ARBUTHNOT BANKING GROUP PLC

Interim Report 2019

The importance of history and Sun Tzu

The importance of previous experience cannot be overstated. "Those who are not willing to learn from history are doomed to repeat the mistakes of previous generations."

A good place to start, therefore, is with the famous Chinese General, Sun Tzu and his writings in "The Art of War" ca. 2500 years ago. He established some basic truths such as:

"He whose ranks are united in purpose will be victorious."

"The commander will surely choose those who are most fortunate."

"The traits of a true commander are: courage, wisdom, humanity and integrity."

Origins of Arbuthnot Latham

George Arbuthnot (1772 – 1843) was a son of the Edinburgh banker Robert Arbuthnot. He started in 1803 as a partner in Latour & Co. in Madras (today Chennai), Southern India. Latour & Co. had been set up in 1780 by Count Francis Joseph Louis Latour de Quercy, who died in 1808. In 1807 Latour & Co. became Arbuthnot & Co. and George Arbuthnot became the leading partner until he retired in 1824. In his farewell letter to the partners he said:

"…not only give the constituent (client) the assurance that his money is safe, but also give him the feeling that he is benefitting himself by dealing with the House."

In 1826 John Alves Arbuthnot started as a clerk at Arbuthnot & Co. and in 1831 became a partner. He married the daughter of George Arbuthnot. Upon his return to London he established, together with Alfred Latham, the trading house Arbuthnot & Latham on 13 March 1833.

(For more details, read the book: Arbuthnot Latham 1833 – 2013 by David Lascelles)

Directors

Sir Henry Angest
Chairman and Chief Executive

Nigel Boardman
Independent Non-Executive Director

James Cobb FCA
Group Finance Director

Ian Dewar FCA
Independent Non-Executive Director

Sir Christopher Meyer
Independent Non-Executive Director

Andrew Salmon FCA
Chief Operating Officer

Sir Alan Yarrow FCSI (Hons)
Independent Non-Executive Director

Secretary
Nicholas Jennings FCA

Arbuthnot Banking Group PLC

The Seven Principles

Ever since George Arbuthnot first gave guidance about corporate behaviour, it has been the culture of Arbuthnot to follow his advice. The Seven Principles summarise Arbuthnot's corporate philosophy and ethics.

During the 186 year history of serving its customers, Arbuthnot has proven its ability to adopt and grow by applying such principles with pragmatism and common sense.

1. Arbuthnot serves its **shareholders**, its **customers** and its **employees** with **integrity** and **high ethical standards.** This is demonstrated in a **progressive dividend** policy, in **fair pricing** and in **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 business is conducted in an **innovative, flexible** and **entrepreneurial** manner, with an **opportunistic** and **counter-cyclical** attitude.

5. Arbuthnot's approach is based on **diversification** to spread the risk, a **long-term view** to further growth, **empowerment of management** and a culture of **rewards for achievements** to engender loyalty.

6. Arbuthnot does not sacrifice **long term prospects** for short term gains – nor sacrifice **stability** for quick profits, and it will never put the whole company at **risk.**

7. Ultimately, the success of Arbuthnot depends on the **teamwork, commitment**, and **performance** of its employees, combined with the **determination** to win.

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.
To this end, an inclusive and balanced work environment will provide a rewarding as well as challenging multiformity.

Sir Henry Angest
Chairman & CEO

16 July 2019

Chairman's Statement

Arbuthnot Banking Group PLC

I am pleased to report that Arbuthnot Banking Group ("ABG", "the Group") has delivered a profit before tax of £2.9m for the first six months of 2019. This compares to a profit of £1.2m for the same period in 2018.

While profit before tax has increased by 142%, this is not the main highlight of the first half. The capital raising activities that have been completed are more significant for the longer term prospects. Firstly, following a good set of financial results by Secure Trust Bank PLC, we were able to sell a further 1.05 million shares or 37% of our remaining holding in that company. This was completed at the market price of £14.60 per share and released a further £15.3m of capital, which is available for use by the Group.

Secondly, following the AGM the Group dual listed its Ordinary Shares on the NEX Exchange Growth Market ("NEX") and on admission issued 152,621 new Ordinary Non-Voting shares. This now provides an alternative potential means of raising capital.

Interestingly, the issuance of the new non-voting shares received 99.9% approval at the AGM after the shareholder service agency, ISS, recommended that shareholders should vote in favour of the resolution, pointing out that "…the Company has clearly explained the rationale behind the proposal and no significant concerns have been identified.". In the current environment of heightened scrutiny on corporate governance, we welcomed such a resounding endorsement of our plans.

Finally, on 3 June we announced that we had issued £25m of subordinated tier 2 qualifying loan notes to Proventus, a Swedish debt fund. We are delighted to have found such a partner for the business and hope that we can develop a long-term relationship, such that the capital instrument can be increased and also renewed over time.

Given the increase in surplus capital, strong liquidity and also the newly established Arbuthnot Direct deposit platform, the Group was in a good position to participate in a residential mortgage portfolio transaction that was introduced to us in the second quarter of the year. Following on from the due diligence phases, we announced on 3 July that we had exchanged contracts to purchase approximately £266m of loan balances for a blended discounted rate of 97.2%. This transaction is expected to complete on 8 August 2019 when the mortgage contracts will be released from the securitisation vehicle in which they are currently held. The loans have very similar characteristics to the portfolio that we acquired from the administrators of the Dunfermline Building Society in December 2014. This portfolio has performed very well for us over the past 4 and a half years, with our credit loss experience totalling only £40,000 compared to forecast losses at the time of the acquisition of approximately £3m.

Given the strong financial position of the Group, the Board has decided to increase the interim dividend by 1p to 16p, which will be paid on 16 August 2019 to shareholders on the register on 26 July 2019.

Arbuthnot Latham & Co., Limited

Arbuthnot Latham ("AL") has reported a profit before tax for the first half of the year of £6.7m (H1 2018: £5.4m), which represents an increase of 24%. The total assets of the Bank have increased to £2.33bn (H1 2018: £1.96bn), an increase of 19%. This is a result of the ongoing activity in the Bank to generate new customer loan and deposit balances. Customer loans ended the first half at £1.28bn (H1 2018: £1.10bn), an increase of 16% from the previous year and £51m higher than the balance at 31 December 2018.

The Bank originated new loans of £206m during the first half which is in line with the prior period. However, as previously communicated, the lending markets remain competitive and the number of loan repayments continues to impact the loan portfolios of the Bank.

Customer deposits have increased to £1.83bn (H1 2018: £1.55bn), an increase of 18% and £115m higher than at the end of 2018. The increase reflects the good work done by both the Private and Commercial Bankers in attracting new clients to the Bank and also building on existing relationships. Assets Under Management have increased from the low point at the end of 2018 to £1.03bn (H1 2018: £1.07bn).

Credit impairments have increased by £1.1m, with £200k of impairments as a result of the IFRS 9 Stage 1 requirement. Outside of this, the credit trends appear to be in line with expectations although Renaissance Asset Finance ("RAF") has seen a slight increase in arrears in the SME sector, which appears to be an industry wide occurrence.

Private Bank

As the strategy has evolved to refocus the Private Bankers on developing relationships with new and existing criteria clients, the lending activities have migrated toward the Commercial Bank that contains specialist lenders better placed to underwrite the lending. As a result, the Private Banking loan portfolio has fallen by 2% with written loan volumes being 32% lower than in the previous year. Loan repayments have also remained at high levels as we continue to refuse to defend refinance offers instead, preferring to maintain our stance of not chasing business that offers returns below our expectations or that are not appropriately priced for the risk we would take.

However, interaction and activity levels with criteria clients have increased as the new business development team became established. As a result, the level of new private clients joining the Bank has increased by 13% compared to the prior year, which has led to an increase in deposits balances to £1.04bn.

Commercial Bank

The Commercial Bank continues to make good progress. The volume of transactional payments has increased by 16% year on year and online transactions have seen an uplift of 15%. Lending balances have increased 36% compared to the previous period.

The relationship banking model is proving to be popular with clients as demonstrated by the increase in the level of deposits to £669m, compared to £471m in the previous year.

We were disappointed that the Commercial Bank was not successful in its application for the second tranche of the Capability and Innovation Fund awards, which is part of the RBS remedies scheme. However, the Bank has reapplied to be part of the third tranche.

Renaissance Asset Finance (“RAF”)

The lead indicators for the business have continued to show good performance during the first half. Customer balances have increased by 26% compared to the previous year to £98m. RAF delivered a record growth of lending in May 2019, generating new lending volumes of £9.1m.

However, despite the higher level of activity, profitability has declined due to yield compression with increased competition in asset finance markets. The business has also experienced materially lower levels of early termination of contracts. In particular, clients who have financed the purchase of high value cars are holding on to these vehicles for longer than before. This has resulted in the income being earned over a longer period of time rather than being brought forward at the termination event.

Other Divisions

The Asset Based Lending division had a good start to the year increasing its customer balances by 559% to stand at £58m. This is also an increase of 130% from the balances at year end 31 December 2018.

The business has developed a good network of introducers with a distribution team that covers the vast majority of England. The future pipeline of opportunities remains healthy.

The management team have consistently delivered ahead of their forecast milestones and as a result, have managed to achieve monthly breakeven since April 2019.

The Specialist Lending division have written its first loan in the second quarter of the year and despite holding back market interest while they remain in a soft launch phase, has a growing pipeline of deals on which to concentrate on as they move into full production in the second half of the year.

Secure Trust Bank PLC

As explained in the Annual Report and Accounts for 2018, our holding in Secure Trust Bank (“STB”) is now classified as a financial investment, rather than an Associate company. This treatment results in the dividend income of £1m for the first half of the year being recorded in Other Income, while the income received from the Associate in the prior year is classified as a discontinued activity.

Outlook

The geopolitical and macroeconomic environment is unclear and the potential damaging effect of a hard left Labour government remains a real threat. However, the Group continues to diversify its sources of income and deposits. This, along with the soon to be completed purchase of the mortgage portfolio, means that we are confident that the prospects of the Group remain good.

Sir Henry Angest
Chairman & CEO

16 July 2019

Consolidated Statement of Comprehensive Income

	Note	Six months ended 30 June 2019 £000	Six months ended 30 June 2018 £000
Interest income		35,251	28,628
Interest expense		(6,483)	(3,651)
Net interest income		**28,768**	**24,977**
Fee and commission income		6,935	6,513
Fee and commission expense		(80)	(112)
Net fee and commission income		**6,855**	**6,401**
Operating income		**35,623**	**31,378**
Net impairment loss on financial assets		(1,317)	(208)
Other income	6	2,384	1,649
Operating expenses		(33,801)	(31,636)
Profit before income tax		**2,889**	**1,183**
Income tax expense		(413)	(275)
Profit after income tax from continuing operations		**2,476**	**908**
Profit from discontinued operations after tax	9	–	2,329
Profit for the period		**2,476**	**3,237**
Other comprehensive income			
Items that will not be reclassified to profit or loss			
Changes in fair value of equity investments at fair value through other comprehensive income		7,370	135
Tax on other comprehensive income		(53)	(26)
Other comprehensive income for the period, net of tax		**7,317**	**109**
Total comprehensive income for the period		**9,793**	**3,346**
Profit attributable to:			
Equity holders of the Company		2,476	3,237
		2,476	**3,237**
Total comprehensive income attributable to:			
Equity holders of the Company		9,793	3,346
		9,793	**3,346**
Earnings per share for profit attributable to the equity holders of the Company during the period (expressed in pence per share):			
– basic	8	16.6	21.7
– diluted	8	16.6	21.7

The notes on pages 8 to 18 are an integral part of these consolidated financial statements

Consolidated Statement of Financial Position

	At 30 June 2019 £000	At 30 June 2018 £000	At 31 December 2018 £000
ASSETS			
Cash and balances at central banks	431,760	361,892	405,325
Loans and advances to banks	85,775	76,840	54,173
Debt securities at amortised cost	383,459	307,560	342,691
Assets classified as held for sale	8,020	8,017	8,002
Derivative financial instruments	1,354	1,906	1,846
Loans and advances to customers	1,275,372	1,096,739	1,224,656
Other assets	15,286	23,036	12,716
Financial investments	27,467	2,459	35,351
Deferred tax asset	1,438	2,032	1,490
Investment in associate	–	84,032	–
Intangible assets	17,349	15,941	16,538
Property, plant and equipment	5,453	5,311	5,304
Right-of-use assets	20,559	–	–
Investment properties	69,446	59,439	67,081
Total assets	**2,342,738**	**2,045,204**	**2,175,173**
EQUITY AND LIABILITIES			
Equity attributable to owners of the parent			
Share capital	154	153	153
Retained earnings	207,940	236,007	209,083
Other reserves	(4,273)	(840)	(13,280)
Total equity	**203,821**	**235,320**	**195,956**
LIABILITIES			
Deposits from banks	236,203	232,152	232,675
Derivative financial instruments	174	1,383	188
Deposits from customers	1,829,227	1,546,607	1,714,286
Current tax liability	649	550	236
Other liabilities	14,124	16,103	18,549
Lease liabilities	20,882	–	–
Debt securities in issue	37,658	13,089	13,283
Total liabilities	**2,138,917**	**1,809,884**	**1,979,217**
Total equity and liabilities	**2,342,738**	**2,045,204**	**2,175,173**

The notes on pages 8 to 18 are an integral part of these consolidated financial statements

Consolidated Statement of Changes in Equity

	Attributable to equity holders of the Group						
	Share capital £000	Revaluation reserve £000	Capital redemption reserve £000	Fair value reserve £000	Treasury shares £000	Retained earnings £000	Total £000
Balance at 1 January 2019	**153**	**–**	**20**	**(12,169)**	**(1,131)**	**209,083**	**195,956**
Total comprehensive income for the period							
Profit for the six months ended 30 June 2019	–	–	–	–	–	2,476	2,476
Other comprehensive income, net of income tax							
Changes in the fair value of financial assets at FVOCI	–	–	–	7,370	–	–	7,370
Tax on other comprehensive income	–	–	–	(53)	–	–	(53)
Total other comprehensive income	**–**	**–**	**–**	**7,317**	**–**	**–**	**7,317**
Total comprehensive income for the period	**–**	**–**	**–**	**7,317**	**–**	**2,476**	**9,793**
Transactions with owners, recorded directly in equity							
Contributions by and distributions to owners							
Issue of non-voting share capital	1	–	(2)	–	–	(32)	(33)
Unwind Employee Trust	–	–	–	–	–	1,083	1,083
Sale of Secure Trust Bank shares	–	–	–	1,692	–	(1,692)	–
Final dividend relating to 2018	–	–	–	–	–	(2,978)	(2,978)
Total contributions by and distributions to owners	**1**	**–**	**(2)**	**1,692**	**–**	**(3,619)**	**(1,928)**
Balance at 30 June 2019	**154**	**–**	**18**	**(3,160)**	**(1,131)**	**207,940**	**203,821**

	Attributable to equity holders of the Group						
	Share capital £000	Revaluation reserve £000	Capital redemption reserve £000	Fair value reserve £000	Treasury shares £000	Retained earnings £000	Total £000
Balance at 31 December 2017	**153**	**–**	**20**	**162**	**(1,131)**	**237,171**	**236,375**
IFRS 9 adjustment	–	–	–	–	–	(2,257)	(2,257)
Balance at 1 January 2018	**153**	**–**	**20**	**162**	**(1,131)**	**234,914**	**234,118**
Total comprehensive income for the period							
Profit for the six months ended 30 June 2018	–	–	–	–	–	3,237	3,237
Other comprehensive income, net of income tax							
Changes in the fair value of financial assets at FVOCI	–	–	–	135	–	–	135
Tax on other comprehensive income	–	–	–	(26)	–	–	(26)
Total other comprehensive income	**–**	**–**	**–**	**109**	**–**	**–**	**109**
Total comprehensive income for the period	**–**	**–**	**–**	**109**	**–**	**3,237**	**3,346**
Transactions with owners, recorded directly in equity							
Contributions by and distributions to owners							
Unwind Employee Trust	–	–	–	–	–	685	685
Final dividend relating to 2017	–	–	–	–	–	(2,829)	(2,829)
Total contributions by and distributions to owners	**–**	**–**	**–**	**–**	**–**	**(2,144)**	**(2,144)**
Balance at 30 June 2018	**153**	**–**	**20**	**271**	**(1,131)**	**236,007**	**235,320**

The notes on pages 8 to 18 are an integral part of these consolidated financial statements

Consolidated Statement of Cash Flows

	Six months ended 30 June 2019 £000	Six months ended 30 June 2018 £000
Cash flows from operating activities		
Interest received	46,707	39,584
Interest paid	(6,796)	(3,889)
Fees and commissions received	4,798	6,740
Net trading and other income	2,384	1,649
Cash payments to employees and suppliers	(16,938)	(40,947)
Cash flows from operating profits before changes in operating assets and liabilities	30,155	3,137
Changes in operating assets and liabilities:		
- net decrease in derivative financial instruments	478	1,097
- net increase in loans and advances to customers	(51,806)	(50,442)
- net increase in other assets	(23,147)	(7,742)
- net increase in deposits from banks	3,528	37,055
- net increase in amounts due to customers	114,941	155,826
- net increase / (decrease) in other liabilities	16,457	(136)
Net cash inflow from operating activities	**90,606**	**138,795**
Cash flows from investing activities		
Purchase of financial investments	(128)	(107)
Disposal of financial investments	15,330	136
Purchase of computer software	(1,723)	(748)
Refurbishment cost investment property	(2,365)	–
Purchase of property, plant and equipment	(837)	(1,799)
Proceeds from sale of property, plant and equipment	–	39
Purchases of debt securities	(325,055)	(153,823)
Proceeds from redemption of debt securities	285,187	75,288
Net cash outflow from investing activities	**(29,591)**	**(81,014)**
Cash flows from financing activities		
Dividends paid	(2,978)	(2,829)
Net cash used in financing activities	**(2,978)**	**(2,829)**
Net increase in cash and cash equivalents	58,037	54,952
Cash and cash equivalents at 1 January	459,498	383,780
Cash and cash equivalents at 30 June	**517,535**	**438,732**

The notes on pages 8 to 18 are an integral part of these consolidated financial statements

Notes to the Consolidated Financial Statements

1. Basis of preparation

The interim financial statements have been prepared on the basis of accounting policies set out in the Group's 2018 statutory accounts as amended by standards and interpretations effective during 2019 as set out below and in accordance with IAS 34 "Interim Financial Reporting". The directors do not consider the fair value of the assets and liabilities presented in these financial statements to be materially different from their carrying value.

The statements were approved by the Board of Directors on 16 July 2019 and are unaudited. The interim financial statements will be available on the Group website (www.arbuthnotgroup.com) from 17 July 2019.

2. 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.

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

Strategic risk

Strategic risk is the risk that may affect the Group's ability to achieve its corporate and strategic objectives. This risk is important to the Group as it continues its growth strategy. However, the Group seeks to mitigate strategic risk by focusing on a sustainable business model which is aligned to the Group's business strategy. Also, the Board of Directors meets once a year to hold a two day board meeting to ensure that the Group's strategy is appropriate for the market and economy.

Credit risk

Credit risk is the risk that a counterparty will be unable to pay amounts in full when due. This risk exists in Arbuthnot Latham, which currently has a loan book of £1,275m. The lending portfolio in AL is extended to clients, the majority of which is secured against cash, property or other assets. Credit risk is managed through the Credit Committee of AL.

Market risk

Market risk arises in relation to movements in 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. As a result, 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. The Group actively monitors its exposure to future interest rate rises.

The Group is exposed to changes in the market value of properties. The current carrying value of Investment Property is £69.4m. Any changes in the market value of the property will be accounted for in the Income Statement and as a result could have a significant impact on the profit or loss of the Group.

The Group has a 9.85% interest in STB. This is currently recorded in the Group's balance sheet as a Financial Investment. The carrying value is adjusted to market value at each balance sheet date, according to the share price of STB. Any gains or losses that arise are recorded in Other Comprehensive Income.

Liquidity risk

Liquidity risk is the risk that the Group cannot meet its obligations as they fall due. The Group takes a conservative approach to managing its liquidity profile. Retail client deposits and drawings from the Bank of England Term Funding Scheme fund the Group. The loan to deposit ratio is maintained at a prudent level, and consequently the Group maintains a high level of liquidity. The AL Board annually approves the Individual Liquidity Adequacy Assessment Process ("ILAAP"). The Directors model various stress scenarios and assess the resultant cash flows in order to evaluate the Group's potential liquidity requirements. The Directors firmly believe that sufficient liquid assets are held to enable the Group to meet its liabilities in a stressed environment.

Operational risk

Operational risk is the risk that the Group may be exposed to financial losses from conducting its business. The Group is 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.

Notes to the Consolidated Financial Statements *continued*

2. Risks and uncertainties (continued)

Cyber risk

Cyber risk is an increasing risk that the Group is subject to within its operational processes. This is the risk that the Group is subject to some form of disruption arising from an interruption to its IT and data infrastructure. The Group regularly test the infrastructure to ensure that it remains robust to a range of threats, and has continuity of business plans in place including a disaster recovery plan.

Conduct risk

As a financial services provider we face conduct risk, including selling products to customers which do not meet their needs, failing to deal with customers' complaints effectively, not meeting customers' expectations, and exhibiting behaviours which do not meet market or regulatory standards.

The Group adopts a zero risk appetite for any unfair customer outcomes. It 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 followed. The Group also has insurance policies in place to provide some cover for any claims that may arise.

Regulatory risk

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 its capital. The Board approves an ICAAP annually, which includes the performance of stringent stress tests to ensure that capital resources are adequate over a three year horizon. Capital and liquidity ratios are regularly monitored against the Board's approved risk appetite as part of the risk management framework.

Regulatory change also exists as a risk to the Group's business. Notwithstanding the assessments carried out by the Group to manage the regulatory risk, it is not possible to predict how regulatory and legislative changes may alter and impact the business. Significant and unforeseen regulatory changes may reduce the Group's competitive situation and lower its profitability.

Macroeconomic and competitive environment

The Group is also exposed to indirect risks that may arise from the macroeconomic and competitive environment. The economic environment is relatively stable in the UK. However, the international landscape is increasingly uncertain. The uncertain performance of the economies in the EU and the increasingly protectionist stance being taken by other major economies may have an adverse affect on the UK. In particular, this may cause a further softening of central London property prices, which may spread out further to the South East.

The Group monitors its exposure to future interest rate rises and currently has minimal lending to customers in products that would be directly sensitive to interest rate rises. However, at the current levels of interest rates, the affordability enjoyed by the Group's customers is beneficial.

Brexit

Given the uncertainty that exists over Brexit with the UK due to exit from the EU, the Group has tried to anticipate the risks that it may face if an economic shock arises as a result. It has also examined how business activities may be affected if free provision of services cross borders is prohibited.

The Group's only overseas operation is in Dubai, so the vast majority of the Group's income and expenditure is based in the UK. However, after leaving the EU we may no longer be able to provide financial advisory services to EU citizens in the EU. This amounts to an insignificant value of fees within the Income Statement. We have however made plans to be able to generate uninterrupted EU payments via the SEPA network.

Analysis is ongoing with our card service providers to ensure that data transfers made from the UK to EU and vice versa are compliant with the appropriate Data Protection Rules.

Finally, there are two significant business risks that may arise in an economic shock. Firstly, increased credit risk as borrowers are unable to continue to meet their interest obligations as they fall due. This would be alongside a significant fall in the collateral values of our security held against the loans. The average loan to value of our lending book is 53.7%, so to have any material impact this fall in collateral values would have to be severe and prolonged. In our ICAAP stress test scenarios, we are able to withstand a property value fall of 40% over an 18 month period alongside a doubling of our loss rates.

The second significant asset class that would be at risk in a down turn would be the Investment Properties, in particular 20 King Street. Any potential reduction in confidence in the West End prime office market would manifest itself in a lower valuation.

Notes to the Consolidated Financial Statements *continued*

3. Changes in significant accounting policies

IFRS 16, 'Leases'

This note explains the impact of the adoption of IFRS 16 Leases on the Group's financial statements.

The Group has adopted IFRS 16 under the modified retrospective transition approach from 1 January 2019 and has not restated comparatives for the 2018 reporting period, as permitted under the specific transitional provisions in the standard.

a) Adjustments recognised on adoption of IFRS 16

On adoption of IFRS 16, the Group recognised lease liabilities in relation to leases which had previously been classified as 'operating leases' under the principles of IAS 17 Leases. These liabilities were measured at the present value of the remaining lease payments, discounted using the lessee's incremental borrowing rate as of 1 January 2019.

The associated right-of-use assets were measured on the modified retrospective transition approach option two. The right-of-use assets were measured at the amount equal to the lease liability, adjusted by the amount of any prepaid or accrued lease payments relating to that lease recognised in the balance sheet as at 31 December 2018. There were no onerous lease contracts that would have required an adjustment to the right-of-use assets at the date of initial application.

The recognised right-of-use assets relate to the following types of assets:

	30 June 2019 £000	1 January 2019 £000
Investment properties	7,992	8,029
Properties	12,131	13,385
Equipment	436	–
Total Right-of-use assets	**20,559**	**21,414**

The change in accounting policy affected the following items on the balance sheet on 1 January 2019:

- Investment properties - increase by £8,029k (shown as right-of-use asset)
- Property, plant and equipment - increase by £13,385k (shown as right-of-use asset)
- Lease liabilities - increase by £21,459k

There was no impact to retained earnings due to the retrospective modified approach option two being used.

b) Practical expedients applied

In applying IFRS 16 for the first time, the Group has used the following practical expedients permitted by the standard:

- the use of a single discount rate to a portfolio of leases with reasonably similar characteristics
- reliance on previous assessments on whether leases are onerous
- the accounting for operating leases with a remaining lease term of less than 12 months as at 1 January 2019 as short-term leases
- the exclusion of initial direct costs for the measurement of the right-of-use asset at the date of initial application, and
- the use of hindsight in determining the lease term where the contract contains options to extend or terminate the lease.

The Group has also elected not to reassess whether a contract is, or contains a lease at the date of initial application. Instead, for contracts entered into before the transition date the group relied on its assessment made applying IAS 17 and IFRIC 4 Determining whether an Arrangement contains a Lease.

Notes to the Consolidated Financial Statements *continued*

3. Changes in significant accounting policies (continued)

c) The Group's leasing activities and how these are accounted for

The Group has leasehold investment property, offices and equipment all under operating leases. Rental contracts are typically made |for fixed periods but may have extension or termination options. Extension and termination options are included in a number of property and equipment leases across the Group. These terms are used to maximise operational flexibility in terms of managing contracts. The extension and termination options held are exercisable only by the Group and not by the respective lessor.

Lease terms are negotiated on an individual basis and contain a wide range of different terms and conditions. The lease agreements do not impose any covenants, but leased assets may not be used as security for borrowing purposes.

Until the 2018 financial year, leases of investment property and property, plant and equipment were classified as operating leases. Payments made under operating leases (net of any incentives received from the lessor) were charged to profit or loss on a straight-line basis over the period of the lease.

From 1 January 2019, leases are recognised as a right-of-use asset and a corresponding liability at the date at which the leased asset is available for use by the Group. Each lease payment is allocated between the liability and finance cost. The finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. The right-of-use asset is depreciated over the shorter of the asset's useful life and the lease term on a straight-line basis.

Assets and liabilities arising from a lease are initially measured on a present value basis. Lease liabilities include the net present value of the following lease payments:

- fixed payments less any lease incentives receivable
- the exercise price of a purchase option if the lessee is reasonably certain to exercise that option, and
- payments of penalties for terminating the lease, if the lease term reflects the lessee exercising that option.

The lease payments are discounted using the lessee's incremental borrowing rate, being the rate that the Group would have to pay to borrow the funds necessary to obtain an asset of similar value in a similar economic environment with similar terms and conditions.

Right-of-use assets are measured at cost comprising the following:

- the amount of the initial measurement of the lease liability
- any lease payments made at or before the commencement date less any lease incentives received
- any initial direct costs, and
- any restoration costs payable.

Payments associated with short-term leases and leases of low-value assets are recognised on a straight-line basis as an expense in profit or loss. Short-term leases are leases with a lease term of 12 months or less.

Notes to the Consolidated Financial Statements *continued*

4. Valuation of financial instruments

The Group measures the fair value of an instrument using quoted prices in an active market for that instrument. A market is regarded as active if quoted prices are readily and regularly available and represent actual and regularly occurring market transactions.
If a market for a financial instrument is not active, the Group establishes fair value using a valuation technique. 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 be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants. In the event that fair values of assets and liabilities cannot be reliably measured, they are carried at cost.

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). This category includes instruments valued using: quoted market prices in active markets for similar instruments; quoted prices for identical or similar instruments in markets that are considered less than active; or other valuation techniques in which all significant inputs are directly or indirectly observable from market data.
- Level 3: Inputs that are unobservable. This category includes all instruments for which the valuation technique includes inputs not based on observable data and the unobservable inputs have a significant effect on the instrument's valuation. This category includes instruments that are valued based on quoted prices for similar instruments for which significant unobservable adjustments or assumptions are required to reflect differences between the instruments.

The consideration of factors such as the magnitude and frequency of trading activity, the availability of prices and the size of bid/offer spreads assists 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 analyse financial instruments measured at fair value by the level in the fair value hierarchy into which the measurement is categorised:

At 30 June 2019	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
ASSETS				
Derivative financial instruments	–	1,354	–	1,354
Financial assets at FVOCI	25,932	–	1,535	27,467
	25,932	**1,354**	**1,535**	**28,821**
LIABILITIES				
Derivative financial instruments	–	174	–	174
	–	**174**	**–**	**174**

Notes to the Consolidated Financial Statements *continued*

4. Valuation of financial instruments (continued)

At 30 June 2018	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
ASSETS				
Derivative financial instruments	–	1,906	–	1,906
Financial investments	17	–	2,442	2,459
	17	**1,906**	**2,442**	**4,365**
LIABILITIES				
Derivative financial instruments	–	1,383	–	1,383
	–	**1,383**	**–**	**1,383**

At 31 December 2018	Level 1 £000	Level 2 £000	Level 3 £000	Total £000
ASSETS				
Derivative financial instruments	–	1,846	–	1,846
Financial investments	34,223	–	1,128	35,351
	34,223	**1,846**	**1,128**	**37,197**
LIABILITIES				
Derivative financial instruments	–	188	–	188
	–	**188**	**–**	**188**

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

The following table reconciles the movement in level 3 financial instruments measured at fair value (financial investments) during the year:

Movement in level 3	At 30 June 2019 £000	At 30 June 2018 £000	At 31 December 2018 £000
At 1 January	1,128	2,203	2,203
Acquisitions	128	–	–
Consideration received	–	104	163
Disposals	–	–	(1,403)
Movements recognised in Other Comprehensive Income	279	135	135
Movements recognised in the Income Statement	–	–	30
At 30 June / 31 December	**1,535**	**2,442**	**1,128**

Notes to the Consolidated Financial Statements *continued*

5. Operating segments

The Group is organised into five operating segments as disclosed below:

1) Private Banking – Provides traditional private banking services as well as offering financial planning and investment management services. This segment includes Dubai and the Tay mortgage portfolio.

2) Commercial Banking – Provides bespoke commercial banking services and tailored secured lending against property investments and other assets.

3) RAF – Specialist asset finance lender mainly in high value cars but also business assets.

4) All Other Divisions – All other smaller divisions and central costs in Arbuthnot Latham & Co., Ltd (Arbuthnot Commercial Asset Based Lending, Arbuthnot Direct, Arbuthnot Specialist Finance, Investment properties and Central unallocated items)

5) Group Centre – ABG Group Centre management.

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 loans and advances to customers and customer deposits, being the majority of the balance sheet.

	Continuing operations					
Six months ended 30 June 2019	Private Banking £000	Commercial Banking £000	RAF £000	All Other Divisions £000	Group Centre £000	Group Total £000
Interest revenue	17,582	12,210	4,562	1,002	33	**35,389**
Inter-segment revenue	–	–	–	–	(138)	**(138)**
Interest revenue from external customers	17,582	12,210	4,562	1,002	(105)	**35,251**
Fee and commission income	5,522	634	144	635	–	**6,935**
Revenue from external customers	**23,104**	**12,844**	**4,706**	**1,637**	**(105)**	**42,186**
Interest expense	(2,253)	(1,539)	(1,312)	(1,072)	(105)	**(6,281)**
Add back inter-segment revenue	–	–	–	–	138	**138**
Subordinated loan note interest	–				(340)	**(340)**
Fee and commission expense	(28)	(34)	(12)	(6)	–	**(80)**
Segment operating income	20,823	11,271	3,382	559	(412)	**35,623**
Impairment losses	(824)	(225)	(202)	(66)	–	**(1,317)**
Other income	–	–	–	1,872	512	**2,384**
Operating expenses	(17,931)	(8,054)	(2,319)	(1,600)	(3,897)	**(33,801)**
Segment profit / (loss) before tax	2,068	2,992	861	765	(3,797)	**2,889**
Income tax expense	–	–	(188)	–	(225)	**(413)**
Segment profit / (loss) after tax	**2,068**	**2,992**	**673**	**765**	**(4,022)**	**2,476**
Loans and advances to customers	645,524	474,302	97,663	69,384	(11,500)	**1,275,373**
Other assets	–	–	–	1,046,678	20,687	**1,067,365**
Segment total assets	**645,524**	**474,302**	**97,663**	**1,116,062**	**9,187**	**2,342,738**
Customer deposits	1,042,634	668,792	–	117,801	–	**1,829,227**
Other liabilities	–	–	–	322,279	(12,589)	**309,690**
Segment total liabilities	**1,042,634**	**668,792**	**–**	**440,080**	**(12,589)**	**2,138,917**
Other segment items:						
Capital expenditure	–	–	(5)	(4,920)	–	**(4,925)**
Depreciation and amortisation	–	–	(6)	(1,581)	(13)	**(1,600)**

The “Group Centre” segment above includes the parent entity and all intercompany eliminations.

Notes to the Consolidated Financial Statements *continued*

5. Operating segments (continued)

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

The UK private bank has a branch in Dubai, which generated £2.1m (2018: £2.2m) income and had direct costs of £1.4m (2018: £1.5m). All Dubai branch income is booked in the UK. Other than the Dubai branch, all operations of the Group are conducted wholly within the United Kingdom and geographical information is therefore not presented.

	Continuing operations						Discontinued operations	
Six months ended 30 June 2018	Private Banking £000	Commercial Banking £000	RAF £000	All Other Divisions £000	Group Centre £000	Total £000	Retail Bank Associate Income £000	Group Total £000
Interest revenue	17,166	7,580	3,948	26	54	**28,774**	–	**28,774**
Inter-segment revenue	–	–	–	–	(146)	**(146)**	–	**(146)**
Interest revenue from external customers	17,166	7,580	3,948	26	(92)	**28,628**	–	**28,628**
Fee and commission income	5,885	527	100	1	–	**6,513**	–	**6,513**
Revenue from external customers	**23,051**	**8,107**	**4,048**	**27**	**(92)**	**35,141**	–	**35,141**
Interest expense	(1,046)	(1,132)	(1,007)	(340)	(92)	**(3,617)**	–	**(3,617)**
Add back inter-segment revenue	–	–	–	–	146	**146**	–	**146**
Subordinated loan note interest	–	–	–	–	(180)	**(180)**	–	**(180)**
Fee and commission expense	(57)	(47)	(8)	–	–	**(112)**	–	**(112)**
Segment operating income	21,948	6,928	3,033	(313)	(218)	**31,378**	–	**31,378**
Impairment losses	(122)	(52)	(34)	–	–	**(208)**	–	**(208)**
Other income	–	–	31	1,949	(331)	**1,649**	–	**1,649**
Operating expenses	(17,335)	(7,724)	(1,940)	(987)	(3,650)	**(31,636)**	–	**(31,636)**
Segment profit / (loss) before tax	4,491	(848)	1,090	649	(4,199)	**1,183**	–	**1,183**
Income tax expense	–	–	(237)	–	(38)	**(275)**	–	**(275)**
Segment profit /(loss) after tax	**4,491**	**(848)**	**853**	**649**	**(4,237)**	**908**	–	**908**
Profit from discontinued operations	–	–	–	–	–	–	**2,329**	**2,329**
Segment profit / (loss) after tax	**4,491**	**(848)**	**853**	**649**	**(4,237)**	**908**	**2,329**	**3,237**
Loans and advances to customers	664,127	346,160	77,602	20,350	(11,500)	**1,096,739**	–	**1,096,739**
Other assets	–	–	–	855,781	92,684	**948,465**	–	**948,465**
Segment total assets	**664,127**	**346,160**	**77,602**	**876,131**	**81,184**	**2,045,204**	–	**2,045,204**
Customer deposits	964,190	471,442	–	110,975	–	**1,546,607**	–	**1,546,607**
Other liabilities	–	–	–	284,108	(20,831)	**263,277**	–	**263,277**
Segment total liabilities	**964,190**	**471,442**	–	**395,083**	**(20,831)**	**1,809,884**	–	**1,809,884**
Other segment items:								
Capital expenditure	–	–	(40)	(2,416)	(95)	**(2,551)**	–	**(2,551)**
Depreciation and amortisation	–	–	(7)	(1,452)	(13)	**(1,472)**	–	**(1,472)**

Notes to the Consolidated Financial Statements *continued*

6. Other income

Other income mainly includes rental income received from the investment properties of £1.3m (2018: £1.2m) and £1m dividend income received from STB (2018: £nil). 2018 also included £0.3m rental income from STB for office space occupied.

7. Underlying profit reconciliation

The profit before tax from continuing operations as reported in the operating segments can be reconciled to the underlying profit from continuing operations for the year as disclosed in the tables below.

Underlying profit reconciliation Six months ended 30 June 2019	Arbuthnot Latham & Co. £000	Arbuthnot Banking Group £000
Profit before tax from continuing operations	6,686	2,889
Investment in new ventures	482	482
Underlying profit	**7,168**	**3,371**

Underlying profit reconciliation Six months ended 30 June 2018	Arbuthnot Latham & Co. £000	Arbuthnot Banking Group £000
Profit before tax from continuing operations	5,382	1,183
Investment in new ventures	621	621
Dividend from STB as if deconsolidated from 1 January 2018	–	1,110
IFRS 16 impact applied to 2018	(241)	(241)
Underlying profit	**5,762**	**2,673**

Notes to the Consolidated Financial Statements *continued*

8. Earnings per ordinary share

Basic

Basic earnings per ordinary share are calculated by dividing the profit after tax attributable to equity holders of the Company by the weighted average number of ordinary shares 14,926,992 (2018: 14,889,048) in issue during the period. On 17 May 2019, the Company issued 152,621 Ordinary Non-Voting shares.

Diluted

Diluted earnings per ordinary share are calculated by dividing the dilutive profit after tax attributable to equity holders of the Company by the weighted average number of ordinary shares in issue during the period, as well as the number of dilutive share options in issue during the period. There were no dilutive share options in issue at the end of June (2018: nil).

Profit attributable	Six months ended 30 June 2019 £000	Six months ended 30 June 2018 £000
Total profit after tax attributable to equity holders of the Company	2,476	3,237
Profit after tax from continuing operations attributable to equity holders of the Company	2,476	908
Profit after tax from discontinued operations attributable to equity holders of the Company	–	2,329

Basic earnings per share	Six months ended 30 June 2019 p	Six months ended 30 June 2018 p
Total Basic Earnings per share	16.6	21.7
Basic Earnings per share from continuing operations	16.6	6.1
Basic Earnings per share from discontinued operations	–	15.6

9. Discontinued operations

On 8 August 2018 Sir Henry Angest and Andrew Salmon resigned their positions on the board of STB and the Group do not have the right to appoint any future directors to the board of STB. As a result of this the Group lost significant influence over the associated company and the shareholding has since been recognised as a financial investment. The investment is marked to market through the Fair Value Reserve in Other Comprehensive Income. The profit from associate for the period up to 30 June 2018 is reflected as a discontinued operation as the income was previously shown as a separately reported operating segment.

Since the 8 August 2018, ABG sold 575,000 STB shares in November 2018 and a further 1,050,000 shares in April 2019. The current shareholding in STB is 9.85%.

Notes to the Consolidated Financial Statements *continued*

10. Events after the balance sheet date

On 3 July 2019, Arbuthnot Latham & Co., Limited agreed the purchase of a residential mortgage portfolio for cash consideration of approximately £258m, which is subject to adjustment for the final loan balances at completion. The mortgages are being acquired from Raphael Mortgages Limited Designated Activity Company (“Raphael” or “Portfolio A”) and Magellan Funding No2. Designated Activity Company (“Magellan” or “Portfolio B”).

Portfolio A has been in run off since it was originated by Edeus Mortgages and Victoria Mortgage Funding between 2005 and 2008. Portfolio B was originated in 2018 and 2019 by Magellan Homeloans. Both portfolios are geographically distributed around the UK.

Based on loan balances as at 31 March 2019 Portfolio A consists of 1,457 loans with customer balances of £201m of which 20 per cent are buy-to-let and the remainder are owner occupied with an average loan to value of 67.4 per cent. Portfolio B consists of 462 loans with customer balances of £65m all of which are owner occupied with an average loan to value of 70 per cent.

The overall yield on the portfolios is 3.6 per cent before taking into account the effect of the negotiated purchase discount. The aggregate consideration of the purchase will be 97 per cent of Portfolio A and 98 per cent of Portfolio B at the time of the completion, which is expected to be 8 August 2019. The consideration will be satisfied by cash from the Group’s own resources.

It is expected that in due course the Group will preposition these assets with the Bank of England to act as collateral for the schemes within the Sterling Monetary Framework. It is expected that these assets will then be included in the Group’s liquidity resources.

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