

ARBUTHNOT BANKING GROUP PLC



Pillar 3 disclosures for the year ended 31 December 2008

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1. Overview

Background

Since 1 January 2008, Arbuthnot Banking Group PLC (“the Group”) has been operating under the Basel II regime. The Capital Requirements Directive (Basel II) sets out new disclosure requirements for banks operating under the regime. The disclosure requirements (Pillar 3) aim to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2) and aim to encourage market discipline by allowing market participants to assess key pieces of information on risk exposures and the risk assessment processes of the Group.

Basis of disclosures

The disclosures have been prepared for Arbuthnot Banking Group PLC. These disclosures cover the Pillar 3 qualitative and quantitative disclosure requirements.

Frequency

This report will be made on an annual basis. The disclosures will be as at the Accounting Reference Date (ARD), i.e. as at 31 December, and will be published within four months of the ARD. The Group will aim, however, to make the disclosures shortly after the publication of the Annual Report & Accounts.

Media and location

The report will be published on the Arbuthnot Banking Group PLC corporate website (www.arbuthnotgroup.com).

Verification

The Pillar 3 disclosures are subject to internal review procedures broadly consistent with those undertaken for unaudited information published in the Annual Report. The information contained in this document has not been audited by the Group’s external auditors, except to the extent it is deemed to be equivalent to those made under accounting or listing requirements.

The Pillar 3 disclosures have been prepared purely for explaining the basis on which the Group has prepared and disclosed certain capital requirements and information about the management of certain risks and for no other purpose. They do not constitute any form of financial statement and must not be relied upon in making any judgement on the Group.

2. Risk management

Principal governing bodies

The Group is led and controlled by an effective Board which comprises seven executive directors and four non-executive directors. The Board, including its non-executive members takes a strong interest in risk management.

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 FSA, 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.

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.

Principal risks

The Group regards the monitoring and controlling of risks as a fundamental part of the management process. Consequently, senior management is involved in the development of risk management policies and in monitoring their application. The principal risks inherent in the Group's business are operational, credit, liquidity and market risks.

Operational risk

Operational risk is the risk of loss arising through fraud, unauthorised activities, error, omission, inefficiency, systems failure or from external events. It is inherent to every business organisation and covers a wide spectrum of issues. The terms 'error', 'omission' and 'inefficiency' include process failures, systems/machine failures and human error.

In each of the Group's subsidiaries, business managers are responsible for maintaining an acceptable level of internal control, commensurate with the scale and nature of operations. They are responsible for identifying and assessing risks, designing controls and monitoring the effectiveness of these controls.

Operational risk self assessments are performed by individual business units and functions. The risk assessment process is designed to support the management rather than the total avoidance of risk. Management attention is focused on those risks where additional work is likely to provide the greatest economic benefit from reducing losses or exposure.

The Group has adopted the Standardised Approach for calculating the Pillar 1 capital requirements for operational risk.

Credit risk: overview

Credit risk is the risk of loss arising from a customer or counterparty failing to meet their financial obligations to the Group as and when they fall due. Of the risks the Group takes on, credit risk generates the largest regulatory capital requirement.

The Group has adopted the Simplified Standardised Approach to credit risk under Basel II, and has nominated Moody's Investor Services as its external credit assessment institution (ECAI) to provide ratings for financial institutions.

Credit risk: loan books

Credit risk is managed through the Credit Committees of Secure Trust Bank and Arbuthnot Latham & Co, with significant exposures also being approved by the Group Risk Committee.

Credit risk management uses a combination of lending policy criteria, credit scoring, cash flow forecasting and policy rules to make a decision on applications for credit. The primary factors considered are the borrower's background (including management), proposal and rationale, source of repayment, analysis of security, pricing / return, and analysis of business and financial risk. In addition, confirmation of borrower identity and an assessment of the value of any security are undertaken prior to granting a credit facility. When considering applications, the primary focus is placed on the willingness and ability to repay.

Credit scoring is used to support the retail customer account management process in the following ways:

- To set customer maximum lending limits.
- To pre-determine lending limits for selected further advances.
- To determine account specific recommended limits and product types.
- To set shadow limits to manage unauthorised borrowing.
- To prioritise collections activity.

The Group structures 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. Limits on the level of credit risk 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 lending limits where appropriate. Exposure to credit risk is also managed in part by obtaining collateral and corporate and personal guarantees.

The Group employs a range of policies and practices to mitigate credit risk. The most traditional of these is the taking of collateral for fund 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 cash, 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 capital 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 exist for 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.

Credit risk: treasury assets

The Group has exposures to a range of banks and building societies in its treasury portfolio of bank deposits, Certificates of Deposit, and money market funds. These exposures arise due to the placement in the market of surplus client cash which is held under a banking relationship. Exposures are with counterparties with a minimum rating of A3 from Moody's. These exposures are held purely for liquidity purposes, and all have a minimum rating of credit step quality 2 or higher (as per FSA guidance).

Policy limits and approved counterparties are recorded on the Counterparty Schedule and are advised to the FSA, together with a copy of the policy on an annual basis. Counterparty exposures are monitored against limits by the Treasury department on a daily basis and limits are formally approved by the Board annually.

Liquidity risk

The Group is exposed to daily calls on its available cash resources from overnight deposits, current accounts, maturing deposits, loan draw-downs and guarantees, and from margin and other calls on cash-settled trading securities. The Group does not maintain cash resources to meet all of these needs, as experience shows that a minimum level of reinvestment of maturing funds can be predicted with a high level of certainty. The Group's liquidity is therefore managed on a mismatch basis, the mismatch being the difference between the levels of assets and liabilities in the same maturity bands. The Group's aim is to maintain a prudent liability margin when compared with the mismatch criteria set by the regulators. The group maintains long-term committed bank facilities and use is made of certificates of deposit (debt securities) in the management of liquidity.

The management and controlled mismatching of the maturities and interest rates of assets and liabilities is fundamental to the management of the Group. It is unusual for banks to be completely matched, as transacted business is often of uncertain terms and of different types.

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.

Arbuthnot Latham maintains committed banking lines of £22.5m, although these have not been required since 2006. Similarly, Secure Trust Bank maintains sufficient liquidity as a result of the terms and conditions of the OneBill and savings accounts.

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. Hence, the Group's exposure to adverse movements in interest rates and currencies is limited to the interest earnings on its free cash and interest rate repricing mismatches.

Through Arbuthnot Securities, the Group is also involved in market-making and underwriting in UK equities. The market making book is subject to Group-approved limits, both in aggregate and in relation to individual stocks. Outstanding positions are monitored against these limits both intraday and overnight. The Group looks to manage its trading book exposure to market price risk through Board imposed position and trading book limits. The Board monitors these limits regularly and will amend the limits to reflect prevailing market conditions. The Group occasionally seeks to mitigate market risk by taking offsetting positions in equity derivative instruments such as index futures and options.

All significant underwriting transactions are individually approved by the Group Risk Committee.

Counterparty credit risk

The Group is not materially exposed to counterparty credit risk; however a limited exposure exists as a result of its investment banking business. The counterparty risk is

that a brokerage client fails to pay for a trade or deliver the stock in time for settlement. This failure can fall into the category of a timing difference or a failure of the counterparty to honour the trade.

Additionally, there is a small element of counterparty risk in Arbuthnot Latham due to the foreign exchange activities.

Given the Group's limited exposure to counterparty credit risk, the directors have not complied with all the disclosure requirements of BIPRU 11.5.7 on the basis of materiality.

Interest rate risk

Interest rate risk is the potential adverse impact on the Group's future cash flows from changes in interest rates and arises from the differing interest rate risk characteristics of the 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 balance sheet. However, this is not a perfect match and interest rate risk is present on:

- Money market deposits of a fixed rate nature;
- Fixed rate loans; and
- Fixed rate savings accounts.

The principal interest rate mismatch is in Arbuthnot Latham and 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 both a parallel and worse case scenario of 200 basis points. A severe 200bp movement in interest rates would result in a £0.6m fall in profits in Arbuthnot Latham and £0.3m in Secure Trust Bank.

Securitisation risk

The Group has not securitised any assets to date and has no current plans to do so. Therefore, the Board has concluded that securitisation risk is not applicable to the Group.

3. Scope of application of Directive requirements

The Pillar 3 disclosures have been prepared for Arbuthnot Banking Group PLC in accordance with the rules laid out in the FSA handbook BIPRU Chapter 11. These disclosures provide information on the capital adequacy and risk management of the Group.

The principal operating subsidiary undertakings of Arbuthnot Banking Group PLC at 31 December 2008 are listed below. These subsidiary undertakings, which all have 31 December year ends, are incorporated and all operate in Great Britain, except Arbuthnot AG which is incorporated and operates in Switzerland. The Group has applied for a banking licence in Switzerland to incorporate Arbuthnot Bank AG. This has been included in the Group structure as this could be operational in 2009.

Subsidiary	Nature of business
Secure Trust Bank PLC	Retail banking
Arbuthnot Latham & Co., Limited	Private banking
Arbuthnot AG	Private banking
Arbuthnot Securities Limited	Investment banking

All subsidiary undertakings are limited by ordinary shares and are unlisted. The Company holds a 100% interest in the ordinary share capital and voting rights of all its subsidiary undertakings, except for Arbuthnot Securities Limited where 40.4% of the ordinary share capital is owned by its employees.

The results of and information about all regulated subsidiary undertakings have been included in the consolidated Pillar 3 disclosures.

Other than the need to maintain regulatory capital requirements at a subsidiary level, there are no current or foreseen material practical or legal impediments to the prompt transfer of capital resources or repayment of liabilities when due between Arbuthnot Banking Group PLC and its regulated subsidiaries.

During the year ended 31 December 2008, the individual entities within the Group and the Group complied with all of the externally imposed capital requirements to which they are subject.

4. Capital resources

The table below summarises the composition of regulatory capital for the Group as at 31 December 2008.

	Notes	2008 £000
Core tier 1		
Called up share capital		150
Share premium account		21,085
Retained earnings and other reserves		11,257
Other reserves	1	1,981
		34,473
Deductions from tier 1		
Intangible assets	2	(2,831)
Treasury shares		(445)
Tier 1 capital after deductions		31,197
Upper Tier 2 capital		
Revaluation reserve		366
Subordinated debt	3	13,972
Tier 2 capital after deductions		14,338
Deductions from total of tier 1 and tier 2 capital		-
Consolidated capital resources		45,535

Notes

1. Other reserves represents revaluation reserves and minority interest
2. Intangible assets represent goodwill on consolidation and software costs
3. The subordinated debt was raised in order to increase the capital base of the Group and was issued on 7 November 2005, denominated in Euros. The principal amount outstanding at 31 December 2008 was €15 million. The notes carry interest at 3% over interbank rate for three month deposits in Euros and repayable at par in August 2035 unless redeemed or repurchase earlier by the Group.

5. Capital adequacy

In order to protect the solvency of the Group, internal capital is held to provide a cushion for unexpected losses. In assessing the adequacy of its capital, the Group considers its risk appetite, the material risks to which the Group is exposed and the appropriate management strategies for each of the Group's material risks, including whether or not capital provides an appropriate mitigant.

The Internal Capital Adequacy Assessment Process (ICAAP) is a key element of the Group's implementation of the EU Capital Requirements Directive (CRD). It is a process that brings together the risk management framework that the Group has previously implemented to identify, manage and mitigate its risks within the financial discipline of budgeting and business planning.

The intention is that the ICAAP will be reviewed and updated each year in conjunction with the annual budget process, unless there are any changes in the control environment or other events that warrant a more immediate update. When performing the annual update the Board will review the continued appropriateness of the stated risk appetite and compare it against actual performance. It will also request the recalculation of the stress tests if they are still appropriate for the Group. If not it will devise additional stress tests.

The Board will monitor performance against the ICAAP through its key committees and operating company boards all of which have main board representation and report to the main board.

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 that needs to be held. This method takes the Pillar I capital formula calculations (for credit, market and operational risk) as a starting point and then considers whether each of these calculations delivers an adequate capital sum to cover to cover management's anticipated risks. Where the Board considers that the Pillar I calculations do not adequately reflect the risk, additional capital has been added on in Pillar II.

The following table shows the Group's Pillar 1 capital requirements by asset class (credit risk requirements represent gross exposures and exposures after credit risk mitigants):

	2008
	£000
<i>Credit risk requirements, arising from exposures to:</i>	
• Institutions	2,491
• Corporates	6,067
• Retail	3,628
• Secured on real estate property	1,110
• Other items	1,582
Counterparty risk requirement arising on trading book	167
<i>Market risk capital requirement arising on trading book:</i>	
• Equity PRR	546
• Foreign currency PRR	46
Operational risk capital requirement	7,869
Total Pillar 1 capital requirement	23,506

6. Credit risk

Impairment of financial assets: 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. A financial asset or a group of financial assets is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a 'loss event') and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that 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; and
- 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 income statement. 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 income statement.

Loans subject to collective impairment assessment and whose terms have been renegotiated are no longer considered to be past due or impaired but are treated as new loans after the minimum required number of payments under the new arrangements have been received. Loans subject to individual impairment assessment, whose terms have been renegotiated, are subject to ongoing review to determine whether they remain impaired or are considered to be past due.

Impairment of financial assets: assets classified as available for sale

The Group assesses at each balance sheet 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 income statement. Impairment losses recognised in the income statement on equity instruments are not reversed through the income statement.

The Group also makes equity investments in special purpose vehicles set up to acquire and enhance the value of commercial properties. These investments are likely to be of a medium term nature. There is no open market for these investments therefore the Group has valued them using appropriate valuation methodologies.

The following tables provide an analysis of impaired and past due loans for the Retail and Private Banking segments (as disclosed in the Group's Annual Report):

	2008
	£000
Neither past due nor impaired	147,492
Past due but not impaired	12,044
Impaired	8,936
Gross	168,472
Less: allowance for impairment	(5,122)
Net	163,350

Of the above net exposures £150,799k relates to Arbuthnot Latham and £12,551k relates to Secure Trust Bank.

	2008
	£000
Past due up to 30 days	1,907
Past due 30 - 60 days	559
Past due 60 - 90 days	3,336
Over 90 days	6,242
Total	12,044

Impairment losses

A reconciliation of the allowance account for losses on loans and advances by class is as follows (as disclosed in the Group's Annual Report):

		2008
		£000
At 1 January		5,381
Adjustments for disposals		(1,264)
Impairment losses		977
Loans written off during the year as uncollectible		(185)
Amounts recovered during the year		213
At 31 December		5,122

A further analysis of allowances for impairment of loans and advances is as follows:

		2008
		£000
Loans and advances to customers - Arbuthnot Latham		684
Factoring debtors - Arbuthnot Commercial Finance		-
Loan and advances to customers - unsecured - Secure Trust Bank		4,438
At 31 December		5,122

Note

Secure Trust Bank's provisioning policy is that loans and advances are not written off until all potential avenues of recovery have been exhausted.

Analysis of credit risk exposures

The following table analyses the Group's regulatory risk exposures as at 31 December 2008 by asset class (the average exposures in the year were not materially different to those disclosed below):

	2008
	£000
Institutions	155,703
Corporates	86,055
Retail	52,042
Secured on real estate property	39,180
Other items	37,998
Credit risk exposure as at 31 December	370,978

£321,732k of the above exposures relates to Arbutnot Latham and £49,246k relates to Secure Trust Bank.

Note

The credit risk exposures above are disclosed on a regulatory basis and therefore do not reconcile to financial asset classifications as reported in the Group's Annual Report.

Analysis of loans and advances

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 (as disclosed in the Group's Annual Report):

	2008
	£000
Aaa	5,973
Aa1	4,508
Aa2	5,381
Aa3	68
	15,930

Analysis of debt securities

The table below presents an analysis of debt securities by rating agency designation at 31 December, based on Moody's long term ratings (as disclosed in the Group's Annual Report):

	2008
	£000
Aaa	-
Aa1	44,868
Aa2	80,126
Aa3	12,922
	137,916

Maturity analysis

The table below analyses the contractual discounted cash flows into relevant maturity groupings at balance sheet date (as disclosed in the Group's Annual Report):

	Not more than 3 months	More than 3 months but less than 1 year	More than 1 year but less than 5 years	More than 5 years	Total
At 31 December 2008	£000	£000	£000	£000	£000
Assets					
Loans and advances to banks	15,930	-	-	-	15,930
Loans and advances to customers	104,651	36,512	22,121	66	163,350
Debt securities	63,760	74,156	-	-	137,916
Other assets	15,471	10,670	6,690	9,728	42,559
Total assets	199,812	121,338	28,811	9,794	359,755
Liabilities					
Deposits from banks	2,898	-	-	-	2,898
Deposits from customers	219,455	71,451	836	-	291,742
Other liabilities	14,172	1,825	732	13,972	30,701
Total liabilities	236,525	73,276	1,568	13,972	325,341
Liquidity surplus / (deficit)	(36,713)	48,062	27,243	(4,178)	34,414