demonstrated that interconnectedness is complex and unpredictable – the accountants are still trying to quantify and unwind the trades entered into by Lehman three years after it collapsed! Once contagion starts to spread it is very difficult to stop. We believe that the consequences of allowing an investment bank to fail can never really be understood by a government or regulator until the event happens and the full ramifications unfold. It would be a reckless act by a government to allow this to happen without understanding fully the impact of the collapse.

Response to Independent Commission on Banking Report continued

If you want any further demonstration that ring-fencing is irrelevant, and that banking crises are grounded in the actions of governments, central bankers and regulators, look at the current threat to the banking system – sovereign debt. A ring-fenced bank's balance sheet would be as likely (perhaps even more likely) to be full of Greek and other dubious government bonds as the most aggressive investment bank. And why? Because central bankers and regulators treated these bonds as fungible with the bonds issued by serious countries, it made some sort of sense for banks to invest heavily into these bonds even as their yields rose, given the lack of return available elsewhere. Thus was the global system presented with its current existential threat.

How robust would a ring-fence be in separating retail and investment banking anyway? The ring-fence is an artificial division between the retail and investment banks which relies on procedures, definitions and controls to ensure that products and activities remain on the intended side of the divide. We can be sure that armies of highly intelligent investment bankers will be hard at work devising products and transactions which cross over the ring-fence – because it is by crossing over the ring-fence that banks will maximise their return on capital. Ultimately Vickers intends that the integrity of the ring-fence will be policed by non-executive directors and regulators. In the last crisis, both demonstrated their limitations comprehensively.

Let us draw to a conclusion on the ring-fence. It is doubtful that it will make a material difference to the security of the banking system in a crisis. Even taken together with the other measures being put in place by the Basel Committee on Banking Supervision, the EU and the UK, it is not obvious the financial system will prove robust when subjected to extreme stress.

Capital
Vickers follows the approach of Basel, the EU and the UK regulatory authorities in calling for banks to hold more capital – specifically, that UK ring-fenced banks be required to have a minimum equity – to – Risk-Weighted Assets (“RWA”) ratio of at least 10%. We have two criticisms to make of this proposal. First, it is prescriptive, “one-size-fits-all”, and therefore bears no relation to the actual risks being taken by any one bank. We would argue that some banks need more than 10%, (where Vickers agrees), but some banks need less capital – and not all RWA's actually bear the risk allocated to them by regulators, as the sovereign debt crisis is showing. Second, the size of the losses incurred – or likely to be incurred once banks finally recognise them – by UK banks in the crisis is likely to be so great that no sensible capital base would have been capable of absorbing them. So Vickers seems to be missing the point on capital, and if his proposals are implemented they will raise costs to banks, reduce lending in the economy and raise barriers to entry for new banks, while perhaps not solving the problem! Vickers does have some positive ideas on the subject of capital, though. We think it makes great sense to introduce overall “leverage” limits, and that the proposal to make quasi equity or subordinated debt more truly risk-bearing through “bail-ins” is useful.

Competition
Turning now to another area touched on by Vickers – competition. It is clear from the language of the report that for Vickers competition means mainly the creation of a fifth, sixth or seventh major national bank to challenge the big four, created probably by the acquisition of branches from one or more of the majors. He does touch on the need to reduce the barriers to entry for new smaller banks but we would argue that this is a limited view of competition.

One of the consequences of the financial crisis is that the major banks have withdrawn from a large number of specialised and niche lending markets as part of their general policy of retrenchment. They have also taken a step back from the unsecured lending market and, in some cases, from the mortgage market as well. The effect on consumers and on small businesses has not showed up as a readily identifiable component of the general business gloom, but there can be little doubt that the withdrawal of lending capacity from these markets is having a negative effect on the overall economy. Some niche lenders have been able to benefit from the opportunity that the withdrawal of the big banks has created.

It is our contention that a competition policy which encouraged and facilitated the growth of more small banks could be hugely beneficial both to the economy and to the health and stability of the banking system. Although these small banks would compete in a limited way with the majors in certain products, sectors or geographical area, they would have the vital function of providing lending in specific niches where the major banks had reduced their exposure. If conditions were created which permitted such small banks to flourish, the result would be a major enhancement of both competition within the sector and improved access to lending for businesses and consumers, through the introduction of players who represent no systemic risk.

There is no shortage of entrepreneurs ready to create such small banks. The market opportunity which exists at the moment is widely understood. The barriers to entry are very high. These barriers are represented by regulation which seeks to impose rules devised for large, complex, multinational banks to all banks, irrespective of size and complexity. This “one size fits all” approach to regulation saddles prospective new entrants to the sector with unnecessarily onerous capital requirements, high ongoing costs relating to compliance and governance and leads to interminable delays in securing licences, launching products and hiring staff.

It is a pity that Vickers missed the opportunity to emphasise more the role of small banks in a healthy and stable financial system. The measures needed to remove the regulatory barriers are easy to implement. What is required is not less regulation, but rather regulation which is more tailored to the particular risks being taken. “Sensitive” regulation would be based around an understanding of the business model, and would take account of management’s record and experience, the ownership structure of the business, and the Board’s overall attitude to risk. That approach to regulation might be better for the major banks too!

Avoiding “Too Big to Fail”

We cannot leave the topic of ring-fencing, without considering the question of what approach would work to solve this problem. We have already said that the role of government, central banks and regulators is key, but we recognise that bank executives are far from blameless, and we have some suggestions to offer as to how the management of banks can be put on a more prudential footing.

The best solution, in an ideal world, would be to break the big banks up into many smaller players of manageable size. With many smaller banks, the demise of any one would have no systemic impact on the financial system, and a wide choice would become available to bank customers. In other business sectors the benefits of this approach have long been understood. We think of the breakup of the Rockefellers’ Standard Oil in the United States into the “Seven Sisters”, and of the Bell Corporation into numerous “Baby Bells”. In banking, however, the trend has been in the opposite direction, partly because of weak competition policy (allowing, for example, the disastrous takeover of HBoS by Lloyds Banking Group), partly as a result of globalisation, and partly as a result of the collapse of some competitors during the banking crisis (e.g. Northern Rock, Alliance & Leicester and Bradford & Bingley). Realistically, we have to acknowledge that breaking up of the big banks is politically unacceptable. It would certainly precipitate the flight of some banking head offices and a large chunk of international banking business abroad, and destroy the eminence of London as a global financial centre.

If we cannot de-risk the system by downsizing the banking juggernauts, we have to consider ways in which we can most effectively influence the behaviour of banking executives to make them more responsible. We would suggest that the way to do this is not to hedge executives about with ineffective corporate governance structures, but rather to align their interests more directly and more tightly to the long-term health and success of the banks they lead. What we are suggesting is that they should be put into the position of proprietors – in a partnership sense – of the businesses that they manage, to reverse the separation between ownership and management which we believe encourages irresponsible, short-termist behaviour.

Suppose we encouraged – even required – the senior executives of banks (including key officeholders like the Chairman) to purchase amounts of equity substantial in personal terms in the banks which they run. These shareholdings would be financed by loans from the banks covered on commercial terms. This arrangement would focus the mind of management wonderfully on not just the share price performance but also the security of the banks of which they have charge, since a banking failure would have the effect of putting the directors at risk of personal bankruptcy. This approach is completely against the grain of Vickers and all other attempts to regulate the banking sector, which emphasise the role of independent non-executive directors and take the separation of ownership from management as a given. We believe the opposite approach stands a better chance of working: placing reliance not on a myriad of controls but rather on aligning the personal interests of the executives with the objective of financial stability. Their minds could be concentrated even further by introducing a criminal offence of creating a banking failure through irresponsible management of a bank, adding the risk of prison to that of bankruptcy as a sanction.

Henry Angest and Atholl Turrell
Arbuthnot Banking Group PLC

Corporate Contacts & Advisers

Group Address

Arbuthnot Banking Group
Arbuthnot House
20 Ropemaker Street
London EC2Y 9AR
T 020 7012 2400
E info@arbuthnotgroup.co.uk
www.arbuthnotgroup.com

Registered Office

One Arleston Way
Solihull B90 4LH
T 0121 693 9100
F 0121 693 9124

Corporate Contacts

Secure Trust Bank
One Arleston Way
Solihull B90 4LH
T 0121 693 9100
F 0121 693 9124
E banking@securetrustbank.com
www.securetrustbank.com

Arbuthnot Latham & Co
Arbuthnot House
20 Ropemaker Street
London EC2Y 9AR
T 020 7012 2500
F 020 7012 2501
E banking@arbuthnot.co.uk
www.arbuthnot.co.uk

17 Southernhay West
Exeter EX1 1PJ
T 01392 496061
F 01392 495313

Advisers

Auditors:
KPMG Audit Plc

Principal Bankers:
Barclays Bank PLC
Lloyds TSB plc

Stockbrokers:
Numis Securities Limited

Nominated Advisor:
Canaccord Genuity Hawkpoint

Registrars:
Capita Registrars
The Registry
34 Beckenham Road
Beckenham, Kent BR3 4TU

Arbuthnot House
20 Ropemaker Street
London EC2Y 9AR

T 020 7012 2400
E info@arbuthnotgroup.com
www.arbuthnotgroup.com

Registration No. 1954085